BankGuam Holding Co
Form 10-K
March 15, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 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: 000-54483

BankGuam Holding Company

(Exact name of registrant as specified in its charter)

Guam	66-0770448
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

111 W Chalan Santo Papa

Hagåtña, Guam 96910

(671) 472-5300

(Address, including Zip Code, and telephone number, including area code, of the registrant's principal executive offices)

Securities registered pursuant to Section 12(g) of the Act:

Title of Each Class	Name of Each Exchange on which Registered
Common Stock, $0.2083 par value	None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 registration was required to submit such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K.

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting stock held by non-affiliates of the Registrant was $54,604,681 based on the number of shares held by non-affiliates of the registrant as of June 30, 2018, and based on the closing sale price of common stock on June 29, 2018, which is the last business day of the registrant's most recently completed second fiscal quarter. This calculation does not reflect a determination that persons are affiliates for any other purposes.

Number of shares of common stock outstanding as of March 15, 2019: 9,647,819.

BANKGUAM HOLDING COMPANY

FORM 10-K

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Exhibit No.	Exhibit Description	Incorporated by Reference Form	Exhibit	Filing Date	Filed Herewith
2.01	Agreement and Plan of Reorganization and Merger dated October 29, 2010 between BankGuam Holding Company and Bank of Guam	8-K (File No. 000-54483)	2.01	August 16, 2011	
3.01	Second Amended and Restated Articles of Incorporation of BankGuam Holding Company (including Certificate of Designation of 5.50% Fixed Rate/Floating Rate Noncumulative Preferred Stock, Series A, of BankGuam Holding Company)	8-K (File No. 000-54483)	3.1	August 26, 2016	
3.02	First Amended By-Laws of BankGuam Holding Company	10-Q (File No. 000-54483)	3.03	November 13, 2012	
9.01	Voting Trust Agreement dated November 29, 2013 between certain shareholders of BankGuam Holding Company and Lourdes A. Leon Guerrero, as Trustee	10-K (File No. 000-54483)	9.02	March 17, 2014	
10.01	Stock Purchase Agreement dated May 27, 2016 between David J. John and BankGuam Holding Company	8-K (File No. 000-54483)	10.01	January 17, 2017	
10.02*	Employment Agreement dated January 11, 2017 between Bank of Guam and Francisco M. Atalig	8-K (File No. 000-54483)	10.07	January 17, 2017	
10.03*	Exhibits A and B to the Employment Agreement dated January 11, 2017 between Bank of Guam and Francisco M. Atalig	8-K/A (File No. 000-54483)	10.07	January 20, 2017	
10.04*	Employment Agreement dated May 1, 2013 between Bank of Guam and Lourdes A. Leon Guerrero	10-K (File No. 000-54483)	10.01	March 17, 2014	
10.05*	Agreement to Extend Employment Agreement dated December 29, 2017 between Lourdes A. Leon Guerrero and Bank of Guam	8-K (File No. 000-54483)	10.1	January 4, 2018	
10.06*	Second Agreement to Extend Employment Agreement dated March 26, 2018 between Lourdes A. Leon Guerrero and Bank of Guam	10-K (File No. 000-54483)	10.06	June 29, 2018	
10.07*	Employment Agreement dated June 27, 2013 between Bank of Guam and William D. Leon Guerrero	10-K (File No. 000-54483)	10.02	March 17, 2014	
10.08*	Agreement to Extend Employment Agreement dated May 29, 2018 between William D. Leon Guerrero and Bank of Guam	10-K (File No. 000-54483)	10.08	June 29, 2018	
10.09*	BankGuam Holding Company 2011 Amended and Restated Employee Stock Purchase Plan	S-8 (File No. 333-182615)	99.1	July 11, 2012	
10.10*	BankGuam Holding Company Stock Service Award Plan	S-8 (File No. 333-196854)	99.1	June 18, 2014	
10.11	Form of Private Placement Subscription Agreement	8-K (File No. 000-54483)	10.1	September 21, 2016	

21.01	List of Significant Subsidiaries of the Company	S-1 (File No. 333-220357)	21.01	September 6, 2017	
23.01	Consent of Independent Registered Public Accounting Firm				X
31.01	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act – Joaquin P.L.G. Cook				X
31.02	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act – Francisco M. Atalig				X
32.01	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act				X
101	Interactive Data Files Pursuant to Rule 405 of Regulation S-T: (i) Consolidated Statements of Financial Condition as of December 31, 2018 and 2017, (ii) Consolidated Statements of Income for the years ended December 31, 2018, 2017 and 2016, (iii) Consolidated Statements of Comprehensive Income for the years ended December 31, 2018, 2017 and 2016; (iv) Consolidated Statements of Stockholders' Equity for the years ended December 31, 2018, 2017 and 2016; (v) Consolidated Statements of Cash Flows for the years ended December 31, 2018, 2017 and 2016 ; and (vi) Notes to Consolidated Financial Statements				X

* Management contract or compensatory plan or arrangement.

Cautionary Note Regarding Forward-Looking Statements

For purposes of this Annual Report, the terms the “Company,” “we,” “us” and “our” refer to BankGuam Holding Company and its subsidiaries. This Annual Report on Form 10-K contains statements that are not historical in nature, are predictive in nature, or that depend upon or refer to future events or conditions or contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. These include, among other things, statements regarding:

- Competition for loans and deposits and failure to attract or retain deposits and loans;
- Local, regional, national and global economic conditions and events, and the impact they may have on us and our customers, and our assessment of that impact on our estimates, including the allowance for loan losses and fair value measurements;
- Risks associated with concentrations in real estate related loans;
- Changes in the level of nonperforming assets and charge-offs and other credit quality measures, and their impact on the adequacy of our allowance for loan losses and our provision for loan losses;
- The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;
- Stability of funding sources and continued availability of borrowings;
- The effect of changes in laws and regulations with which the Company and Bank of Guam must comply, including any change in Federal Deposit Insurance Corporation insurance premiums;
- Our ability to raise capital or incur debt on reasonable terms;
- Regulatory limits on Bank of Guam’s ability to pay dividends to the Company;
- The impact of the Dodd Frank Wall Street Reform and Consumer Protection Act and the implementation of its associated rules and regulations;
- The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;
- Changes in the deferred tax asset valuation allowance in future quarters;
- The costs and effects of legal and regulatory developments, including resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations or reviews;
- The ability to increase market share and control expenses; and,
- Our success in managing the risks involved in the foregoing items,

as well as other statements regarding our future operations, financial condition and prospects, and business strategies. Forward-looking statements may be preceded by, followed by or include the words “expects,” “anticipates,” “intends,” “plans,” “believes,” “seeks,” “estimates,” “will,” “is designed to” and similar expressions. We claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 for all forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to risks, uncertainties and assumptions about our business that could affect our future results and could cause those results or other outcomes to differ materially from those expressed or implied in the forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in “Risk Factors” included elsewhere in this Annual Report and as may be updated in filings we make from time to time with the U.S. Securities and Exchange Commission (“SEC”), including our Quarterly Reports on Form 10-Q to be filed by us in our fiscal year ending December 31, 2019. We have no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or risks, except to the extent required by applicable securities laws. If we do update one or more forward-looking statements, no inference should be drawn that we will make additional updates with respect to those or other forward-looking statements. New information, future events or risks could cause the forward-looking events we discuss in this Annual Report not to occur. You should not place undue reliance on these forward-looking statements, which reflect our opinions only as of the date of this Annual Report.

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PART I

ITEM 1. Business

General

BankGuam Holding Company (the “Company”), a Guam corporation organized in 2011, is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company provides a wide range of banking services through Bank of Guam, our wholly-owned subsidiary and principal asset (the “Bank”). Unless the context indicates otherwise, references to the “Company” include the Company’s subsidiaries, including the Bank. The Company, the Bank and their subsidiaries are sometimes referred to hereinafter as “we,” “our” or “us”.

The Bank is a regional community bank that was organized in Guam, a United States flag territory, in 1972. The Bank provides a variety of financial services to individuals, businesses and government entities through its branch network. The Bank’s primary deposit products are demand deposits, savings and time certificates of deposit, and its primary lending products are consumer, commercial and real estate loans. We attract deposits throughout our market area with a customer-oriented product mix, competitive pricing and convenient locations. We lend in all markets where we have a physical presence through our branch network. The Bank also provides many other financial services to its customers, including trade financing and trust services.

In addition to the traditional financial services offered, the Bank offers credit life, health, auto and homeowners insurance through its subsidiary, BG Insurance, as agents for various insurance companies, and also offered retail wealth management services in collaboration with its former affiliate, Money Concepts, through the end of May 2016. In August 2015, the Company chartered a second subsidiary, BankGuam Investment Services (“BGIS”) (formerly BankGuam Investment and Insurance Services), in an effort to enhance the options and opportunities of our customers to build future income and wealth. BGIS was capitalized in the amount of $300 thousand during the first quarter of 2016, and was in full operation by the end of May 2016.

In May 2016, the Company entered into a Stock Purchase Agreement to acquire 25% of ASC Trust Corporation, a Guam trust company. In July 2016, subsequent to the approval of the Federal Reserve Bank of San Francisco in June 2016, the purchase was executed. The Company borrowed $3.5 million in the form of subordinated debt in connection with the purchase to finance the transaction. The Agreement provides for the acquisition of an additional 20% of the stock of ASC Trust Corporation in April 2019, which has been revised to July 2019, and another 25% in April 2021, with both future purchases subject to regulatory approval. The Stock Purchase Agreement contains customary warranties, representations and indemnification provisions.

Other than holding the shares of the Bank, BGIS and ASC Trust Corporation, the Company conducts no significant activities, although it is authorized, with the prior approval of its principal regulator, the Board of Governors of the Federal Reserve System, to engage in a variety of activities related to the business of banking. Currently, substantially all of the Company’s operations are conducted and substantially all of its assets are owned by the Bank, which accounts for substantially all of its consolidated revenues, expenses and operating income. BGIS is a registered investment company, primarily involved in providing investment advisory services and trading securities for its customers. ASC Trust Corporation is primarily involved in administering 401(k) retirement plans and other employee benefit programs for its customers.

Bank of Guam

The Bank is a Guam-chartered bank headquartered at 111 West Chalan Santo Papa in Hagåtña, Guam 96910. It was incorporated in March 1972 and opened for business in December of that year. We operate through 22 full service branch offices, including 11 in Guam; two in Saipan and one each in Tinian and Rota, all in the Commonwealth of the

Northern Mariana Islands; one in the Republic of Palau; one each in the states of Yap, Chuuk, Pohnpei and Kosrae in the Federated States of Micronesia; one in the Republic of the Marshall Islands; and one in San Francisco, California.

The Bank’s business strategy has been to emphasize and support economic growth and development in and among the U.S.-affiliated islands in the western Pacific Ocean. To accomplish this goal, the Bank offers competitively-priced deposit and loan products and other financial services that are primarily tailored to the needs of consumers, small businesses and government entities. Although the needs of our customers in a small, remote island environment can be particularly challenging for a community bank, we have succeeded in providing a broad range of services, such as trade financing and corporate trust services, that are typically provided only by much larger, money center institutions.

Our lending products include commercial, real estate, construction, consumer and Small Business Administration-guaranteed loans. We also provide home mortgage and home equity loans. Commercial loans and industrial loans comprise the largest portion of the Bank’s loan portfolio. Residential mortgage loans comprise the second largest portion of the Bank’s loan portfolio.

We offer a wide range of deposit products for retail and business banking markets including checking accounts, interest-bearing transaction accounts, savings accounts, time deposits and retirement accounts. Our branch network enables us to attract deposits from throughout our market area with a customer-oriented product mix, competitive pricing and convenient locations.

In addition, correspondent bank deposit accounts are maintained to enable the Bank to transact types of activity that it would otherwise be unable to perform or would not be cost effective due to the size of the Bank or the volume of activity. The Bank has utilized several correspondent banks to process a variety of transactions. The Bank also provides a multitude of other products and services to complement our lending and depository services. These include wire and Automated Clearing House transfers, cashier's checks, traveler's checks, corporate and consumer credit cards, bank-by-mail, ATMs, night depositories, safe deposit boxes, direct deposit, electronic funds transfers, online banking and bill payments, merchant services, check imaging, and other customary banking services. We currently operate ATMs in eighty-five locations.

The Bank has a trust department, primarily engaged in corporate trust services under indenture.

Competition

Banking and the financial services industry in Guam are highly competitive. The market is dominated by the Bank, two of Hawaii's largest banks and two locally-organized federal credit unions. Also, as a result of the U.S. military presence as a longtime employer, military credit unions have physical branches at the island's main military facilities and in the civilian community. The Bank's presence in the remaining areas of the western Pacific is less competitive, and in many cases the Bank remains the dominant financial services organization in the islands. In the San Francisco Bay area, where the Bank has had a branch office since 1983, the Bank's California division primarily focuses its lending efforts on owner-occupied commercial real estate and commercial investor properties. The division provides financing to hotels, gasoline service stations, apartments, office and retail space, and residential care homes for the elderly and disabled, and also works closely with selected banks in loan participations. Framing this environment is the increasingly competitive setting as a result of regulatory, technological and product delivery systems changes.

Larger banks have a competitive advantage because of global marketing campaigns and U.S. name recognition. They also offer extensive international trade finance and discount brokerage services that the Bank is not currently prepared to provide. To compensate for this, the Bank has arrangements with correspondent banks and other financial institutions to deliver such services to its customers.

To compete with other financial institutions in its service area, the Bank relies principally on local media as well as personal contact by directors, officers and employees with existing and potential customers. The Bank emphasizes to customers the advantages of dealing with a locally-owned and managed community-oriented institution. Because decisions are made locally by people who are intimately familiar with the economy, the legal structure and the developmental needs of the islands, the Bank is able to respond quickly and effectively to its customers' needs. The Bank also provides local service and timely decision-making for small businesses and local governments.

The financial services industry continues to undergo rapid technological changes involving the frequent introductions of new technology-driven products and services that have further increased competition. The Bank often adopts these new technologies and products ahead of its competitors, but there is no assurance that these technological improvements, if made, will increase the Company's operational efficiency, or that the Company will be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

Employees

At December 31, 2018, the Bank had 623.5 full-time equivalent employees (FTEs), an increase from 617.5 FTEs a year earlier. The Bank's employees are not represented by any union or collective bargaining agreement, and the Bank believes its employee relations are good.

Supervision and Regulation

Recent Developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") of 2010 significantly changed the U.S. bank regulatory structure and affected the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act required various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies were given significant discretion in drafting the implementing rules and regulations. Although many of the final rules and regulations called for by the Dodd-Frank Act have been adopted, the implementation of some of those rules and regulations is in its early stages, and rulemaking has not yet become final for certain Dodd-Frank Act provisions. On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "EGRRCPA") amended provisions in the Dodd-Frank Act as well as certain other statutes administered by the federal bank agencies. We continue to monitor and implement rules and regulations of the Dodd-Frank Act and the EGRRCPA as they are adopted and modified, and to evaluate their application to our business.

Among other things, the Dodd-Frank Act requires the federal banking agencies to establish minimum leverage and risk-based capital requirements for insured banks and their holding companies. The federal banking agencies issued a joint final rule, or the ''Final Capital Rule,'' that implements the Basel III capital standards and establishes the minimum capital levels required under the Dodd-Frank Act. We commenced compliance with the Final Capital Rule on January 1, 2015, we have been in compliance with that Rule throughout 2018, and we expect to continue to be in full compliance with the increasingly stringent capital requirements that it will phase in through 2019. The Final Capital Rule establishes a minimum common equity Tier 1 capital ratio of 6.5% of risk-weighted assets for a ''well-capitalized'' institution and increases the minimum Tier 1 risk-based capital ratio for a ''well-capitalized'' institution from 6.0% to 8.0%. Additionally, the Final Capital Rule requires an institution to maintain a 2.5% common equity Tier 1 capital conservation buffer over the 6.5% minimum risk-based capital requirement to avoid restrictions on the ability to pay dividends, discretionary bonuses, and engage in share repurchases. The Final Capital Rule also increases the required capital for certain categories of assets, including high-volatility construction real estate loans, but retains the current capital treatment of residential mortgages. Under the Final Capital Rule, we made the election to exclude unrealized gains and losses from the calculation of our regulatory capital. Implementation of these standards, or any other new regulations, may adversely affect our ability to pay dividends, or require us to reduce business levels or raise capital, including in ways that may adversely affect our results of operations or financial condition.

In December 2017, the Basel Committee published standards that it described as the finalization of the Basel III post-crisis regulatory reforms (the standards are commonly referred to as "Basel IV"). Among other things, these standards revise the Basel Committee's standardized approach for credit risk (including by recalibrating risk weights and introducing new capital requirements for certain "unconditionally cancellable commitments," such as unused credit card lines of credit) and provide a new standardized approach for operational risk capital. Under the proposed framework, these standards will generally be effective on January 1, 2022, with an aggregate output floor phasing-in through January 1, 2027. Under the current capital rules, operational risk capital requirements and a capital floor apply only to advanced approaches institutions, and not to the Company. The impact of Basel IV on the Company and the Bank will depend on the manner in which it is implemented by the federal bank regulatory agencies.

On August 28, 2018, the Federal Reserve Board issued an interim final rule required by the EGRRCPA that expands the applicability of the Federal Reserve Board's small bank holding company policy statement (the "SBHC Policy Statement") to bank holding companies with total consolidated assets of less than $3 billion (up from the prior $1 billion threshold). Under the SBHC Policy Statement, qualifying bank holding companies have additional flexibility in the amount of debt they can issue and are also exempt from the Basel III capital standards (subsidiary depository institutions of qualifying bank holding companies are still subject to capital requirements). The Company currently has less than $3 billion in total consolidated assets and would likely qualify under the revised SBHC Policy Statement. However, the Company does not currently intend to issue a material amount of debt or take any other action that would cause its capital ratios to fall below the minimum ratios required by the Basel III capital standards.

On November 21, 2018, the federal banking agencies jointly issued a proposed rule required by the EGRRCPA that would permit qualifying banks and bank holding companies that have less than $10 billion in consolidated assets to elect to be subject to a 9% leverage ratio that would be applied using less complex leverage calculations (commonly referred to as the community bank leverage ratio or "CBLR"). Under the proposed rule, banks and bank holding companies that opt into the CBLR framework and maintain a CBLR of greater than 9% would not be subject to other risk-based and leverage capital requirements under the Basel III Capital Rules and would be deemed to have met the well capitalized ratio requirements under the “prompt corrective action” framework. The rule is in proposed form so the content and scope of the final rule, and its impact on the Company and the Bank (if any), cannot be determined. Consequently, the Company and the Bank cannot yet determine whether they intend to opt into the CBLR framework.

It is difficult to predict at this time what other specific impacts the Dodd-Frank Act and the remaining, yet-to-be-written implementing rules and regulations will have on community banks. However, compliance with the EGRRCPA, the Dodd-Frank Act and its implementing rules and regulations has resulted in, and is expected to continue to result in, increased operating and compliance costs.

Introduction

Banking is a complex, highly regulated industry. The primary goals of the regulatory scheme are to maintain a safe and sound banking system, protect depositors and the FDIC insurance fund, and facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress and the states have created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies and the financial services industry in general. Consequently, the growth and earnings performance of the Bank can be affected not only by management decisions and general economic conditions, but also by the requirements of applicable state and federal statues, regulations and the policies of various governmental regulatory authorities, including the Federal Reserve Board, the FDIC, and the banking authorities of each of the jurisdictions in which the Bank operates.

The Bank's business is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the Federal Reserve Board and the FDIC. The Federal Reserve Board implements national monetary policies (with objectives such as curbing inflation and combating unemployment) through its open-market operations in U.S. Government securities, by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target Federal Funds and discount rates applicable to borrowings by depository institutions. The actions of the Federal Reserve Board in these areas influence the growth of bank loans, investments and deposits, and also affect interest earned on interest-earning assets and paid on interest-bearing liabilities. The nature and impact of any future changes in monetary and fiscal policies on the Bank are difficult to predict.

The system of supervision and regulation applicable to financial services businesses governs most aspects of the business of the Bank, including: (i) the scope of permissible business; (ii) investments; (iii) reserves that must be maintained against deposits; (iv) capital levels that must be maintained; (v) the nature and amount of collateral that may be taken to secure loans; (vi) the establishment of new branches; (vii) mergers and consolidations with other financial institutions; and (viii) the payment of dividends.

From time to time, federal and local legislation is enacted which may have the effect of materially increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers. In addition, the various bank regulatory agencies often adopt new rules, regulations and policies to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations or changes in policy may be enacted, or the extent to which the business of the Bank or the Company would be affected thereby. The Bank cannot predict whether or when potential legislation will be enacted and, if enacted, the effect that it, or any implemented regulations and supervisory policies, would have on our financial condition or results of operations. In addition, the outcome of examinations, any litigation or any investigations initiated by federal or local authorities may result in necessary changes in our operations that may increase our costs.

Set forth below is a description of the significant elements of the laws and regulations applicable to the Company and the Bank. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by the U.S. Congress and local legislatures and federal and local regulatory agencies, and, where applicable, their foreign counterparts. A change in statutes, regulations or regulatory policies applicable to the Company or the Bank could have a material effect on our business.

Regulation of BankGuam Holding Company

As a bank holding company, the Company is registered under the Bank Holding Company Act of 1956, as amended ("BHCA"), and is subject to regulation and periodic examination by the Federal Reserve Board. The Company is also required to file periodic reports of its operations and any additional information regarding its activities and those of its subsidiaries, as may be required by the Federal Reserve Board.

Federal Reserve Board regulations require bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Under these regulations, the holding company is expected to commit resources to support its bank subsidiary, including at times when the holding company may not be in a financial position to provide such support. Bank holding companies must also maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting their subsidiary bank. A bank holding company's failure to meet its obligations to serve as a source of strength to its subsidiary bank will generally be considered by the Federal Reserve Board to be an unsafe and unsound banking practice, a violation of the Federal Reserve Board's regulations, or both.

Under the BHCA, a bank holding company must obtain the Federal Reserve Board's approval before: (i) directly or indirectly acquiring more than 5% ownership or control of any voting shares of another bank or bank holding company; (ii) acquiring all or substantially all of the assets of another bank; or (iii) merging or consolidating with another bank holding company.

The business activities of the Company, as a bank holding company, are restricted by the BHCA. Under the BHCA and the Federal Reserve's bank holding company regulations, the Company may only engage in, acquire or control voting securities or assets of a company engaged in: (i) banking, or managing or controlling banks and other subsidiaries authorized under the BHCA; and, (ii) any non-banking activity the Federal Reserve has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. These include any incidental activities necessary to carry on those activities as well as a variety of activities that the Federal Reserve has determined to be so closely related to the business of banking as to be a proper incident thereto.

There are various restrictions on the ability of the holding company to borrow from, and engage in certain other transactions with, its bank subsidiary. In general, these restrictions require that any extensions of credit by the Bank to any single affiliate of the Bank must be secured by designated amounts of specified collateral and are limited to 10% of the Bank's capital stock and surplus, and, as to the Company and all other affiliates of the Bank collectively, to 20% of the Bank's capital stock and surplus. Federal law also provides that extensions of credit and other transactions between the Bank and the Company must be on terms and conditions, including credit standards, that are substantially the same or at least as favorable to the Bank as those prevailing at the time for comparable transactions involving non-affiliated companies or, in the absence of comparable transactions, on terms and conditions, including credit standards, that in good faith would be offered to or would apply to non-affiliated companies.

Federal law prohibits a bank holding company and any subsidiary banks from engaging in certain tie-in arrangements in connection with the extension of credit. Thus, for example, the Bank may not extend credit, lease or sell property, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that: (i) the customer must obtain or provide some additional credit, property or services from or to the Bank other than a loan, discount, deposit or trust services; (ii) the customer must obtain or provide some additional credit, property or service from or to the Company or the Bank; or, (iii) the customer must not obtain some other credit, property or services from competitors, except reasonable requirements to ensure soundness of the credit extended.

The principal source of the Company's cash revenues are dividends from its subsidiary, the Bank. The Company's earnings and activities are affected by legislation, by regulations and by local legislative and administrative bodies and decisions of courts in the jurisdictions in which we conduct business. For example, these include limitations on the ability of the Bank to pay dividends to the Company and our ability to pay dividends to our stockholders. It is the policy of the Federal Reserve Board that bank holding companies should pay cash dividends on common stock only out of income available over the past year and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company's ability to serve as a source of strength to its banking subsidiary.

Regulation of the Bank

General. As a Guam-chartered bank, the Bank is subject to supervision, periodic examination and regulation by the Guam Banking Commission. As a member of the Federal Deposit Insurance Corporation, the Bank is also subject to supervision, periodic examination and regulation by the FDIC as the Bank's primary federal regulator. If, as a result of an examination, the Guam Banking Commission or the FDIC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of the Bank's operations are unsatisfactory, or that the Bank or its management is violating or has violated any law or regulation, the Guam Banking Commission and the FDIC have residual authority to: (i) require affirmative action to correct any conditions resulting from any violation or practice; (ii) direct an increase in capital; (iii) restrict the Bank's growth geographically, by products and services, or by mergers and acquisitions; (iv) enter into informal nonpublic or formal public memoranda of understanding or written agreements; (v) enjoin unsafe and unsound practices and issue cease and desist orders to take corrective action; (vi) remove officers and directors and assess civil monetary penalties; and, (vii) take possession of, close and liquidate the Bank.

Guam law permits locally-chartered commercial banks to engage in any activity permissible for national banks. Therefore, the Bank may form subsidiaries to engage in the many so-called "closely related to banking" or "nonbanking" activities commonly conducted by national banks in operating subsidiaries, and further, pursuant to the Gramm-Leach-Bliley Act, the Bank may conduct certain "financial" activities in a subsidiary to the same extent as may a national bank, provided the Bank is and remains "well-capitalized," "well-managed" and in satisfactory compliance with the Community Reinvestment Act (discussed below).

The Bank is a member of the Federal Home Loan Bank ("FHLB") of Des Moines. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region and makes available loans or advances to its members. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. As an FHLB member, the Bank is required to own a certain amount of capital stock in the FHLB. At December 31, 2018, the Bank was in compliance with the FHLB's stock ownership requirement.

Regulatory Capital Guidelines. The federal banking agencies have established minimum capital standards known as risk-based capital guidelines. These guidelines are intended to provide measures of capitalization that reflect the degree of risk associated with a bank's operations. The risk-based capital guidelines include both a definition of capital and a framework for calculating the amount of capital that must be maintained against a bank's assets and off-balance sheet items. The amount of capital required to be maintained is based upon the credit risks associated with the various types and quality of a bank's assets and off-balance sheet items. A bank's assets and off-balance sheet items are classified under several risk categories, with each category assigned a particular risk weighting from 0% to 150%. The Bank's Tier 1 capital consists of its capital stock, capital surplus, treasury stock, undivided earnings and the cumulative effect of the FDIC's adjustment of our intangible assets. Our Tier 2 capital adds to Tier 1 the allowed portion of our reserves for possible loan losses. The inclusion of Tier 2 capital as qualifying capital for regulatory purposes is subject to certain other requirements and limitations of the federal banking agencies. The federal regulators require a minimum ratio of total qualifying capital to risk-adjusted assets of 9.875%, a minimum ratio of Tier 1 capital to risk-adjusted assets of 7.875%, a minimum amount of Tier 1 capital to total assets (referred to as the “leverage ratio”) of 4% and a minimum ratio of Common Equity Tier 1 Capital to risk-adjusted assets of 6.375%. As of December 31, 2018, the Company’s capital levels met all minimum regulatory requirements and the Bank was considered “well capitalized” under the regulatory framework for prompt corrective action described below. There is no condition or event since December 31, 2018, that management believes has changed the Company’s or the Bank’s capitalization category.

As described above, on November 21, 2018, the federal banking agencies jointly issued a proposed rule required by the EGRRCPA that would permit qualifying banks and bank holding companies that have less than $10 billion in consolidated assets to elect to opt into the CBLR framework. Banks opting into the CBLR framework and maintaining a CBLR of greater than 9% would be deemed to have met the well capitalized ratio requirements under the "prompt corrective action" framework. The rule is in proposed form so the content and scope of the final rule, and its impact on the Company and the Bank (if any), cannot be determined. Consequently, the Company and the Bank cannot yet determine whether they intend to opt into the CBLR framework.

Prompt Corrective Action. The federal banking agencies possess broad powers to take prompt corrective action to resolve the problems of regulated banks. Each federal banking agency has issued regulations defining five capital categories: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized.” Under the regulations, a bank shall be deemed to be:

- “well capitalized” if it has a total risk-based capital ratio of 10.0% or more, has a Tier 1 risk-based capital ratio of 8.0% or more, has a leverage capital ratio of 5.0% or more, and a Common Equity Tier 1 risk-based capital ratio of 6.5% or more, and is not subject to specified requirements to meet and maintain a specific capital level for any capital measure;
- “adequately capitalized” if it has a total risk-based capital ratio of 9.875% or more, a Tier 1 risk-based capital ratio of 7.875% or more, a leverage capital ratio of 4.0% or more, and a Common Equity Tier 1 risk-based capital ratio of 6.375% or more, each excepting the leverage ratio including the 1.875% capital buffer required during 2018, and does not meet the definition of “well capitalized”;
- “undercapitalized” if it has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio that is less than 6.0%, a leverage capital ratio that is less than 4.0% (3.0% under certain circumstances), or a Common Equity Tier 1 risk-based capital ratio that is less than 4.5%;
- “significantly undercapitalized” if it has a total risk-based capital ratio that is less than 6.0%, a Tier 1 risk-based capital ratio that is less than 4.0%, a leverage capital ratio that is less than 3.0%, or a Common Equity Tier 1 risk-based capital ratio that is less than 3.0%; and
- “critically undercapitalized” if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%.

Banks are prohibited from paying dividends or management fees to controlling persons or entities if, after making the payment, the bank would be “undercapitalized,” that is, the bank fails to meet the required minimum level for any relevant capital measure. Asset growth and branching restrictions apply to “undercapitalized” banks. Banks classified as “undercapitalized” are required to submit acceptable capital plans guaranteed by their holding company, if any. Broad regulatory authority was granted with respect to “significantly undercapitalized” banks, including forced mergers, growth restrictions, ordering new elections for directors, forcing divestiture by their holding company, if any, requiring management changes, and prohibiting the payment of bonuses to senior management. Even more severe restrictions are applicable to “critically undercapitalized” banks, those with capital at or less than 2%. Restrictions for these banks include the appointment of a receiver or conservator. All of the federal banking agencies have promulgated substantially similar regulations to implement this system of prompt corrective action.

A bank, based upon its capital levels, that is classified as “well capitalized,” “adequately capitalized” or “undercapitalized” may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for a hearing, determines that an unsafe or unsound condition, or an unsafe or unsound practice, warrants such treatment. At each successive lower capital category, an insured bank is subject to more restrictions. The federal banking agencies, however, may not treat an institution as “critically undercapitalized” unless its capital ratios actually warrant such treatment.

In addition to measures taken under the prompt corrective action provisions, insured banks may be subject to potential enforcement actions by federal banking agencies, or the banking regulators in any of the jurisdictions in which the Bank operates, for unsafe or unsound practices in conducting their businesses, or for violations of any law, rule, regulation or any condition imposed in writing by the agency, or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, and the issuance of removal and prohibition orders against “institution-affiliated” parties. The enforcement of such actions through injunctions or restraining orders may be based upon a judicial determination that the agency would be harmed if such equitable relief was not granted.

Neither the Company nor the Bank is currently operating under any corrective actions by their respective regulatory authorities.

Safety and Soundness Standards. The federal banking agencies have also adopted guidelines establishing safety and soundness standards for all insured depository institutions, as have the other regulatory authorities in jurisdictions in which the Bank operates. Those guidelines relate to internal controls, information systems, internal audit systems, loan underwriting and documentation, compensation and interest rate exposure. In general, the standards are designed to assist the various banking authorities in identifying and addressing problems at depository institutions before capital becomes impaired. If an institution fails to meet these standards, the appropriate banking authority may require the institution to submit a compliance plan and may institute enforcement proceedings if an acceptable compliance plan is not submitted.

FDIC Insurance and Insurance Assessments. The FDIC is an independent federal agency that insures deposits, up to prescribed statutory limits, of federally insured banks and savings institutions, and safeguards the safety and soundness of the banking and savings industries. The FDIC insures the Bank’s customer deposits through the Deposit Insurance Fund (“DIF”). The maximum deposit insurance amount is $250,000.

The amount of FDIC assessments paid by each DIF member institution is based on its relative risk of default as measured by regulatory capital ratios and other supervisory factors. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the FDIC is required to set the reserve ratio for the DIF annually at no less than 1.35% of estimated insured deposits. The FDIC may increase or decrease the assessment rate schedule on a semi-annual basis.

On February 7, 2011, as required by the Dodd-Frank Act, the FDIC adopted final rules to revise the assessment base to consist of average consolidated total assets during the assessment period minus the average tangible equity during the assessment period. In addition, the revisions eliminate the adjustment for secured borrowings and make certain other changes to the impact of unsecured borrowings and brokered deposits on an institution’s deposit insurance assessment. The rule also revises the assessment rate schedule to provide assessments ranging from 5 to 45 basis points, which took effect on April 1, 2011.

The FDIC may terminate a depository institution’s deposit insurance upon a finding that the institution’s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices that pose a risk to the DIF or that may prejudice the interest of depositors.

Depositor Preference. In the event of the “liquidation or other resolution” of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors, and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including the parent bank holding company, with respect to any extensions of credit they have made to such insured depository institution.

Community Reinvestment Act (“CRA”). The CRA is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal bank regulatory agencies, in examining insured depository institutions, to assess their record of helping to meet the credit needs of their entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution’s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, consummating mergers or acquisitions, or holding company formations.

The federal banking agencies have adopted regulations which measure a bank's compliance with its CRA obligations on a performance-based evaluation system. This system bases CRA ratings on an institution's actual lending service and investment performance rather than the extent to which the institution conducts needs assessments, documents community outreach or complies with other procedural requirements. The ratings range from "outstanding" to a low of "substantial noncompliance." The Bank had a CRA rating of "satisfactory" as of its most recent regulatory examination. A copy of the rating report is publicly available for review in the Bank's branches.

Other Consumer Protection Laws and Regulations. The bank regulatory agencies are increasingly focusing attention on compliance with consumer protection laws and regulations, and banks have been advised to carefully monitor their compliance with these laws and regulations. The federal Interagency Task Force on Fair Lending issued a policy statement on discrimination in home mortgage lending describing three methods that federal agencies will use to prove discrimination: overt evidence of discrimination, evidence of disparate treatment, and evidence of disparate impact. In addition to CRA and fair lending requirements, the Bank is subject to numerous other federal consumer protection statutes and regulations. Due to heightened regulatory concern related to compliance with consumer protection laws and expanded regulations generally, the Bank may incur additional compliance costs or be required to expend additional funds for investments in the local communities it serves.

Privacy. The Federal Reserve Board and other bank regulatory agencies have adopted guidelines for safeguarding confidential, personal customer information. These guidelines require financial institutions to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazards to the security or integrity of such information, and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. The Bank has adopted a customer information security program to comply with these requirements.

Financial institutions are also required to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to non-affiliated third parties. In general, financial institutions must provide explanations to consumers on policies and procedures regarding the disclosure of such nonpublic personal information, and, except as otherwise required by law, prohibits disclosing such information except as provided in the Bank's policies and procedures. The Bank has implemented privacy policies addressing these restrictions, and these policies are distributed regularly to all existing and new customers of the Bank.

USA Patriot Act of 2001. Under the USA Patriot Act of 2001 (the "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act," or the "Patriot Act"), financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers. Among other things, the Patriot Act requires: (i) enhanced due diligence policies, procedures, and controls on banks opening or holding accounts for foreign banks or wealthy foreign individuals; and, (ii) requires all financial institutions to establish anti-money laundering programs. The Bank has adopted and implemented policies and procedures to comply with the requirements of the Patriot Act.

Office of Foreign Assets Control Regulation. The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These are typically known as the "OFAC" rules based on their administration by the U.S. Treasury Department Office of Foreign Assets Control ("OFAC"). The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and, (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal and reputational consequences, including civil money penalties and potential criminal prosecution. The Bank has established policies and implemented procedures to detect and prohibit transactions that would violate the OFAC rules.

Other Aspects of Banking Law. The Bank is also subject to federal statutory and regulatory provisions covering, among other things, security procedures, insider and affiliated party transactions, management interlocks, electronic funds transfers, funds availability, and truth-in-savings.

Other Pending and Proposed Legislation

Other legislative and regulatory initiatives which could affect the Bank, the Company and the banking industry in general may be proposed or introduced before the United States Congress, the Guam legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject the Bank or the Company to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of the Bank or the Company would be affected thereby.

Available Information

The Company makes available free of charge through the Bank's website (www.bankofguam.com) the Company's Annual Reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports. The Company makes these reports available on the Bank's website as soon as reasonably practicable after we electronically file such material with, or otherwise furnish it to, the SEC. The information posted on our website is not incorporated by reference into this Annual Report. The SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

ITEM 1A. Risk Factors

Our business, financial condition and results of operations are subject to various risks, including those discussed below. The risks discussed are those that we believe are the most significant risks, although additional risks not presently known to us or that we currently deem less significant may also adversely affect our business, financial condition and results of operations, perhaps materially.

Risks Relating to Recent Economic Conditions and Governmental Response Efforts

Our business may be adversely affected by conditions in the financial markets and economic conditions generally.

The United States economy continues to recover from a downturn that started in 2007, but business activity and growth across industries and regions have not yet been fully restored. There are indications that the recovery is accelerating, and the decisions of the Federal Open Market Committee, which guides current monetary policy actions on behalf of the Federal Reserve System in carrying out its broader monetary policies, to raise its target interest rate on March 21, June 13, September 26 and December 19, 2018, expressed its confidence in the sustainability of recent economic growth in the United States. Consumer spending, liquidity and availability of credit are all improving, and the unemployment rate, which has fallen by more than half since October 2009, reached what many consider to be a full-employment level nationally. The unemployment rate in our California region is low, but has been persistently high in the island markets we serve.

The financial services industry was materially and adversely affected by the weakened economy and by the monetary policy responses intended to correct that weakness. The negative effect of historically low market interest rates reduced our interest rate margin despite us having established minimum rate levels on our variable rate loans. In order to retain core deposits and as a reputational matter, our consumer savings account rates have been higher than our competitors' offerings for the past nine years. The recovery of the economy and gradual reduction of unemployment impacted our operating results negatively; however, the Bank has not experienced any adverse liquidity issues in recent years. Additionally, the remaining adverse conditions in the island economies may continue to have a negative effect on the ability of our borrowers to make timely repayments of their loans. These factors could expose us to an increased risk of loan defaults and losses, and have an adverse impact on our earnings.

Recent legislative and required regulatory initiatives will impose restrictions and requirements on financial institutions that could have an adverse effect on our business.

Current and future legal and regulatory requirements, restrictions, and regulations, including those imposed under the 2010 Dodd-Frank Act, which was enacted in response to the 2008 financial crisis and subsequent economic weakness, may adversely impact our profitability, financial condition and operations; may require us to invest significant management attention and resources to evaluate and make any changes required by the legislation and related regulations; and may make it more difficult for us to attract and retain qualified executive officers and employees. Few provisions of the Dodd-Frank Act were effective immediately, with various provisions becoming effective in stages. Many of the provisions required governmental agencies to implement rules that have increased regulation of the banking industry. As examples, these rules impact the ability of banks to charge certain fees and impose new restrictions on lending practices. The Dodd-Frank Act created a new financial consumer protection agency, known as the Consumer Financial Protection Bureau (the "Bureau"), that is empowered to promulgate new consumer protection regulations and revise existing regulations in many areas of consumer compliance, which may increase our regulatory compliance burden and costs, and may restrict the financial products and services we offer to our customers.

The Dodd-Frank Act prohibits new trust preferred issuances from counting as Tier 1 capital. These restrictions limit our future capital strategies. Although neither the Bank nor the Company use derivative transactions, the Dodd-Frank Act also increases regulation of derivatives and hedging transactions, which could limit our ability in the future to enter into, or increase the costs associated with, interest rate and other hedging transactions. Although certain provisions of the Dodd-Frank Act, such as direct supervision by the Bureau, will not apply to banking organizations with less than $10 billion of assets, such as the Company, the changes resulting from the legislation will impact our business nonetheless. These and future changes may have a material, adverse effect on our business, our financial condition and the results of our operations. As discussed above, the EGRRCPA adopted in 2018 amended certain provisions of the Dodd-Frank Act as well as certain other statutes administered by the federal bank regulatory agencies. No other significant banking or bank holding company regulations were implemented during 2018.

On December 22, 2017, the Tax Cuts and Jobs Act ("the Act") was signed into law. Most of the changes made to the Internal Revenue Code by the Act became effective January 1, 2018, and therefore had no effect on the profitability, financial condition or operations of the Company or the Bank during the year ended December 31, 2017. However, the lowering of the maximum corporate income tax rate from 35% to 21% required a revaluation of the Company's deferred tax asset during the 2017 tax year, which resulted in a one-time negative effect on our profitability and our financial condition. During the year ended December 31, 2018, the Act had a substantial effect on the Company's and the Bank's net income after income taxes, primarily due to the reduction in the effective corporate income tax rate.

Implementation of the new Basel III capital rules adopted by the federal bank regulatory agencies will require increased capital levels that could impede our growth and profitability.

The federal bank regulatory agencies adopted new capital requirements in mid-2013 that increased the minimum Tier 1 risk-based capital ratio, added a new minimum common equity Tier 1 capital ratio, established a new capital conservation buffer and changed the risk-weighting of certain assets. These requirements, initially implemented beginning in January 2015, are being phased in through 2019, providing banks with adequate time to adjust their balance sheets. Management has assessed the effects of the new rules on the Company and the Bank's capital position. Although we currently exceed the new minimum requirements, they could have a material and adverse effect on our liquidity, capital resources, financial performance and financial condition in the future.

Any future FDIC insurance premium increases will adversely affect our earnings.

In April 2009, the FDIC revised its risk-based assessment system. The changes to the system involve adjustments to the risk-based calculation of an institution's unsecured debt, secured liabilities and brokered deposits. Depending on any future losses that the FDIC Deposit Insurance Fund may suffer due to failed institutions, there can be no assurance that there will not be additional premium increases in order to replenish the Fund, but the rate of bank failures has diminished over the past four years, returning to historical norms. Our FDIC deposit insurance expense for the year ended December 31, 2018, was $1.3 million.

Risks Related to Our Markets and Business

Our profitability is dependent upon the economic conditions of the markets in which we operate.

We operate on ten relatively remote Pacific islands and in San Francisco, California, and, as a result, our financial condition and results of operations are affected by changes in the economic conditions in each of those areas. Our success depends upon the business activity, population, income levels, deposits and lending activity in these markets. Because some of our customers' business and financial interests may extend well beyond these market areas, adverse economic conditions that affect those other market areas could reduce our growth rate, affect the ability of those customers to repay their loans, and generally affect our financial condition and results of operations. Other than in San Francisco, our lending operations are located in market areas dependent on tourism and fishing, along with a military presence and other federal government activities in Guam. The island economies have remained relatively stable, and the Commonwealth of the Northern Mariana Islands has resumed its economic growth after several years of challenges. However, because of the magnified influence of external events, these small island economies tend to be somewhat more volatile than larger economic systems. Thus, our borrowers could be adversely impacted by a downturn in these sectors of the economy that could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans, which would, in turn, increase our nonperforming assets. Because of our geographic concentration in several relatively small island economies, we are less able than many regional or national financial institutions to diversify our credit risks across multiple dissimilar markets. In recent years, we have taken the initiative to expand our operations in California in an effort to increase and help to stabilize our profitability.

Our loan portfolio has a large concentration of real estate loans in Guam and in San Francisco, which involves risks specific to real estate values.

A downturn in our real estate markets could adversely affect our business because many of our loans are secured by real estate. Real estate lending (including commercial and construction) is a large portion of our loan portfolio. At December 31, 2018, approximately $741.2 million, or 59.8% of our loan portfolio, was secured by various forms of real estate, including residential and commercial real estate. The real estate securing our loan portfolio is concentrated in Guam and San Francisco. From time to time, there have been adverse developments affecting real estate values in one or more of our markets, and the market value of real estate can fluctuate significantly in a short period of time as a result of changing market conditions. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies, and acts of nature, such as earthquakes and typhoons. Additionally, commercial real estate lending typically involves larger loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. If real estate values decline, the value of the collateral securing some of our loans could be significantly reduced. Our ability to recover on defaulted loans by foreclosing and selling the real estate collateral would then be diminished, and we would be more likely to suffer losses on defaulted loans.

If we fail to maintain an effective system of internal controls and disclosure controls and procedures, we may not be able to accurately report our financial results or prevent fraud.

Effective internal control over financial reporting and disclosure controls and procedures are necessary for us to provide reliable financial reports, effectively prevent fraud and to operate successfully as a public company. If we cannot provide reliable financial reports or prevent fraud, our reputation and business would be harmed. In addition, failure in our internal control over financial reporting and disclosure controls and procedures could cause us to fail to meet the requirements of Rules 13a-15 and 15d-15 under the Exchange Act and, as a result, risk errors in our financial reporting to the Securities and Exchange Commission.

Each calendar quarter, management conducts an assessment of the effectiveness of the Company's internal control over financial reporting based on the framework established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. For additional information on the effectiveness of our internal controls over financial reporting, see Part II. Item 9A. "Controls and Procedures" in this Annual Report on Form 10-K.

Our performance depends on attracting and retaining key employees and skilled personnel to operate our business effectively, and the loss of one or more of those key personnel may materially and adversely affect our prospects.

Our success is dependent on our ability to recruit and retain qualified, skilled management, loan origination, finance, administrative, marketing and technical personnel to operate our business effectively. Competition for qualified employees and personnel in the banking industry is intense, and there is a limited number of persons with knowledge of, and experience in, the community banking industry in the markets we serve. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our Chief Executive Officer, our Chief Operating Officer, our Chief Financial Officer, and certain other key employees. Failure to maintain adequate staffing in key positions could adversely impact our operations and our ability to compete. We have implemented a succession plan to help mitigate this risk, including the appointment of two Executive Vice Presidents who will ultimately assume critical executive level positions.

As previously reported, our former Chief Executive Officer and President, Lourdes A. Leon Guerrero, resigned effective December 31, 2018, in advance of her inauguration as the Governor of Guam. Joaquin P.L.G. Cook, the Company's and Bank's Executive Vice President and Chief Sales & Service Officer, is serving as the Company's and Bank's Interim Chief Executive Officer and President until the Company identifies a successor for Ms. Leon Guerrero.

We are subject to credit risk.

There are inherent risks associated with our lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets where we operate, as well as those within our region, across the United States and abroad. Increases in interest rates and/or weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing those loans. We are also subject to various laws and regulations that affect our lending activities. Failure to comply with applicable laws and regulations could subject us to regulatory enforcement action, which could result in the assessment of significant civil money penalties against us.

We seek to mitigate the risks inherent in our loan portfolio by adhering to specific underwriting practices. Although we believe that our underwriting criteria are appropriate for the various kinds of loans we make, we may incur losses on loans that meet our underwriting standards, and these losses may exceed the amounts set aside as reserves in our allowance for loan losses. Due to economic conditions in the recent past, many lending institutions, including the Bank, experienced declines in the performance of their loans, including consumer and commercial loans. The value of real estate collateral supporting some commercial loans declined and may decline again in the future. Developments in the financial industry and credit markets may adversely impact our financial condition and results of operations.

Our allowance for loan losses may not be adequate to cover actual loan losses, which could adversely affect our earnings.

We maintain an allowance for loan losses for possible defaults and other reductions in the principal value of the Bank’s loan portfolio. The allowance is established through a provision for loan losses based on management’s evaluation of the risks inherent in the loan portfolio and the general economy. The allowance is also appropriately increased for new loan growth. The allowance is based upon a number of factors, including the size of the loan portfolio, asset classifications, economic trends, industry experience and trends, industry and geographic concentrations, estimated collateral values, management’s assessment of the credit risk inherent in the portfolio, historical loan loss experience and loan underwriting policies.

We strive to carefully manage and monitor credit quality and to identify deteriorating loans, and adjust the allowance for loan losses accordingly. However, because future events are uncertain and because we may not successfully identify all deteriorating loans in a timely manner, there may be loans that deteriorate in an accelerated time frame. As a result, future additions to the allowance may be necessary. Further, because the loan portfolio contains some commercial real estate, construction, and land development loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required due to changes in the financial condition of borrowers, such as changes resulting from potentially worsening economic conditions, or as a result of incorrect assumptions by management in determining the allowance for loan losses. As discussed in Note 20 to our Consolidated Financial Statements included in this Annual Report on Form 10-K, at January 16, 2019, one large commercial loan customer with an outstanding relationship of $10.1 million in unsecured loans sought bankruptcy protection in order to reorganize under Chapter 11 of Title 11 of the United States Code. The Bank retains the right of offset against a minimum of $4.7 million in the customer's depository accounts, and has made a specific allowance for loan losses of $5.2 million at December 31, 2018.

Our regulators, as an integral part of their examination process, periodically review our allowance for loan losses and may require us to increase our allowance for loan losses by making additional provisions for loan losses, charged as an expense, or to decrease our allowance for loan losses by recognizing loan charge-offs, net of recoveries. Any such additional provisions for loan losses or charge-offs, as required by these regulatory agencies, could have a material adverse effect on our financial condition and results of operations.

Nonperforming assets take significant time to resolve and adversely affect our results of operations and financial condition.

At December 31, 2018, nonperforming loans were 0.57% of the total loan portfolio, and 0.37% of total assets, as compared to 0.66% and 0.41% at December 31, 2017, respectively, indicating a decreased level of risk. Nonperforming assets adversely affect our earnings in various ways. Depending upon economic and market conditions, we may incur losses relating to an increase in nonperforming assets. We do not record interest income on non-accrual loans or other real estate owned, thereby adversely affecting our income, and increasing our loan administration costs. Upon foreclosure or similar proceedings, we record the foreclosed asset at the fair value of the asset, reduced by estimated selling costs, which may result in a loss. An increase in the level of nonperforming assets increases our risk profile and may impact the capital levels our regulators believe are appropriate in light of the increased risk profile. While we reduce problem assets through collection efforts, asset sales, workouts, restructurings and otherwise, decreases in the value of the underlying collateral or in these borrowers' performance or financial condition, whether or not due to economic and market conditions beyond our control, could adversely affect our business, our results of operations and our financial condition.

In addition, the resolution of nonperforming assets requires significant commitments of time from management and our directors, which can hinder the performance of their other responsibilities. If economic and market conditions worsen, it is possible that we will experience future increases in nonperforming assets, particularly if we are unsuccessful in our efforts to reduce our classified assets, which would have an adverse effect on our business.

We may be required to make additional provisions for loan losses and charge off additional loans in the future, which could adversely affect our results of operations.

For the year ended December 31, 2018, we recorded a $12.9 million provision for loan losses, charged off $8.2 million of loans, and recovered $1.8 million of loans previously charged off. At December 31, 2018, we had $741.2 million in commercial and residential real estate loans and construction loans, of which $11.8 million was on non-accrual. Commercial real estate loans comprise 17.1% of our nonperforming assets, while residential mortgage loans comprise 41.3%. Deterioration in the real estate market in Guam, San Francisco and/or the Commonwealth of the Northern Mariana Islands could affect the ability of our loan customers to service their debt, which could result in additional loan charge-offs and provisions for loan losses in the future, and could have a material adverse effect on our financial condition, results of operations and capital.

A large commercial loan borrower that filed for bankruptcy on January 16, 2019, was evaluated under ASC 450 – "Contingencies". The Bank holds \$4.7 million in deposits for which the Court has approved a right of offset against the borrower's loans. The Bank also has assigned a specific allowance of \$5.2 million to the outstanding debt. The outstanding loans under bankruptcy have been classified as substandard, but are still accruing interest and the scheduled payments on the loans remain current.

Our business is subject to interest rate risk, and variations in interest rates may negatively affect our financial performance.

Our earnings and cash flows are highly dependent upon net interest income. Net interest income is the difference between interest income earned on interest-bearing assets, such as loans and securities, and interest expense paid on interest-bearing liabilities, such as deposits and borrowed funds. Our net interest income (including net interest spread and margin) and ultimately our earnings are impacted by changes in interest rates and monetary policy. Changes in interest rates and monetary policy can impact the demand for new loans, the credit profile of our borrowers, the yields earned on loans and securities, and the rates paid on deposits and borrowings. Given our current volume and mix of interest-bearing liabilities and interest-earning assets, we expect our interest rate spread (the difference in the rates paid on interest-bearing liabilities and the yields earned on interest-earning assets) as well as net interest income to increase as interest rates rise and, conversely, to decline if interest rates fall. Additionally, increasing levels of in-market and out-of-market competition in the banking and financial services business may decrease our net interest spread as well as net interest margin by forcing us to offer lower lending interest rates and pay higher deposit interest rates. Although we believe our current level of interest rate sensitivity is reasonable, significant fluctuations in interest rates (such as a sudden and substantial increase in Prime and Fed Funds rates) as well as increasing competition may require us to increase rates on deposits at a faster pace than the yield we receive on interest-earning assets increases. The impact of any sudden and substantial move in interest rates and/or increased competition may have an adverse effect on our business, financial condition and results of operations, as our net interest income may be adversely affected.

Additionally, a sustained decrease in market interest rates could negatively affect our earnings. When interest rates decline, borrowers tend to refinance higher-rate, fixed-rate loans at lower rates, prepaying their existing loans. Under those circumstances, we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans. In addition, our commercial loans, which carry variable interest rates that generally adjust in accordance with changes in the prime rate, will adjust to lower rates. Because of this, we have established minimum interest rates on those loans to mitigate our interest rate risk and potential reductions in income.

We are also significantly affected by the level of loan demand available in our markets. The inability to make sufficient loans directly affects the interest income we earn. Lower loan demand will generally result in lower interest income realized as we place funds in lower-yielding investments.

Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity due to a market downturn in markets in which our loans are concentrated, a change in our financial condition or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a severe disruption of the financial markets or negative views and expectations about the prospects for the financial services industry as a whole.

If we lost a significant portion of our low-cost deposits, it would negatively impact our liquidity and profitability.

Our profitability depends in part on our success in attracting and retaining a stable base of low-cost deposits. At December 31, 2018, 31.1% of our deposit base was comprised of non-interest bearing deposits, and the average rate on our interest-bearing deposits during 2018 was 0.17%. While we generally do not believe these core deposits are very sensitive to interest rate fluctuations, the competition for these deposits in our markets is strong. If we were to lose a significant portion of our low-cost deposits, it could negatively impact our liquidity and profitability.

We may be the subject of litigation, which could result in legal liability and damage to our business and reputation.

From time to time, we may be subject to claims or legal action from customers, employees or others. Financial institutions like the Company and the Bank are facing a growing number of significant class actions, including those based on the manner of calculation of interest on loans and the assessment of overdraft fees. Future litigation could include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages.

We are also involved from time to time in other reviews, investigations and proceedings (both formal and informal) by governmental and other agencies regarding our business. These matters also could result in adverse judgments, settlements, fines, penalties, injunctions or other relief. Like other large financial institutions, we are also subject to risk from potential employee misconduct, including non-compliance with policies and improper use or disclosure of confidential information.

Our insurance may not cover all claims that may be asserted against us, and any claims asserted against us, regardless of merit or eventual outcome, may harm our reputation. Should the ultimate judgments or settlements in any litigation exceed our insurance coverage, they could have a material adverse effect on our financial condition and results of operations. In addition, we may not be able to obtain appropriate types or levels of insurance in the future, nor may we be able to obtain adequate replacement policies with acceptable terms, if at all.

If we are limited in our ability to originate loans secured by commercial real estate we may face greater risk in our loan portfolio.

Federal banking agencies have issued guidance regarding high concentrations of commercial real estate loans within bank loan portfolios. The guidance requires financial institutions that exceed certain levels of commercial real estate lending compared with their total capital to maintain heightened risk management practices that address the following key elements: board and management oversight and strategic planning, portfolio management, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing, and maintenance of increased capital levels as needed to support the level of commercial real estate lending. If there is any deterioration in our commercial real estate portfolio or if our regulators conclude that we have not implemented appropriate risk management practices, it could adversely affect our business, and could result in the requirement to maintain increased capital levels. Such capital may not be available at that time, and may result in our regulators requiring us to reduce our concentration in commercial real estate loans.

If because of our concentration of commercial real estate loans, or for any other reasons, we are limited in our ability to originate loans secured by commercial real estate, our results of operations may be negatively impacted and we may incur greater risk in our loan portfolio.

The laws and regulations, including the Dodd-Frank Act, applicable to the banking industry could change at any time, and these changes may adversely affect our business and profitability.

We are subject to extensive federal and state regulation. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, our cost of compliance could adversely affect our ability to operate profitably. The increased scope, complexity, and cost of corporate governance, reporting, and disclosure practices are proportionately higher for a company of our size and will affect our profitability more than that of some of our larger competitors. We expect to experience increasing compliance costs related to this supervision and regulation.

Also, the 2016 national election results and new administration have introduced additional uncertainty into future implementation and enforcement of the Dodd-Frank Act and other financial sector regulatory requirements. Such additional regulation and supervision may increase our costs and limit our ability to pursue business opportunities. The effects of any such recently enacted, or proposed, legislation and regulatory programs on us cannot reliably be determined at this time.

The Consumer Financial Protection Bureau (the “CFPB”) recently issued “ability-to-repay” and “qualified mortgage” rules that may have a negative impact on our loan origination process and foreclosure proceedings, which could adversely affect our business, operating results and financial condition.

On January 10, 2013, the CFPB issued a final rule to implement the “qualified mortgage” provisions of the Dodd-Frank Act requiring mortgage lenders to consider consumers’ ability to repay home loans before extending them credit. The CFPB’s “qualified mortgage” rule, which became effective on January 10, 2014, describes certain minimum requirements for lenders making ability-to-repay determinations, but does not dictate that they follow particular underwriting models. Lenders will be presumed to have complied with the ability-to-repay rule if they issue “qualified mortgages,” which are generally defined as mortgage loans prohibiting or limiting certain risky features. Loans that do not meet the ability-to-repay standard can be challenged in court by borrowers who default, and the absence of ability-to-repay status can be used against a lender in foreclosure proceedings. Any loans that we make outside of the “qualified mortgage” criteria could expose us to an increased risk of liability and reduce or delay our ability to foreclose upon the underlying property. Any decreases in loan origination volume or increases in compliance and foreclosure costs caused by the rule could negatively affect our business, operating results and financial condition. The CFPB also has adopted a number of additional requirements and issued additional guidance, including with respect to appraisals, escrow accounts and servicing, each of which entails increased compliance costs. In addition, the CFPB likely will continue to make rules relating to consumer protection, and it is difficult to predict which of our products and services will be subject to these rules or how these rules will be implemented.

Compliance with the Dodd-Frank Act has increased our regulatory compliance burdens, may increase our operating costs and may adversely impact our earnings or capital ratios, or both.

Signed into law on July 21, 2010, the Dodd-Frank Act has represented a significant overhaul of many aspects of the regulation of the financial services industry. Among other things, the Dodd-Frank Act created the CFPB, tightened capital standards, imposed clearing and margining requirements on many derivatives activities and generally increased oversight and regulation of financial institutions and financial activities.

In addition to the self-implementing provisions of the statute, the Dodd-Frank Act calls for over 200 administrative rulemakings by numerous federal agencies to implement various parts of the legislation. While many rules have been finalized or issued in proposed form, additional rules have yet to be proposed. It is not possible at this time to predict when all such additional rules will be issued, their final form or requirements, their applicability to the Company or the Bank, or when they will be implemented.

The cost of complying with the new consumer protection regulations and policies could adversely affect our business.

The Dodd-Frank Act created the CFPB, a new regulatory entity with broad powers to supervise and enforce consumer protection laws. The CFPB has extensive rulemaking authority for a wide range of consumer protection laws that apply to banks and other types of lenders, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. It also has examination and enforcement authority over all banks with more than $10 billion in assets. Institutions with less than $10 billion in assets, like the Bank, are examined for compliance with consumer protection laws by their primary bank regulators, but these regulators defer to the CFPB's rules and interpretations in evaluating a bank's compliance with consumer protection laws. Therefore, although the CFPB does not directly supervise us, the actions of the CFPB significantly impact our operations.

The CFPB has set forth numerous rules and guidance documents since its inception concerning a wide range of consumer protection laws, many of which are directly applicable to our operations. For example, the CFPB recently imposed new requirements regarding the origination and servicing of residential mortgage loans, limitations on the manner in which loan originators may be compensated, mandatory disclosures on documentation given to borrowers, and an obligation on the part of lenders to verify a borrower's "ability to repay" a residential mortgage loan before extending credit, among others. The CFPB likely will continue to make rules relating to consumer protection, and it is difficult to predict which of our products and services will be subject to these rules or how these rules will be implemented. However, compliance with CFPB regulations likely will result in additional operating and compliance costs that could have a material adverse effect on our business, consolidated financial condition, results of operations, or cash flows.

We have the ability to borrow from the Federal Home Loan Bank, and there can be no assurance their programs will continue in their current manner.

We have access to funding by the Federal Home Loan Bank of Des Moines for term advances; we also borrow from correspondent banks under our Fed Funds lines of credit from time to time, primarily to test the continuing availability of those lines. The amount loaned to us is generally dependent on the value of the collateral pledged. These lenders could reduce the percentages loaned against various collateral categories, could eliminate their acceptance of certain types of collateral, and could otherwise modify or even terminate their loan programs, particularly to the extent they are required to do so because of capital adequacy or other balance sheet concerns. Any change or termination of the programs under which we borrow from the Federal Home Loan Bank of Des Moines or correspondent banks could have an adverse effect on our liquidity and profitability.

Our results of operations may be adversely affected by other-than-temporary impairment charges relating to our securities portfolio.

We may be required to record future impairment charges on our securities, including our stock in the Federal Home Loan Bank of Des Moines, if they suffer declines in value that we consider other-than-temporary. Numerous factors, including the lack of liquidity for re-sale of certain securities, the absence of reliable pricing information for some securities, adverse changes in the business climate, adverse regulatory actions or unanticipated changes in the competitive environment, could have a negative effect on our securities portfolio in future periods. Significant impairment charges could also negatively impact our regulatory capital ratios and result in the Bank not being classified as “well-capitalized” for regulatory purposes.

We may need to raise additional capital in the future, and such capital may not be available when needed or at all.

We may need to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet regulatory requirements, our commitments or our business needs. Our ability to raise additional capital, if needed, will depend, among other things, on conditions in the capital markets at that time, which are outside of our control, and our financial performance. The loss of confidence in financial institutions may increase our cost of funding and limit our access to some of our customary funding sources, including, but not limited to, inter-bank borrowings and borrowings from the discount window of the Federal Reserve.

We cannot provide assurances that such capital will be available to us on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of debt purchasers, depositors of the Bank or counterparties participating in the capital markets, may adversely affect our capital costs and our ability to raise capital and, in turn, our liquidity.

We must effectively manage our growth strategy.

As part of our general growth strategy, we may expand into additional communities or attempt to strengthen our position in our current markets by opening new offices. To the extent that we are able to open additional offices, we are likely to temporarily experience the effects of higher operating expenses relative to operating income from the new operations for a period of time, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Our current growth strategies involve internal growth from our current offices and the addition of new offices over time, so that the additional overhead expenses associated with recent openings are absorbed prior to opening other new offices.

We have a nominal amount of deferred tax asset and cannot assure that it will be fully realized.

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between the carrying amounts and tax basis of assets and liabilities computed using enacted tax rates. If we determine that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we are required under generally accepted accounting principles to establish a full or partial valuation allowance. If we determine that a valuation allowance is necessary, we are required to incur a charge to operations. We regularly assess available positive and negative evidence to determine whether it is more likely than not that our net deferred tax asset will be realized. Realization of a deferred tax asset requires us to apply significant judgment and is inherently speculative because it requires estimates that cannot be made with certainty. At December 31, 2018, we had a net deferred tax asset of $6.9 million. For the year ended December 31, 2018, we established a partial valuation allowance of $2.2 million to reduce the net deferred tax asset of $9.1 million because, in management’s opinion, it is more likely than not that only the remaining $6.9 million will be realized. If we were to determine at some point in the future that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we would be required, under generally accepted accounting principles, to establish a full or increase any partial valuation allowance, which would require us to incur a charge to operations for the period in which the determination was made. Such an increase in the valuation allowance was made in the year ending December 31, 2017, due to the passage of the Tax Cuts and Jobs Act into law on December 22, 2017, which, among other things, reduced the maximum corporate income tax rate from 35% to 21%. The deferred tax asset valuation allowance at December 31, 2018, was increased by $215 thousand, as compared to a decrease of $1.2 million at December 31, 2017.

We face strong competition from financial service companies and other companies that offer banking services.

We face substantial competition in all phases of our operations from a variety of different competitors. Our competitors, including larger commercial banks, community banks, savings and loan associations, credit unions, consumer finance companies, insurance companies, brokers, investment advisors and other financial institutions, compete with the lending and deposit-gathering services we offer. Increased competition in our markets may result in reduced loans and deposits.

Many of these competing institutions have much greater financial and marketing resources than we have. Due to their size, many competitors can achieve larger economies of scale in a broader range of products and services than we can. If we are unable to offer competitively priced products and services, our business may be negatively affected.

Some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies and federally insured financial institutions, and are not subject to increased supervisory oversight arising from regulatory examinations. As a result, these non-bank competitors have certain advantages over us in accessing funding and in providing various services. The banking business in our primary market areas is very competitive, and the level of competition facing us may increase further, which may limit our asset growth and financial results.

In the future, the Bank and/or the Company may become subject to supervisory actions and/or enhanced regulation that could have a material adverse effect on our business, operating flexibility, financial condition, the value of our common stock and our ability to pay dividends to our stockholders.

Under federal, state and local laws and regulations pertaining to the safety and soundness of insured depository institutions, various state or local regulators (for non-federally chartered banks), the Federal Reserve Board (for bank holding companies and member banks), the local financial industry regulators of the various jurisdictions in which the Bank operates and, separately, the FDIC as the insurer of bank deposits, each have the authority to compel or restrict certain activities on our part if they determine that we have insufficient capital or are otherwise operating in a manner that may be deemed to be inconsistent with safe and sound banking practices. Under their respective authority, our bank regulators can require us to enter into informal or formal enforcement orders, including board resolutions, memoranda of understanding, written agreements, and consent or cease and desist orders, pursuant to which we may be required to take identified corrective actions to address cited concerns or to refrain from taking certain actions. Neither the Bank nor the Company is currently operating under any regulatory enforcement orders.

Technology is continually changing and we must effectively implement new technologies.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables us to reduce costs. Our future success will depend in part upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy their demands for convenience, as well as to create additional efficiencies in our operations as we continue to grow and expand our geographic and product markets. In order to anticipate and develop new technology, we employ a qualified staff of internal information system specialists and consider this area a core part of our business. We do not develop our own software products, but have been able to respond to technological changes in a timely manner through association with leading technology vendors. We must continue to make substantial investments in technology, which may affect our results of operations. If we are unable to make such investments, or we are unable to respond to technological changes in a timely manner, our operating costs may increase, which could adversely affect our operating results.

System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other potential liabilities.

The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from physical theft, fire, power loss, telecommunications failure or a similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms and other disruptive problems caused by malicious parties. Any damage or failure that causes an interruption in our operations could have a material adverse effect on our financial condition and results of operations. Computer break-ins and other disruptions could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and may cause existing and potential customers to refrain from doing business with us. We employ external auditors to conduct auditing and testing for weaknesses in our systems, controls, firewalls and encryption to reduce the likelihood of any security failures or breaches, as well as both internal and external monitoring systems to detect and report any attempt to overcome our electronic defenses. Although we, with the help of third-party service providers and auditors, intend to continue to implement effective security technology and establish operational procedures to prevent such damage, there can be no assurance that these security measures will ultimately be successful. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms we and our third-party service providers use to encrypt and protect customer transaction data. A failure of such security measures would present a reputational risk, and could have a material adverse effect on our financial condition and results of operations.

Breaches of third parties' network security could subject us to increased operating costs and other liabilities.

In recent years, there have been numerous highly publicized breaches of customer databases maintained by both public and private entities, often compromising personally identifiable information. These breaches increase the risk that compromised information may be used to fraudulently obtain financial services. The Bank has established systems to mitigate the possibility that some compromised information could be used fraudulently to open deposit and/or loan accounts. Despite all reasonable efforts, though, we are unable to be absolutely certain that the risk of that form of fraud is entirely eliminated.

Further, some of these third party data breaches have compromised credit card information, creating an opportunity to defraud the Bank and its credit card customers by initiating fraudulent charges using the compromised card information. Under current law, the Bank retains potential liabilities associated with those fraudulent charges. Also, when it is known that a credit card has been compromised, the Bank incurs costs in replacing the card. As a result, a third-party network security breach could have a material adverse effect on our financial condition and the results of our operations.

Managing operational risk is important to attracting and maintaining customers, investors and employees.

Operational risk represents the risk of loss resulting from our operations, including but not limited to, the risk of fraud by employees or persons outside the Bank, the execution of unauthorized transactions by employees, transaction processing errors and breaches of the internal control system, and failure to effectively meet compliance requirements. This risk of loss also includes the potential legal actions that could arise as a result of an operational deficiency or as a result of noncompliance with applicable regulatory standards, adverse business decisions or their implementation, and customer attrition due to potential negative publicity. Operational risk is inherent in all business activities, and the management of this risk is important to the achievement of our business objectives. In the event of a breakdown in our internal control system, improper operation of systems or improper employee actions, we could suffer financial loss, face regulatory action and suffer damage to our reputation. We have a stringent code of ethics and attendant procedures in place to protect our reputation and promote ethical conduct, but these policies and procedures might not be fully effective. Negative publicity regarding our business, employees, or customers, with or without merit, may result in the loss of customers, investors and employees, costly litigation, a decline in revenues and increased regulatory oversight.

Severe weather, natural disasters, acts of war or terrorism, and other external events could significantly impact our business.

Severe weather, natural disasters, acts of war or terrorism, and other adverse external events or conditions have the potential to significantly impact our ability to conduct business. Such events or conditions could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, our primary market areas in Guam and the Commonwealth of the Northern Mariana Islands (the “CNMI”) are subject to typhoons, earthquakes and wildland fires, and our California region is subject to earthquakes and wildland fires. All of the islands in our market are at risk from more frequent and more intense storms, coastal flooding and coastal erosion related to climate change. Operations in our market could be disrupted by both the evacuation of large portions of the population as well as damage and/or lack of access to our banking and operational facilities. While we have experienced severe weather and strong earthquakes in the past and resumed our operations promptly, a recurrence of these, along with acts of war, terrorism or other adverse external events or conditions, may occur in the future. Although management has established a business continuity plan, disaster recovery policies and corresponding procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Uncertain geopolitical conditions could have a material adverse effect on our business and the markets that we serve, which could cause the market price of our common stock to decline.

Our business is subject to geopolitical conditions in the western Pacific, including concerns over North Korea’s nuclear weapons program and China’s expanded military operations in the South and East China Seas. From time to time, there have been heightened security concerns regarding North Korea’s nuclear weapons and long-range ballistic missile programs. This has resulted in increased uncertainty regarding both North Korea’s actions and those of the United States. If North Korea were to take an aggressive action, including acts of war, the markets we serve may be disrupted and our business operations could be affected as well. China’s assertion of sovereignty over several disputed islands and fortification of some of those islands conflicts with the interests of the United States involving safe passage and navigation in the same areas have increased the risks of confrontation in the region. Any of these events could result in a decline in the market price of shares of our common stock.

We have identified material weaknesses in our internal control over financial reporting which could, if not remediated, result in material misstatements in our financial statements.

Our management is responsible for establishing and maintaining adequate internal control over our financial reporting, as defined in Rule 13a-15(f) under the Exchange Act. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.

As further described in Part II. Item 9A. “Controls and Procedures” in this Annual Report on Form 10-K, during the first quarter of 2019, we concluded that a material weakness existed as of December 31, 2018. Specifically, management identified a control deficiency that constituted a material weakness in our internal control over financial reporting related to certain monitoring practices related to our core operating system.

As of the date of this filing, we have made substantial progress in remediating this material weakness. We are continuing to execute and monitor our remediation plan. If our remedial measures are insufficient, or if additional material weaknesses or significant deficiencies in our internal controls are detected, we could be required to restate our financial results, lose investor confidence or experience a decline in the price of our securities.

Risks Related to Our Securities

The price of our common stock may fluctuate significantly, and this may make it difficult for stockholders to resell shares of common stock at times or at prices they find attractive.

The Company common stock is traded in the Over-the-Counter market under the symbol “BKGMF.” The trading volume has historically been substantially less than that of larger financial services companies. This may make it difficult for stockholders to resell shares of common stock at times or at prices they find attractive. Stock price volatility may also make it more difficult to sell common stock quickly and at attractive prices.

During the fourth quarter of 2016, the Company issued $9.8 million of preferred stock in a private placement, structured to qualify as Tier 1 capital. There are restrictions on the ability of shareholders to sell these shares, and the Company is required to obtain prior regulatory approval before they can be redeemed or repurchased.

ITEM 1B. Unresolved Staff Comments
None.

ITEM 2. Properties
Our properties consist primarily of leased office facilities for our branch offices. Our headquarters facility, which we own, consists of 74,240 square feet in Hagåtña, Guam. We also own the buildings of our Santa Cruz branch in Guam, our Garapan branch in Saipan and the Rota branch in the CNMI, which comprise 47,292 square feet in total. These branch buildings are situated on leased land. We believe our facilities are in excellent condition and suitable for the conduct of our business. For purposes of operating efficiency, our Santa Cruz branch was consolidated into our Hagåtña branch in December 2017.

For additional information on operating leases and rent expense, see Note 16 to the Consolidated Financial Statements.

ITEM 3. Legal Proceedings
Neither the Company nor the Bank is involved in any legal proceedings other than those occurring on a routine basis in the ordinary course of business. The majority of such proceedings have been initiated by the Bank in the process of collecting delinquent loans. Such routine legal proceedings, in the aggregate, are believed by management to be immaterial to the financial condition, results of operations and cash flows of the Company as of December 31, 2018.

ITEM 4. Mine Safety Disclosures
None.

PART II

ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market and Dividend Information

The Company's common stock is quoted on the OTC Bulletin Board under the symbol "BKGMF." Transactions of the Company's common stock through private negotiated sales are also facilitated with the assistance of the Bank's Trust Department. Management is not aware of any securities dealers which actively make a market in the Company's common stock. No assurance can be given that an active trading market will be sustained for the common stock at any time in the future. The following table sets forth the high and low sale price for the common stock for the periods indicated, along with cash dividend payments for each of the quarters presented. The stock prices in the table are based upon information provided by the Bank's Trust Department, and are derived from private sales executed through the Bank's Trust Department and prices quoted through the OTC Bulletin Board.

	Stock Price		
	High	Low	Dividend Per Share
Year ended December 31, 2018			
Fourth Quarter	$11.99	$10.00	$ 0.100
Third Quarter	$12.00	$10.00	$ 0.100
Second Quarter	$12.00	$9.00	$ 0.100
First Quarter	$12.25	$7.00	$ 0.100
Year ended December 31, 2017			
Fourth Quarter	$12.25	$7.00	$ 0.100
Third Quarter	$12.00	$9.50	$ 0.100
Second Quarter	$12.66	$10.00	$ 0.100
First Quarter	$12.00	$9.75	$ 0.100

As of March 15, 2019, there were approximately 4,494 holders of record of common stock. There are no other classes of common equity.

Dividend Policy

At its discretion, the Board of Directors of the Company declares dividends to its stockholders on a quarterly basis. The Company declared and paid dividends of $0.10 per share to stockholders as of a declaration date for each share of common stock outstanding in each of the eight calendar quarters ended December 31, 2018.

The amount of future dividends will depend upon our earnings, financial condition, capital requirements and other factors, and will be determined by our Board of Directors on a quarterly basis. It is the policy of the Federal Reserve Board that bank holding companies generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also the policy of the Federal Reserve Board that bank holding companies not maintain dividend levels that undermine the holding company's ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the Federal Reserve Board has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong. Under the federal Prompt Corrective Action regulations, the Federal Reserve Board may prohibit a bank holding company from paying any dividends if the holding company is undercapitalized, and the FDIC may prohibit a non-member bank from paying any dividends if the bank is undercapitalized.

As a holding company, our ability to pay cash dividends is affected by the ability of our bank subsidiary, the Bank, to pay cash dividends. The ability of the Bank (and our ability) to pay cash dividends in the future and the amount of any such cash dividends is and could in the future be further influenced by bank regulatory requirements and approvals and capital guidelines. Funds for payment of any cash dividends by the Company would be obtained from its investments as well as dividends from the Bank. The decision whether to pay dividends will be made by our Board of Directors in light of conditions then existing, including factors such as our results of operations, financial condition, business conditions, regulatory capital requirements and covenants under any applicable contractual arrangements, including agreements with regulatory authorities.

The Company also has $9.8 million in preferred stock outstanding for which it paid $546 thousand in dividends in 2018.

Securities Authorized for Issuance Under Equity Compensation Plans

Stock Purchase Plan

The Bank's 2011 Employee Stock Purchase Plan (the "2011 Plan") was adopted by the Bank's Board of Directors and approved by the Bank's Stockholders on May 2, 2011, to replace the Bank's 2001 Non-Statutory Stock Option Plan. This plan was subsequently adopted by the Company. The 2011 Plan is open to all employees of the Company and the Bank who have met certain eligibility requirements.

Under the 2011 Plan, as amended and restated as of July 1, 2012, eligible employees can purchase, through payroll deductions, shares of common stock at a discount. The right to purchase stocks is granted to eligible employees during a quarterly offer period that is established from time to time by the Board of Directors of the Company. Eligible employees cannot accrue the right to purchase more than $25 thousand worth of stock at the fair market value at the beginning of each offer period. Eligible employees also may not purchase more than one thousand five hundred (1,500) shares of stock in any one offer period. The shares are purchased at 85% of the fair market price of the stock on the enrollment date.

	At December 31, 2018		
Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	-	$ 8.71	1,393,294
Equity compensation plans not approved by security holders	-	$ -	-
Total	-	$ 8.71	1,393,294

ITEM 6. Selected Financial Data

	For the years ended December 31,				
	2018	2017	2016	2015	2014
	(Dollar and Share Amounts in Thousands, Except Per Share Data)				
INCOME STATEMENT DATA:					
Interest income	$90,042	$81,683	$75,549	$69,805	$66,478
Interest expense	2,120	2,195	2,143	1,894	3,760
Net interest income before provision for loan losses	87,922	79,488	73,406	67,911	62,718
Provision for loan losses	12,862	7,519	3,900	4,500	4,540
Net interest income after provision for loan losses	75,060	71,969	69,506	63,411	58,178
Non-interest income	15,719	16,563	13,892	10,992	10,813
Non-interest expense	75,027	70,352	64,129	59,047	55,675
Income before income taxes	15,752	18,180	19,269	15,356	13,316
Income tax expense	2,913	9,636	5,716	4,066	3,756
Net income	12,839	8,544	13,553	11,290	9,560
Preferred stock dividends	(546)	(552)	(49)	-	-
Net income attributable to common stockholders	$12,293	$7,992	$13,504	$11,290	$9,560
PER COMMON SHARE DATA:					
Basic net income	$1.28	$0.86	$1.46	$1.25	$1.08
Diluted net income	$1.28	$0.86	$1.46	$1.25	$1.08
Book value per common share	$14.36	$13.64	$13.21	$12.14	$11.44
Weighted average number of shares outstanding — basic	9,614	9,291	9,251	9,017	8,818
Weighted average number of shares outstanding — diluted	9,614	9,291	9,251	9,017	8,818
Shares outstanding at period end	9,646	9,414	9,268	9,241	8,929
BALANCE SHEET DATA:					
Securities	$454,777	$555,935	$520,927	$329,816	$337,904
Net loans	$1,212,141	$1,209,824	$1,158,045	$1,054,250	$967,399
Allowance for loan losses	$23,774	$17,279	$15,435	$14,159	$12,526
Goodwill and other intangible assets	$783	$783	$783	$783	$783
Total assets	$1,891,702	$1,965,946	$1,921,552	$1,544,284	$1,465,739
Total deposits	$1,728,823	$1,816,132	$1,778,670	$1,422,671	$1,355,514
Total stockholders' equity	$148,295	$138,147	$132,202	$112,142	$102,183
SELECTED PERFORMANCE RATIOS:					
Return on average assets	0.67 %	0.44 %	0.77 %	0.74 %	0.66 %
Return on average equity	8.86 %	6.24 %	11.22 %	10.50 %	9.78 %
Dividend payout	31.35 %	46.52 %	27.41 %	32.07 %	41.59 %
Equity to assets	7.84 %	7.03 %	6.88 %	7.26 %	6.97 %
Net interest margin	4.79 %	4.24 %	4.39 %	4.66 %	4.52 %

CAPITAL RATIOS:										
Total risk-based	13.33	%	12.49	%	12.61	%	12.45	%	11.83	%
Tier 1 risk-based	12.07	%	11.24	%	11.36	%	11.20	%	10.58	%
Tier 1 leverage	7.77	%	6.97	%	7.06	%	7.40	%	7.01	%
Common Equity Tier 1 risk-based	11.66	%	10.83	%	10.93	%	11.20	%	N/A	

ITEM 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of the Company and its wholly-owned subsidiary, the Bank. This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this Annual Report.

Executive Summary

This summary is intended to identify the most important matters on which management focuses when it evaluates the financial condition and performance of the Bank. When evaluating financial condition and performance, management looks at certain key metrics and measures. The Bank’s evaluation includes comparisons with peer group financial institutions and its own performance objectives established in internal planning processes.

The primary activity of the Bank is commercial banking, as it has been since the Bank opened in Guam in 1972. The Company’s operations are located entirely in the U.S. territories, the U.S.-affiliated nations of the western Pacific, and in the San Francisco Bay area of California. The largest community in the Bank’s western Pacific market is Guam, followed by the Commonwealth of the Northern Mariana Islands. The market includes a number of transportation-, travel- and tourism-related companies in the region, as well as substantial U.S. Department of Defense and other U.S. federal government activities in Guam. The Company’s customers are primarily transnational corporations, governments, closely-held businesses and individuals.

During 2018, there were five significant factors that impacted the Company’s financial condition and operations:

- Over the course of the year, tourist arrivals continued to increase in Guam and other islands in the region, excepting the Republic of Palau. In Guam, the number of visitors reached its highest level in history, at 1.55 million. This was due, in part, to the fact that a 9.2% decrease in Japanese arrivals was more than offset by increasing arrivals from South Korea, with the latter increasing by 9.1%. The continuing growth in Guam’s tourism industry and increasing arrivals in the other islands led to modest improvements in payroll employment and other aspects of the regional economy, enhancing the Bank’s business.
- The military buildup continues, and substantial funding is being provided for the relocation of U.S. Marines from Okinawa to Guam. Several contracts, totaling hundreds of millions of dollars, were executed during 2017 and 2018, and additional years of construction and related activity are expected to bring increased investment and income to Guam. Once completed, the activities that these projects support will provide a sustained contribution to the economy.
- Many of Guam’s resident construction workers have been absorbed by military construction projects, and the disinclination of the U.S. Department of Homeland Security to issue H-2B visas to temporary foreign construction workers has brought work on civilian projects nearly to a standstill. The resulting difficulty building new structures in the civilian community as existing structures age and are taken out of service has distorted Guam’s real estate market, causing developed land prices to rise while raw land prices decrease. In addition, many investment opportunities in the private sector that would have brought outside funds into the local economy have been lost, slowing the pace of Guam’s economic growth.
- The Commonwealth of the Northern Mariana Islands experienced two typhoons during 2018, and sustained substantial damage to housing, commercial buildings and public facilities. Bank of Guam offered the temporary suspension of loan payments in order to help the CNMI recover. Repairs to reconstruction of the islands’ infrastructure and superstructure continue through the date of this filing.
- The continuing strength of the economy in the San Francisco Bay area provided ample opportunities to expand the Bank’s business there, leading to an increase of 1.9% in the California region’s loan portfolio, supplementing 13.6% growth in loans in the Commonwealth of the Northern Mariana Islands and supporting overall growth of 0.7% in the

total loan portfolio, as loans in Guam decreased by 1.0%. The 3.8% decrease in the Bank's asset base reflected an 18.3% reduction of our investment portfolio, partially offset by an increase of 23.0% in our cash and cash equivalents. The 4.6% decrease in total liabilities during the year was partially offset by the 7.3% increase in our stockholders' equity.

For the year ended December 31, 2018, net income attributable to common stockholders was $12.3 million, or $1.28 per diluted common share. For the year ended December 31, 2017, net income was $8.0 million, or $0.86 per diluted common share. For the year ended December 31, 2016, net income was $13.5 million, or $1.46 per diluted common share.

The returns on average assets and average equity for the year ended December 31, 2018, were 0.67% and 8.86%, respectively, compared to 0.44% and 6.24%, respectively, for 2017, and 0.77% and 11.22%, respectively, for 2016.

The following are major factors that impacted the Company's results of operations:

- Net interest income increased 10.6% to $87.9 million for the year ended December 31, 2018, from $79.5 million for the year ended December 31, 2017, due to an $8.4 million increase in interest income that was enhanced by a reduction of $75 thousand in interest expense. Net interest income increased by 8.3% to $79.5 million for the year ended December 31, 2017, from $73.4 million for the year ended December 31, 2016, due to a $6.1 million increase in interest income that was partially offset by an increase of $52 thousand in interest expense.
- The net interest margin increased 54 basis points to 4.79% for the year ended December 31, 2018, compared with 4.24% for the year ended December 31, 2017. The increase in the net interest margin for 2018 compared to 2017 was primarily due to a 32 basis point increase in the average yields on loans, a 43 basis point increase in the average yield on our securities portfolio and a 49 basis point increase in the average yield on our deposits with other financial institutions; the average rates that we paid on deposits increased by 0.6 basis points. Despite the decrease in the overall average yield of 16 basis points on our total earning assets, higher loan and investment volumes generated higher interest income that more than offset the higher gross amount of interest paid on our customers' deposits.
- The provision for loan losses was $12.9 million for the year ended December 31, 2018, $5.3 million higher than the provision during 2017. The 2018 provision was increased to reflect the growth of $8.7million in our loan portfolio and as protection against possible losses in relation to a single large borrower that we expected to file and did file for Chapter 11 bankruptcy in January 2019. The provision is deemed by management to provide a sufficient allowance for loan losses due to the higher risk to the overall loan portfolio and to net losses of $6.4 million during the year. The provision for loan losses was $7.5 million for the year ended December 31, 2017, which was $3.6 million higher than the provision during the previous year. The provision for loan losses was $3.9 million for the year ended December 31, 2016, including $12 thousand assigned to the reserve for off-balance sheet risk.
- Non-interest income was $15.7 million for the year ended December 31, 2018, $844 thousand less than the $16.6 million for the year ended December 31, 2017. The decrease in non-interest income in 2018 compared to 2017 was primarily due to a reduction of $881 thousand in trustee fees and a reversal of $597 thousand in net investment securities gains, from a gain of $4 thousand in 2017 to a loss of $593 thousand in 2018, partially offset by a $448 thousand increase in other income and a $289 thousand increase in net cardholder income. The decrease in trustee fees represents a return to a more normal level after a large, one-time increase in 2017. The loss on the sale of investment securities occurred due to a need to replenish our liquidity after large withdrawals and funds transfers during the first half of 2018. Non-interest income was $16.6 million for the year ended December 31, 2017, $2.7 million more than the $13.9 million for the year ended December 31, 2016. The increase in non-interest income in 2017 compared to 2016 was primarily due to increases of $2.5 million in trustee fees, $792 thousand in service charges and fees, $314 thousand in net income from merchant services and a $257 thousand increase in other income, partially offset by an $813 thousand decrease in net cardholder income, and a reduction of $397 thousand in our realized gain on the sale of investment securities.
- Non-interest expense was $75.0 million for the year ended December 31, 2018, compared to $70.4 million for the year ended December 31, 2017. The increase of 6.6%, primarily due to an increase of $2.5 million in salaries and employee benefits, an additional $1.0 million in equipment and depreciation expense, a rise of $810 thousand in professional services expense, a $610 thousand increase in occupancy expense and an increase of $517 thousand in expenses related to other real estate owned, partially offset by a $742 thousand decrease in general, administrative and other expenses. Non-interest expense was $70.4 million for the year ended December 31, 2017, compared to $64.1 million for the year ended December 31, 2016. The increase of 9.7%, primarily due to an increase of $2.6 million in salaries and employee benefits, an additional $1.7 million in equipment and depreciation expense, a rise of $1.0 million in general, administrative and other expenses, and a $400 thousand increase in occupancy expenses.
- The 50.3% increase of net after tax income to $12.8 million in 2018 compared to $8.5 million 2017 was due to the $8.4 million increase in net interest income and the $6.7 million decrease in income tax expense, partially offset by

the $5.3 million increase in our provision for loan losses, the $4.7 million increase in non-interest expense and the $844 thousand decrease in non-interest income. The 37.0% decrease of net after tax income to $8.5 million in 2017 compared to $13.6 million in 2016 was due to the $6.2 million increase in non-interest expense, the $3.9 million increase in income tax expense and the $3.6 million increase in our provision for loan losses, offset by the $6.1 million increase in total interest income.

The following are important factors in understanding our current financial condition and liquidity position:

- Cash, interest-bearing deposits in other banks, and investment securities available-for-sale collectively decreased by $50.8 million (8.7%), to $536.1 million, at December 31, 2018, from $586.9 million at December 31, 2017. This decrease in liquid assets is due to a decrease of $79.7 million in securities available-for-sale, partially offset by a $24.7 million increase in interest bearing deposits in other banks and a $4.2 million increase in cash.
- Total assets decreased by $74.2 million (3.8%), from $1.97 billion at December 31, 2017, to $1.89 billion at December 31, 2018. This decrease was composed of a $101.3 million or 18.3% decrease in investment securities, to $449.1 million at December 31, 2018, compared to $550.5 million at December 31, 2017, and a decrease of $5.5 million in other assets to $44.6 million, partially offset by an increase of $29.0 million in cash and cash equivalents, from $126.1 million at December 31, 2017, to $155.1 million at December 31, 2018, and an increase of $2.3 million in net loans (net of deferred fees and the allowance for loan losses) during the same period. The increase in loans was primarily attributable to an increase of $24.4 million in gross commercial loans, to $844.4 million at the end of 2018 compared to $820.0 million a year earlier, partially offset by a decrease of $15.7 million in gross consumer loans, to $394.2 million at December 31, 2018, from $409.9 million at December 31, 2017. As the contra to the decrease of total assets, total liabilities decreased by $84.4 million, to $1.74 billion at December 31, 2018, based upon a decrease of $87.3 million in total deposits from the previous year end, partially offset by an increase of $2.9 million in other liabilities. Reducing the effect of the decrease in total liabilities, total stockholders’ equity increased by $10.1 million, composed of the $8.4 million increase in retained earnings and $2.7 million in additional paid-in common stock, offset by an increase of $1.1 million in accumulated other comprehensive loss.
- Classified assets increased to $74.5 million at December 31, 2018, compared to $32.2 million at December 31, 2017.
- The allowance for loan losses at December 31, 2018, was $23.8 million, or 1.92% of total gross loans. The allowance for loan losses at December 31, 2017, was $17.3 million, or 1.40% of total gross loans.
- Nonperforming loans decreased by $1.1 million to $7.1 million, or 0.57% of total gross loans, at December 31, 2018, from $8.1 million, or 0.66% of total gross loans, at December 31, 2017.
- Net loan charge-offs were $6.4 million during the year ended December 31, 2018, as compared to the $5.7 million in net charge-offs for the year ended December 31, 2017.
- The ratio of noncore funding of $14.2 million (which consists of $250,000 and over time deposits plus short-term borrowings) to total assets was 0.75% at December 31, 2018, compared to $16.5 million, or 0.84% of total assets, at December 31, 2017.
- The loan-to-deposit ratio increased to 71.6% at December 31, 2018, as compared to 67.7% at December 31, 2017, due to total gross loan growth of $8.7 million and the $87.3 million decrease in deposits.
- Capital ratios significantly exceed regulatory requirements for a well-capitalized financial institution, both at the Company level and in the Bank. The leverage ratio of the Company was 7.99%, with a Tier 1 risk-based capital ratio of 12.40%, a total risk-based capital ratio of 13.66%, and a common equity Tier 1 risk-based capital ratio of 11.61% at December 31, 2018. The leverage ratio at the Company was 7.19%, with a Tier 1 risk-based capital ratio of 11.58%, a total risk-based capital ratio of 12.83% and a common equity Tier 1 risk-based capital ratio of 10.78% at December 31, 2017. The leverage ratio at the Bank was 7.77%, with a Tier 1 risk-based capital ratio of 12.07%, a total risk-based capital ratio of 13.33%, and a common equity Tier 1 risk-based capital ratio of 11.66% at December 31, 2018. The leverage ratio at the Bank was 6.97%, with a Tier 1 risk-based capital ratio of 11.24%, a total risk-based capital ratio of 12.49% and a common equity Tier 1 risk-based capital ratio of 10.83% at December 31, 2017. The regulatory well-capitalized guidelines are a minimum of a 5% leverage ratio, an 8% Tier 1 risk-based capital ratio, a 10% total risk-based capital ratio, and a 6.5% common equity Tier 1 risk-based capital ratio. The changes in our capital ratios from December 31, 2017, to December 31, 2018, were due to the retention of $8.4 million in earnings during 2018.

Deposits

The composition and cost of the Bank’s deposit base are important in analyzing the Bank’s net interest margin and balance sheet liquidity characteristics. The Bank’s depositors are generally located in its primary market area.

Depending on loan demand and other funding requirements, the Bank also attracts deposits through its interest rate pricing. The Bank monitors all deposits that may be sensitive to interest rate changes to help ensure that liquidity risk does not become excessive due to deposit migration. Deposits at December 31, 2018, were $1.73 billion, compared to $1.82 billion at December 31, 2017. The 4.8% decrease was primarily due to the reductions of $44.3 million (9.0%) in deposits in the Freely Associated States of Micronesia, primarily due to the disbursement of funds from one large commercial depositor, $36.0 million (3.8%) in deposits in Guam, in the ordinary course of business, and $8.2 million (2.4%) in the Commonwealth of the Northern Mariana Islands, partially offset by an increase of $1.1 million (2.4%) in the Bank's deposits in the California region.

The Bank does not currently accept brokered deposits because it already maintains ample liquidity.

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. We believe that the Bank’s liquidity position is more than sufficient to meet our operating expenses, borrowing needs and other obligations for 2019, and management has tested and determined that, even under severely stressed scenarios, the Bank’s liquidity will be more than adequate to meet our requirements. Our liquidity decreased substantially during 2018. Once the increases in our loan portfolio and other assets were accommodated, the decrease in our liabilities and smaller increase in our equity were channeled into an increase in cash and cash equivalents, but together they did not fully offset the decrease in our available-for-sale investment securities. At December 31, 2018, we had $155.1 million in cash and cash equivalents and approximately $172.3 million in available borrowing capacity from various sources, including the Federal Home Loan Bank (“FHLB”), the Federal Reserve Bank of San Francisco (“FRB”), and Federal Funds facilities with several financial institutions. The Bank also had $168.9 million in unpledged securities available at December 31, 2018. Our loan-to-deposit ratio increased to 71.6% at December 31, 2018, compared to 67.7% at December 31, 2017, as our gross loans increased by 0.7% and our deposits decreased by 4.8%.

Lending

Our loans originate almost entirely through the branch offices located in our primary market. As the Bank approached a saturation point in our island service area, we expanded our activities in California through our branch in San Francisco. The total loan portfolio remains well diversified with commercial and industrial loans accounting for 19.7% and commercial real estate loans accounting for 45.3% of the total loan portfolio at December 31, 2018. Construction loans rose from 0.8% of the portfolio at December 31, 2017, to 3.2% at December 31, 2018. Residential mortgages and other consumer-related loans accounted for the remaining 31.8% of total loans at December 31, 2018. The increase in gross loans during 2018 compared to 2017 was primarily due to an increase of $24.4 million, or 3.0%, in our commercial loan portfolio, partially offset by a $15.7 million, or 3.8%, decrease in consumer loans. The Bank also had a decrease of $15.9 million in loans sold to the Federal Home Loan Mortgage Corporation (“Freddie Mac”) from $205.5 million at December 31, 2017, to $189.6 million at December 31, 2018, but these loans are off-book, except for the value of the associated mortgage servicing rights. The Bank exercises careful selectivity with respect to the types of loans it chooses to originate.

Net Interest Income

The management of interest income and expense is fundamental to the performance of the Company and the Bank. Net interest income, the difference between interest income and interest expense, is the largest component of the Bank’s total revenue. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets).

The Bank, through its asset and liability management policies and practices, as overseen by its Asset and Liability Committee, seeks to maximize net interest income without exposing itself to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest-bearing assets and liabilities. This is discussed in more detail under Liquidity and Asset/Liability Management. In addition, as the market allows, we take measures and initiatives to improve our net interest margin, including increasing loan rates, maintaining interest rate floors on floating rate loans, reducing nonperforming assets, managing deposit interest rates and reducing higher-cost deposits.

From January 22, 2008, through December 16, 2008, the Federal Reserve's Open Market Committee reduced its target short-term interest rates by 325 basis points, to a range of 0.00% to 0.25%, in response to the credit crisis and economic downturn that resulted from the collapse in the U.S. housing market and the subsequent global recession. The target Federal Funds Rate was raised to a range of 0.25% to 0.50% on December 16, 2015, then again to a range of 0.50% to 0.75% on December 15, 2016. During 2017, the target Federal Funds Rate was increased by 25 basis points three times, on March 15, June 14 and December 13, and four more times during 2018, on March 21, June 13, September 26 and December 19, ending in a target range from 2.25% to 2.50%. The increase in short-term rates has gradually affected the rates applicable to the Bank's floating rate loans. Despite the increase in short-term interest rates, the overall cost of interest-bearing deposits, which represent the Bank's primary funding source, decreased by 3.9% by the end of 2018, as deposits tend to re-price more slowly than floating rate loans and the decrease in higher-yielding deposits, such as savings accounts and certificates of deposit, was more than proportional to the overall decrease in deposits. The increase in the level of short-term interest rates, including the prime rate, has helped the Bank to increase its net interest margin, from 4.24% in 2017 to 4.79% in 2018.

Management of Credit Risk

We continue to proactively identify, quantify and manage our problem loans. Early identification of problem loans and potential future losses helps enable us to resolve credit issues with potentially less risk and lower ultimate losses. We maintain an allowance for loan losses in an amount that we believe is adequate to absorb probable and projected incurred losses in the portfolio. While we strive to carefully monitor and manage credit quality and to identify loans that may be deteriorating, circumstances can change at any time that may result in future losses for loans included in the portfolio, that as of the date of the financial statements have not yet been identified as potential problem loans. Through established credit practices, we adjust the allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that deteriorate, some of which could occur in an accelerated time frame. As a result, future additions to the allowance may be necessary. Because the loan portfolio contains a number of commercial loans, commercial real estate and construction loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers, such as have resulted due to changing economic conditions. Additionally, federal and local banking regulators throughout our market area, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses may have a material adverse effect on our financial condition and results of operation.

We also maintain a reserve against potential credit risks associated with our unfunded off-balance sheet loan commitments.

Further discussion of the management of credit risk appears under “Provision for Loan Losses” and “Allowance for Loan Losses”.

Capital Management

As part of its asset and liability management process, the Company continually assesses its capital position to take into consideration growth, expected earnings, risk profile and potential corporate activities that it may choose to pursue.

During the past several years, the Bank’s principal source of increases in capital has been retained earnings, supplemented by stock purchases through our Employee Stock Purchase Plan. See Note 14 of Notes to Consolidated Financial Statements in Item 15 of this Annual Report for a description of the Employee Stock Purchase Plan. Since the formation of the Company in 2011, though, the Bank’s assets have grown by 71.4%, prompting the Bank to seek additional sources of capital. Those more traditional sources of additional capital are finally catching up, having increased by 67.1% during the same period. A portion of the increase in capital was derived from the sale of additional common and preferred stock.

Although the Bank remains “well capitalized” by all four regulatory measures of capital adequacy, the Bank’s Tier 1 ratio had been decreasing because of its rapid asset growth, primarily attributed to the substantial growth in customer deposits. Consequently, the Company placed an additional $2.8 million of its common stock during, 2015, placed $9.8 million in non-cumulative perpetual preferred stock during 2016 and placed an additional $4.2 million of common stock in a registered public offering between September 29, 2017 and March 31, 2018.

In the 2015 and 2016 offerings, the Company issued its stock to certain "accredited investors" within the meaning of Rule 501 of the Securities Act of 1933, as amended (the "Securities Act") in reliance on the exemption from registration afforded under Section 4(2) of the Securities Act and Rule 504 of Regulation D under the Securities Act, at a purchase price of $9.85 per common share in 2015 and a purchase price of $1,000.00 per preferred share in 2016 (the "Private Offerings"). These were restricted shares, which could not be resold for a period of two years. The terms of the offerings were set forth in their respective Stock Purchase Agreements, dated July 30, 2015, and September 28, 2016, entered into between the Company and each investor. The stock offered in the Private Offerings has not been registered under the Securities Act or state securities laws, and may not be offered or sold in the United States without being registered with the SEC or through an applicable exemption from SEC registration requirements.

During the fourth quarter of 2017 and the first quarter of 2018, the Company issued an additional $4.2 million in common stock in an SEC-registered public offering at a purchase price of $12.25 per common share.

A portion of the proceeds from these offerings was used to retire subordinated debt, while the remainder will allow the Company to support the continued organic growth of its banking subsidiary in its existing market areas and will enable us to further serve the needs of individuals and businesses in those markets.

Results of Operations

The Bank earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less a provision for loan losses and interest expense on interest-bearing liabilities. The second is non-interest income, which primarily consists of service charges and fees, income from merchants for processing credit and debit card transactions, non-interest income from holders of the Bank's credit cards, trustee fees and net investment securities gains. The majority of the Company's non-interest expenses are operating costs that relate to providing a full range of banking services to our customers.

Distribution, Rate and Yield

The following Distribution, Rate and Yield table presents the average amounts outstanding during 2018 and 2017 for the major categories of the Company's balance sheet, the average interest rates earned or paid thereon, and the resulting net interest margin on average interest earning assets for the periods indicated. Average balances are based on monthly averages.

	Years Ended December 31,							
	2018				2017			
	Average Balance	Interest Earned/Paid	Average Yield/Rate		Average Balance	Interest Earned/Paid	Average Yield/Rate	
Interest earning assets:								
Short term investments[1]	$94,878	$ 1,202	1.27	%	$129,699	$ 1,009	0.78	%
Investment Securities[2]	503,180	9,682	1.92	%	549,508	8,217	1.50	%
Loans[3]	1,239,065	79,158	6.39	%	1,193,488	72,457	6.07	%
Total earning assets	1,837,123	90,042	4.90	%	1,872,695	81,683	4.36	%
Noninterest earning assets	86,959				84,985			
Total Assets	$1,924,082				$1,957,680			
Interest-bearing liabilities:								
Interest-bearing checking accounts	$266,061	$ 318	0.12	%	$274,615	$ 326	0.12	%
Money market and savings accounts	921,281	1,676	0.18	%	987,470	1,726	0.17	%
Certificates of deposit	32,708	116	0.35	%	44,165	143	0.32	%
Other borrowings	-	10	0.00	%	-	-	0.00	%
Total interest-bearing liabilities	1,220,050	2,120	0.17	%	1,306,250	2,195	0.17	%
Non-interest bearing liabilities	559,102				514,615			
Total Liabilities	1,779,152				1,820,865			
Stockholders' equity	144,930				136,815			
Total liabilities and stockholders' equity	$1,924,082				$1,957,680			
Net interest income		$ 87,922				$ 79,488		
Interest rate spread			4.73	%			4.19	%
Net interest margin			4.79	%			4.24	%

1

Includes interest bearing deposit balances we maintain with other financial institutions and the Federal Reserve Bank of San Francisco.

[2] Includes all investment securities in the Available-for-Sale and the Held-to-Maturity classifications.

[3] Includes average balances of non-accrual loans.

The Distribution, Rate and Yield table above sets forth the dollar amounts in interest earned and paid for each major category of interest earning assets and interest-bearing liabilities for the noted periods, as well as their respective yields and costs, and the resulting interest rate spreads and net interest margins.

The Bank's net interest margin, expressed as a percentage of average earning assets, was 4.79% for 2018, up 55 basis points from 4.24% for 2017, even as average earning assets decreased by 1.9% during the year, from $1.87 billion in 2017 to $1.84 billion in 2018. The reason for the increase in the net interest margin was that our funding cost decreased by 3.4%, from $2.2 million in 2017 to $2.1 million in 2018, while our average earning assets generated an increase of $8.4 million, from $81.7 million in 2017 to $90.0 million in 2018. Our average loan balances increased by $45.6 million, or 3.8%, and the average yield on the entire loan portfolio increased by 32 basis points so that interest earnings on loans increased by $6.7 million, or 10.2%. New loans made in a rising rate environment, as well as the repricing of outstanding variable rate loans, caused the increase in the average yield on the loan portfolio. Yields on our investment securities portfolio increased by 43 basis points and the yield on short term investments went up by 49 basis points. Average total interest-bearing liabilities decreased by 6.6% during 2018, to $1.22 billion from $1.31 billion the previous year.

Net interest income for the year ended December 31, 2018, increased by $8.4 million, to $87.9 million, compared to $79.5 million a year earlier, primarily due to an increase in interest income derived from the growth in our loan portfolio, supplemented by increases in earnings on average investment securities balances and our short term deposits in other banks, including the Federal Reserve Bank of San Francisco. Net interest income for 2017 increased by $5.9 million, to $79.5 million, compared to $73.4 million in 2016, primarily due to an increase in interest income derived from the growth in our investment securities portfolio, supplemented by increases in earnings on average loan balances and our short term deposits in other banks, including the Federal Reserve Bank of San Francisco. The Bank's net interest margin was 4.24% for 2017, down 15 basis points from 4.39% for 2016, even though average earning assets increased by 12.0% during the year, from $1.67 billion in 2016 to $1.87 billion in 2017.

A substantial portion of the Bank's earning assets are variable-rate loans that re-price when the Bank's reference rate, which usually corresponds with the New York prime lending rate, is changed. This is in contrast to a large base of core deposits that are generally slower to re-price. This causes the Bank's balance sheet to be asset-sensitive, which means that, all else being equal, net interest margin will be higher during periods when short-term interest rates are rising and lower when rates are falling. However, we will not necessarily have to raise rates on the personal savings portion of our core deposits as general market interest rates increase, increasing the sensitivity of our net interest margin to rising interest rates.

The following table provides information regarding the changes in interest income and interest expense, attributable to changes in rates and changes in volumes that contribute to the total change in net interest income for the years ending December 31, 2018 and 2017. Variances attributable to both rate and volume changes are equal to the change in rate times the change in average balance and are included below in the average volume column.

	Years Ended December 31, 2018 and 2017 (In thousands)		
		Attributable to:	
	Net Change in Interest Income/Expense	Change in Rate	Change in Volume
Interest income:			
Short term investments	$193	$634	$(441)
Investment Securities	1,465	2,356	(891)
Loans	6,701	3,789	2,912
Total interest income	$8,359	$10,102	$(1,743)
Interest expense:			
Interest-bearing checking accounts	$(8)	$2	$(10)
Money market and savings accounts	(50)	70	(120)
Certificates of deposit	(27)	14	(41)
Other borrowings	10	14	(4)
Total interest expense	$(75)	$100	$(175)

Net interest income	$8,434	$10,002	$(1,568)

Provision for Loan Losses

Credit risk is inherent in the lending business. The Bank establishes an allowance for loan losses through charges to earnings, which are shown in the statements of income as the provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is allocated monthly and evaluated quarterly through a determination of the adequacy of the Bank's allowance for loan losses, and reset if necessary, charging the shortfall, if any, to the current quarter's expense. This has the effect of creating variability in the amount and frequency of charges to the Bank's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Bank's market area.

For 2018, the Bank had a provision for loan and credit losses of $12.9 million, which included $6 thousand assigned to the reserve for unfunded credit commitments. The remaining 2018 provision was $5.3 million more than the provision for 2017, and higher than the provision of $3.9 million for 2016. The 2018 provision was increased to reflect the growth of $8.7million in our loan portfolio and as protection against possible losses in relation to a single large borrower that expected to file and did file for Chapter 11 bankruptcy in January 2019. The provision is deemed by management to provide a sufficient allowance for loan losses due to net chargeoffs of $6.4 million during the year, as well as to maintain the allowance for loan losses at a level that is adequate to absorb all reasonably expected future losses and to express management's perception of risk in the existing loan portfolio, as well as changes in the quality of that portfolio. The 2017 provision for loan losses increased by $3.6 million compared to the $3.9 million provision during 2016.

The allowance for loan losses represented 1.92%, 1.40% and 1.31% of total gross loans at December 31, 2018, 2017 and 2016, respectively. Provisions for loan losses are charged to operating income to bring the allowance for loan losses to a level deemed appropriate by the Bank based on the factors discussed under "Allowance for Loan Losses."

Non-interest income

The following table sets forth the various components of the Company's non-interest income:

	Years Ended December 31,		Increase (decrease) 2018 versus 2017		Year Ended December 31,	Increase (decrease) 2017 versus 2016	
	2018	2017	Amount	Percent	2016	Amount	Percent
	(Dollars in thousands)						
Non-interest income							
Service charges and fees	$6,550	$6,616	$(66)	-1.0 %	$ 5,824	$ 792	13.6 %
Investment securities gains (losses), net	(593)	4	(597)	-14925.0 %	401	(397)	-99.0 %
Income from merchant services	2,385	2,422	(37)	-1.5 %	2,108	314	14.9 %
Income from cardholders, net	1,230	941	289	30.7 %	1,754	(813)	-46.4 %
Trustee fees	2,548	3,429	(881)	-25.7 %	911	2,518	276.4 %
Other income	3,599	3,151	448	14.2 %	2,894	257	8.9 %
Total non-interest income	$15,719	$16,563	$(844)	-5.1 %	$ 13,892	$ 2,671	19.2 %

While net interest income remains the largest single component of total revenues, non-interest income is an important source, as well. In total, the Bank received $15.7 million in non-interest income during 2018, a decrease of $844 thousand from the $16.6 million recorded for 2017, but $2.7 million more than the $13.9 million received in 2016. The decrease from 2017 to 2018 was primarily due to an $881 thousand decrease in trustee fees to a more normal level after the recovery of significant revenues last year, and a loss of $597 thousand on the sale of securities that was necessitated by a need to supplement our liquidity. These decreases were partially offset by a $448 thousand increase in other income, along with a $289 thousand increase in our net income from cardholders. The decrease in trustee fees was substantially based on the unusual recovery of certain investment fees in 2017. Total non-interest income in 2017 was $2.7 million higher than in 2016, primarily because of increases of $2.5 million in trustee fees, $792 thousand in service charges and fees, $314 thousand in net income from merchant services and $257 thousand in other income, in part due to the implementation of a nominal fee for mailed paper account statements and in part to organic growth. These increases were partially offset by a decrease of $813 thousand in net income from cardholders due to an increase in fees and a decline of $397 thousand in net gains on the sale of securities because of a less favorable interest rate environment.

Non-interest expense

The following table sets forth the various components of the Company's non-interest expense:

	Years Ended December 31, 2018	2017	Increase (decrease) 2018 versus 2017 Amount	Percent	Year Ended December 31, 2016	Increase (decrease) 2017 versus 2016 Amount	Percent
	(Dollars in thousands)						
Non-interest expense:							
Salaries and employee benefits	$36,654	$34,171	$2,483	7.27 %	$ 31,618	$2,553	8.07 %
Occupancy	7,339	6,729	610	9.07 %	6,329	400	6.32 %
Equipment and depreciation	10,142	9,102	1,040	11.43 %	7,382	1,720	23.30 %
Insurance	1,759	1,665	94	5.65 %	1,625	40	2.46 %
Telecommunications	1,959	1,769	190	10.74 %	1,647	122	7.41 %
FDIC insurance assessment	1,330	1,477	(147)	-9.95 %	1,325	152	11.47 %
Professional services	2,686	1,876	810	43.18 %	1,999	(123)	-6.15 %
Contract services	1,759	1,899	(140)	-7.37 %	1,607	292	18.17 %
Other real estate owned	696	179	517	288.83 %	133	46	34.59 %
Stationery and supplies	855	790	65	8.23 %	926	(136)	-14.69 %
Training and education	1,062	1,167	(105)	-9.00 %	1,025	142	13.85 %
General, administrative and other	8,786	9,528	(742)	-7.79 %	8,513	1,015	11.92 %
Total non-interest expense	$75,027	$70,352	$4,675	6.65 %	$ 64,129	$6,223	9.70 %

The following table indicates the percentage of non-interest expense in each category:

	2018 Amount	Percent of Total	2017 Amount	Percent of Total	2016 Amount	Percent of Total
Non-interest expense:						
Salaries and employee benefits	$36,654	49 %	$34,171	49 %	$31,618	49 %
Occupancy	$7,339	10 %	6,729	10 %	6,329	10 %
Equipment and depreciation	$10,142	13 %	9,102	13 %	7,382	12 %
Insurance	$1,759	2 %	1,665	2 %	1,625	2 %
Telecommunications	$1,959	3 %	1,769	2 %	1,647	3 %
FDIC insurance assessment	$1,330	2 %	1,477	2 %	1,325	2 %
Professional services	$2,686	4 %	1,876	3 %	1,999	3 %

Contract services	$1,759	2	%	1,899	3	%	1,607	3	%
Other real estate owned	$696	1	%	179	0	%	133	0	%
Stationery and supplies	$855	1	%	790	1	%	926	1	%
Training and education	$1,062	1	%	1,167	2	%	1,025	2	%
General, administrative and other	$8,786	12	%	9,528	13	%	8,513	13	%
Total non-interest expense	$75,027	100	%	$70,352	100	%	$64,129	100	%

Management considers the control of operating expenses to be a critical element of the performance of the Company and the Bank. As in years past, the Bank has undertaken initiatives to contain its non-interest expense and improve its efficiency. Nevertheless, total non-interest expense was $75.0 million for the year ended December 31, 2018, compared to $70.4 million for the year ended December 31, 2017, an increase of $4.6 million. This increase was largely the result of higher costs associated with salaries and employee benefits, from $34.2 million in 2017 to $36.7 million in 2018, the rise in equipment and depreciation expense, an increase in professional services expense and the increased cost of our other real estate owned, which went up by $1.0 million, $810 thousand and $517 thousand, respectively. Those increases were only partially offset by a reduction of $742 thousand in general, administrative and other expenses. Operating expenses in 2017 were $6.2 million higher than in 2016, primarily due to increasing costs associated with salaries and employee benefits, from $31.6 million in 2016 to $34.2 million in 2017, the rise in equipment and depreciation expense and higher general administrative and other expenses, which increased by $1.7 million and $1.0 million, respectively.

Income Tax Expense

The Company computes its provision for income taxes on a monthly basis. The effective tax rate is determined by applying the Bank’s statutory income tax rate to pre-tax book income, as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include, but are not limited to, tax-exempt interest income, increases in the cash surrender value of life insurance policies, certain expenses that are not allowed as tax deductions, and tax credits.

The Bank pays income taxes in Guam and the Commonwealth of the Northern Mariana Islands under a territorial “mirror” of the U.S. Internal Revenue Code, with payments made to the respective territorial governments instead of the U.S. Treasury; there is no equivalent of a state income tax in either of these jurisdictions. The Bank also pays taxes to the governments of the Republic of Palau, the Federated States of Micronesia, the Republic of the Marshall Islands and the State of California. The Bank’s territorial and state income tax expense in 2018 was $2.9 million, as compared to an income tax expense of $9.6 million in 2017 and $5.7 million in 2016. The increase in 2017 was primarily due to a change in the valuation allowance for our deferred tax asset that resulted from the reduction in the maximum corporate income tax rate under the Tax Cuts and Jobs Act, which became law on December 22, 2017, and which was only partially offset by the reduction in our net income before taxes. The Tax Cuts and Jobs Act reduced the maximum corporate tax rate from 35% to 21% commencing on January 1, 2018.

The difference in the effective tax rate compared to the combined territorial, foreign and state statutory tax rate of 21% in effect for 2018 is primarily the result of the Bank’s portfolio of tax-exempt loans to the government of Guam totaling $14.1million and $25.9 million at December 31, 2018 and 2017, respectively.

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Bank’s actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the “deferred” portion of the Bank’s tax expense or benefit, which is accumulated on the Bank’s books as a deferred tax asset or deferred tax liability until such time as they reverse. At the end of the years 2018 and 2017, the Bank had a gross deferred tax asset of $6.9 million and $7.4 million, respectively.

Realization of the net deferred tax asset is primarily dependent upon the Bank generating sufficient taxable income to obtain a benefit from the reversal of net deductible temporary differences, utilization of tax credit carry-forwards and the net operating loss carry-forwards for Guam, the Commonwealth of the Northern Mariana Islands and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is “more likely than not” that a deferred tax asset will not be realized. The determination of whether the deferred tax assets will actually be realized is highly subjective and dependent upon judgment concerning management’s evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

In assessing the realization of deferred tax assets at December 31, 2018, based on these factors, the Bank believed that it was more likely than not that the Bank will realize only $6.9 million of the benefits of these deductible differences. Therefore, a valuation allowance of $2.2 million for its deferred tax asset was recorded at December 31, 2018.

In assessing the realization of deferred tax assets at December 31, 2017, the Bank believed that it was more likely than not that the Bank would realize only $5.5 million of the benefits of these deductible differences. Therefore, a valuation allowance of $2.0 million for the deferred tax asset was recorded at December 31, 2017.

Financial Condition

As of December 31, 2018, total assets were $1.89 billion, a decrease of 3.8% from $1.97 billion at December 31, 2017. Total securities available-for-sale (at fair value) were $381.0 million, a decrease of 17.3% from $460.8 million at December 31, 2017. The total loan portfolio, net of allowance for loan losses and deferred fees, was $1.21 billion, an increase of just $2.3 million, or 0.2% from $1.21 billion at year-end 2017. Interest bearing deposits in banks were increased by nearly one fourth during 2018, rising to $121.8 million from $97.1 million at the end of 2017. Total deposits were $1.73 billion, a reduction of 4.8% from $1.82 billion at year-end 2017. The Bank had no short-term borrowings at December 31, 2018.

Securities Portfolio

The following table reflects the estimated fair value of Available-for-Sale securities and the amortized cost of Held-to-Maturity securities, for each category for the past two years:

Investment Portfolio

	December 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities Available-for-Sale				
U.S. government agency and government sponsored enterprise (GSE) debt securities	$100,497	$ -	$ (1,587)	$98,910
U.S. government agency pool securities	213,055	24	(1,707)	211,372
U.S. government agency or GSE residential mortgage-backed securities	72,735	-	(1,975)	70,760
Total	$386,287	$ 24	$ (5,269)	$381,042
Securities Held-to-Maturity				
U.S. government agency and government sponsored enterprise (GSE) debt securities	$38,445	$ 46	$ (88)	$38,403
U.S. government agency pool securities	9,089	3	(80)	9,012
U.S. government agency or GSE residential mortgage-backed securities	20,554	29	(521)	20,062
Total	$68,088	$ 78	$ (689)	$67,477

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities Available-for-Sale				
U.S. government agency and government sponsored enterprise (GSE) debt securities	$105,407	$ -	$ (1,380)	$104,027
U.S. government agency pool securities	283,611	51	(1,319)	282,343
U.S. government agency or GSE residential mortgage-backed securities	75,560	-	(1,142)	74,418
Total	$464,578	$ 51	$ (3,841)	$460,788

Securities Held-to-Maturity				
U.S. government agency and government sponsored enterprise (GSE) debt securities	$45,178	$ 505	$ (113)	$45,570
U.S. government agency pool securities	11,756	33	(35)	11,754
U.S. government agency or GSE residential mortgage-backed securities	32,743	243	(311)	32,675
Total	$89,677	$ 781	$ (459)	$89,999

The amortized cost and fair value of investment securities by contractual maturity at December 31, 2018, are shown below.

	December 31, 2018			
	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due within one year	$19,996	$19,739	$11,975	$ 11,911
Due after one but within five years	83,671	82,323	32,511	32,512
Due after five but within ten years	98,465	97,339	13,995	13,769
Due after ten years	184,155	181,641	9,607	9,285
Total	$386,287	$381,042	$68,088	$ 67,477

The securities portfolio is the second largest component of the Bank's interest earning assets, and the structure and composition of this portfolio is important to an analysis of the financial condition of the Bank and the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Bank; and (iii) it is an alternative interest earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.

Eighty-five percent of the Bank's securities at December 31, 2018, were classified under existing accounting rules as "Available-for-Sale" to allow flexibility in the management of the portfolio. Accounting guidance requires Available-for-Sale securities to be marked to fair market value, with an offset to other comprehensive income (loss), a component of stockholders' equity, recorded on a quarterly basis. The remaining 15.2% of the investment portfolio was in Held-to-Maturity securities, which the Bank is willing and believes it will be able to retain until they mature, and which are recorded on an amortized cost basis.

The Bank's portfolio has historically been comprised primarily of: (i) U.S. government agency and sponsored entities' debt securities for liquidity and pledging; (ii) U.S. government agency and sponsored entities' mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; and (iii) U.S. government agency pool securities, which generally enhance the yield of the portfolio. Since the downgrade of many municipal obligations and their respective insurers in the past few years, the Bank no longer holds municipal bonds, but may do so again when markets become more stable.

Compared to December 31, 2017, the Bank's securities portfolio decreased by $101.3 million to 23.7% of total assets at December 31, 2018, from 28.0% at December 31, 2017. The Bank decreased its holding of mortgage-back securities by $15.8 million to $91.3 million at December 31, 2018, from $107.2 million at December 31, 2017. During the same period, the Bank's holdings of U.S. government agency pool securities decreased by $73.6 million, to $220.5 million, and its holdings of U.S. government agency and sponsored enterprise debt securities decreased by $11.9 million, to $137.4 million. The Bank has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

Loans

The Bank's loans represent the largest portion of earning assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when assessing the financial condition of the Bank and the Company.

Gross loans represented 65.5% of total assets at December 31, 2018, as compared to 62.6% at December 31, 2017. The ratio of gross loans to deposits increased to 71.6% at the end of 2018 from 67.7% at the end of 2017. Demand for loans has strengthened within the Bank's Northern Mariana and California markets, but has decreased slightly in our Freely Associated States and Guam markets. The 13.6% increase in gross loans outstanding in the CNMI is partially due to borrowing as a part of typhoon recovery efforts, while the 1.9% growth in California is due to continuing strength in the economy there.

The Loan Distribution table that follows sets forth the Bank's gross loans outstanding, deferred fee income amortized over the life of some loans, the allowance for loan losses and the percentage distribution in each loan category at the dates indicated.

Loan Portfolio

	December 31,			
	2018		2017	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Commercial				
Commercial & industrial	$243,465	19.7 %	$256,022	20.8 %
Commercial mortgage	560,827	45.3 %	553,125	45.0 %
Commercial construction	39,408	3.2 %	10,157	0.8 %
Commercial agriculture	688	0.1 %	716	0.1 %
Total commercial	844,388	68.2 %	820,020	66.7 %
Consumer				
Residential mortgage	138,923	11.2 %	137,962	11.2 %
Home equity	1,325	0.1 %	545	0.0 %
Automobile	26,686	2.2 %	30,490	2.5 %
Other consumer loans[1]	227,242	18.3 %	240,863	19.6 %
Total consumer	394,176	31.8 %	409,860	33.3 %
Gross loans	1,238,564	100.0 %	1,229,880	100.0 %
Deferred loan (fees) costs, net	(2,649)		(2,777)	
Allowance for loan losses	(23,774)		(17,279)	
Loans, net	$1,212,141		$1,209,824	

[1] Comprised of other revolving and installment credit and overdrafts.

Two-thirds of the Bank's loan portfolio is concentrated in commercial loans (which include loans to governments), primarily in commercial real estate, multifamily rentals, hotels and gas stations, with the balance in working capital and equipment financing. These are followed by other consumer loans and residential mortgages. The increase in the Bank's loan portfolio in 2018 was due to customary loan activity throughout our markets and the addition of two significant commercial construction loans in the Guam and CNMI regions. The Bank's gross loans were concentrated in Guam and San Francisco, at 85.3% of our gross loan portfolio as of December 31, 2018, compared to 85.9% as of December 31, 2017. The only industry concentration that was considered significant at December 31, 2018, was within our commercial mortgage loan portfolio, which at 45.3% of total gross loans constituted a higher proportion than the 45.0% of total loans at the end of 2017.

The Bank's commercial & industrial loans are made for working capital, financing the purchase of equipment and other business purposes. Commercial loans include loans with maturities ranging from thirty days to one year and "term loans" with maturities normally ranging from three to ten years. Short- term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally carry floating interest rates, with monthly payments of both principal and interest, but may be amortized over a longer period than the term of the loan, with a balloon payment at the end of the term.

The Bank is an active participant in the Small Business Administration (SBA), State Small Business Credit Initiative (SSBCI), Nor-Cal Financial Development Corp. and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred and Patriot Express Lender Programs. The Bank regularly makes such guaranteed loans, with an outstanding volume of $6.2 million at December 31, 2018.

As of December 31, 2018, commercial and residential real estate loans of $741.2 million consist primarily of adjustable and fixed rate loans secured by deeds of trust or mortgages on commercial and residential property, and comprised 59.8% of the total loan portfolio. The Bank's commercial mortgages at December 31, 2018, consist of $560.8 million, or 45.3% of gross loans. Commercial construction loans comprise $39.4 million, or 3.2%, of gross loans. Residential mortgages, including home equity loans, were $140.2 million, or 11.3% of gross loans. Properties securing the commercial and residential real estate loans are located in the Bank's primary markets, which include the San Francisco Bay area.

The Bank's commercial real estate loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust or mortgages on commercial and residential property to provide a secondary source of repayment. The Bank generally restricts commercial real estate term loans to no more than the lower of 75% of the property's appraised value or the purchase price of the property during the initial underwriting of the credit, depending on the type of property and its utilization. The Bank offers both fixed and floating rate loans. Maturities on commercial real estate loans are generally five years (with amortization up to twenty-five years and a balloon payment due at maturity), and maturities on residential mortgage loans are typically between 15 and 30 years, with many of those loans sold to the Federal Home Loan Mortgage Corporation with the retention of servicing rights. SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The Bank's construction loans primarily finance the development and construction of commercial and residential properties. The Bank uses underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans increased by $29.3 million to $39.4 million at December 31, 2018, from $10.2 million at December 31, 2017.

Additionally, the Bank makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Bank's consumer loans are either unsecured, secured by the personal property being purchased or, in the case of home equity loans, real property.

At December 31, 2018, total gross loans had increased during the year by $8.7 million, or 0.7%, to $1.24 billion from $1.23 billion at December 31, 2017. The increase was largely attributed to a $24.4 million increase in commercial loans to $844.4 million at December 31, 2018, from $820.0 million at December 31, 2017. This was primarily due to increases in commercial construction and commercial mortgage loans. The increase was partially offset by a $13.6 million decrease during 2018 in other consumer loans and a $3.8 million decrease in automobile loans.

At December 31, 2018, loans outstanding were comprised of approximately 67.2% variable rate loans and 32.8% fixed rate loans.

Since it first opened in 1972, the Bank has expanded its operations and its branch network, first in Guam, then in the other islands of our region and in San Francisco, California. In the interests of enhancing performance and stability through market and industry diversification, the Bank has increased its focus on growth in the San Francisco area in recent years, adding personnel with experience and expertise in the Bay Area. The following table provides figures for gross loans in the Bank's administrative regions for the years ending December 31, 2018, 2017 and 2016:

	At December 31,		
	2018	2017	2016
Guam	$697,722	$704,666	$720,479
Commonwealth of the Northern Mariana Islands	$90,291	$79,489	$75,658
The Freely Associated States of Micronesia *	$91,640	$93,560	$76,339
California	$358,911	$352,165	$303,531
Total	$1,238,564	$1,229,880	$1,176,007

* The Freely Associated States are comprised of the Federated States of Micronesia (Chuuk, Kosrae, Pohnpei and Yap), the Republic of Palau and the Republic of the Marshall Islands.

As the table indicates, the Bank's total gross loans increased by 0.7% during 2018 and by 4.6% during 2017. Total loans in the Commonwealth of the Northern Mariana Islands increased by $10.8 million, or 13.6%, accounting for the largest source of total portfolio growth during 2018. Loan growth in California was second, with growth at $6.7 million, or 1.9%, whereas outstanding loan balances in Guam decreased by $6.9 million, primarily in commercial loans due to the repayment of one government loan totaling $7.9 million and a decrease in consumer loans due to payoffs and pay downs. For the two years ended December 31, 2018, California accounted for 88.5% of total loan growth, while the Freely Associated States contributed 24.5% and the Commonwealth of the Northern Mariana Islands provided 23.4% of total gross loan portfolio growth during that two-year period. The economy in the Commonwealth of the Northern Mariana Islands is recovering from two major typhoons during 2018, which has increased demand for credit funding.

Loan Maturities

The following table presents the maturity distribution of the Bank's loans as of December 31, 2018. The table also shows the distribution of such loans between those with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the New York prime rate, as reflected in The Wall Street Journal, and the Bank of Guam prime rate.

	At December 31, 2018				
	Due in Less Than 1 Year	Due in More Than 1 Year But Less Than 5 Years	Due in More Than 5 Years	Non-Accrual	Total
	(Dollars in thousands)				
Commercial loans	$8,528	$ 305,696	$ 522,945	$ 7,219	$844,388
Residential Mortgages	1,349	11,868	122,145	4,886	140,248
Consumer Loans	20,075	123,816	109,759	278	253,928
Total	$29,952	$ 441,380	$ 754,849	$ 12,383	$1,238,564
Variable rate loans	$8,528	$ 250,272	$ 565,823	$ 7,785	$832,408
Fixed rate loans	21,424	191,108	189,026	4,598	406,156
Total	$29,952	$ 441,380	$ 754,849	$ 12,383	$1,238,564

Loan Servicing

As of December 31, 2018 and 2017, there were $189.6 million and $205.5 million, respectively, in Federal Home Loan Mortgage Corporation loans that were serviced by the Bank.

Loan servicing rights are included in Accrued Interest Receivable and Other Assets on the consolidated balance sheets, and are reported at their estimated fair value.

Nonperforming Assets

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Bank and generate the largest portion of its revenues, the Bank's management of credit risk is focused primarily on loan quality.

Banks have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts, and/or downturns in national and regional economies and declines in overall asset values, including real estate prices.

The Bank's credit policies identify allowable geographic credit concentrations. In addition, these policies establish the Bank's underwriting standards and the methods of monitoring credit quality on an ongoing basis. The Bank's internal credit risk controls are focused on underwriting practices, credit originating procedures, training, risk management techniques, and familiarity with loan customers, as well as the relative diversity and geographic concentration of our loan portfolio.

The Bank’s credit risk may also be affected by external factors, such as the level of interest rates, employment, general economic conditions, real estate values, and trends in particular industries or geographic markets. As an independent community bank serving a specific geographic area, the Bank must contend with the unpredictable changes in the general regional market and, particularly, primary local markets. The Bank’s asset quality has been affected in the past by the impact of national and regional recessions, consumer bankruptcies, and depressed real estate values.

Nonperforming assets are comprised of the following: loans for which the Bank is no longer accruing interest; restructured loans that are more than 90 days past due; loans 90 days or more past due and still accruing interest (although they are generally placed on non-accrual when they become 90 days past due, unless they are both well-secured and in the process of revision or collection); and other real estate owned (“OREO”) that is acquired through foreclosures. Management’s classification of a loan as “non-accrual” is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Bank stops accruing interest income, and reverses any uncollected interest that had previously been accrued. These loans may or may not be collateralized, and collection efforts are pursued. The Bank begins recognizing interest income again only as cash interest payments are received and it has been determined that the collection of all outstanding principal is no longer in doubt. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Bank believes the borrower will eventually overcome those circumstances and make full repayment. OREO consists of properties acquired by foreclosure or similar means that management is offering or will offer for sale. Total OREO, net of OREO reserves, was $1.5 million at December 31, 2018, compared to $2.4 million at December 31, 2017.

Nonperforming Assets

The following table provides information about nonperforming assets by asset type as of December 31, 2018 and 2017:

	December 31, 2018	December 31, 2017
	(Dollars in Thousands)	
Nonperforming Assets:		
Non-accrual loans past due 30 days or more	$5,089	$6,179
Loans past due 90 days or more still accruing	1,984	1,946
Restructured loans past due 30 days – not included above	-	-
Other Real Estate Owned, gross	1,543	2,466
Total Nonperforming Assets	$8,616	$10,591

The following table provides information about nonperforming loans by loan type:

	December 31, 2018	December 31, 2017
	(Dollars in Thousands)	
Nonperforming Loans:		
Commercial:		
Commercial & industrial	$544	$243
Commercial mortgage	1,471	1,167
Commercial construction	-	-
Commercial agriculture	-	-
Total commercial	2,015	1,410
Consumer:		
Residential mortgage	3,471	4,491
Home equity	91	-
Automobile	136	201
Other consumer [1]	1,360	2,023
Total consumer	5,058	6,715
Total nonperforming loans	$7,073	$8,125

[1] Comprised of other revolving and installment credit and overdrafts.

Allowance for Loan Losses

The Bank maintains its allowance for loan losses at a level which, in management's judgment, is adequate to absorb prospective credit losses inherent in the loan portfolio as of the balance sheet date. The amount of the allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature and volume of the portfolio, credit concentrations, trends in historical loss experience, the level of certain classified and impaired loans, and economic conditions, along with their related impacts on specific borrowers and industry groups. The allowance is increased by provisions for loan losses, which are charged against earnings, and reduced by charge-offs, net of recoveries. Because of uncertainties inherent in the estimation process, management's estimate of potential credit losses in the loan portfolio and the related allowance may change from time to time.

The Bank's allowance for loan losses increased by $6.5 million to $23.8 million during 2018 from $17.3 million at the end of 2017. The increase in the allowance for loan losses in 2018 was based primarily on increased net losses in our loan portfolio, particularly in consumer loans, a specific reserve for a commercial borrower that we expected to file and did file Bankruptcy in January 2019, and management's periodic reevaluation of the overall portfolio's inherent risk. The Bank had $8.2 million in charge-offs in 2018, which were partially offset by recoveries of previously charged-off loans of $1.8 million.

Net loans charged-off includes the realization of losses in the portfolio that were partially recognized previously through provisions for loan losses and write-downs of loan principal valuations. Net charge-offs were $6.4 million in 2018, compared to $5.7 million in 2017. The 2018 net was higher, also primarily due to higher charge-offs in the consumer loan portfolio. Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Bank will realize in the future.

The table in Note 6 to the Consolidated Financial Statements – Loans, under Credit Quality Indicators, provides a summary of the allocation of the allowance for loan losses for specific categories at the dates indicated. The allocation presented should not be interpreted as an indication that charges to the allowance for loan losses will be incurred in these amounts or proportions, or that the portion of the allowance allocated to each category represents the total amount available for charge-offs that may occur within these categories.

Allocation of Loan Loss Allowance

The material set forth in Note 6 of Notes to Consolidated Financial Statements in Item 15 of this Annual Report on Form 10-K is incorporated by reference.

Deposits

The composition and cost of the Bank's deposit base are important components in analyzing the Bank's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections in this report. The Bank's liquidity is impacted by the volatility of deposits or other funding instruments or, in other words, by the propensity of that money to leave the institution for interest rate-related or other reasons. Deposits can be adversely affected if economic conditions in the Bank's market area weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed $250,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

The following table summarizes the distribution of deposits for the periods indicated:

	December 31,	
	2018	2017
	(Dollars in Thousands)	
Non-interest bearing deposits	$538,168	$508,149
Interest bearing deposits:		
Demand deposits	281,582	288,977
Regular savings	670,640	713,802
Time deposits:		
$250,000 or more	14,201	16,528
Less than $250,000	21,986	23,832
Other interest bearing deposits	202,246	264,844
Total interest bearing deposits	1,190,655	1,307,983
Total Deposits	$1,728,823	$1,816,132

The Bank gathers deposits from among the communities it serves. The Bank's business is not generally seasonal in nature, and the Bank is not primarily dependent upon funds from sources outside the United States of America, but approximately 25.9% of its deposit base at December 31, 2018, is acquired in the Micronesian islands that are politically organized in free association with the United States and use the U.S. dollar as their currency. At December 31, 2018 and 2017, 33.2% and 35.1% of deposits, respectively, were from domestic and foreign government sources.

Non-interest and low interest-bearing demand deposits increased by $22.6 million, or 2.8%, to $819.7 million at December 31, 2018, compared to $797.1 million at December 31, 2017. Other interest bearing deposits, which are comprised of time deposit open accounts, decreased by $62.6 million, or 23.6%, to $202.2 million at December 31, 2018, compared to $264.8 million at December 31, 2017.

As mentioned earlier, the Bank has expanded its operations and its branch network since it first opened in 1972, first in Guam, then in the other islands of our region and in San Francisco, California. As time has passed, the Bank has gathered market share in each of the islands. In recent years, in order to diversify its geographic market, the Bank has increased its focus on growth in the San Francisco area. The following table provides figures for deposits in the Bank's administrative regions for the years ending December 31, 2018, 2017 and 2016:

	At December 31,		
	2018	2017	2016
Guam	$900,273	$936,237	$975,526
Commonwealth of the Northern Mariana Islands	$334,987	$343,149	$319,895
The Freely Associated States of Micronesia *	$447,011	$491,276	$431,865
California	$46,552	$45,470	$51,384
Total	$1,728,823	$1,816,132	$1,778,670

* The Freely Associated States are comprised of the Federated States of Micronesia (Chuuk, Kosrae, Pohnpei and Yap), the Republic of Palau and the Republic of the Marshall Islands.

During 2018, deposits decreased by a total of $87.3 million, of which $44.3 million was in the Bank's Freely Associated States branches, $36.0 million in our Guam branches and $8.2 million in our Commonwealth of the Northern Mariana Islands branches, only slightly offset by an increase of $1.1 million in the California region. Overall, the Bank's deposit base decreased by 4.8% during 2018, after rising by 2.1% during 2017. Deposits increased in the California region by 2.4% in the year ended December 31, 2018, after decreasing by 11.5% the previous year as a normal fluctuation of deposits in that market.

Deposit Maturity Distribution

At December 31, 2018, the scheduled maturities of time deposits were as follows:

Years ending December 31,	
2019	$30,306
2020	2,163
2021	1,075
2022	855
2023 and thereafter	1,788
Total	$36,187

The Bank provides and services government and business deposit accounts that are frequently more than $250,000 in average balance per account. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Bank to ensure its ability to fund withdrawals.

Off-Balance Sheet Arrangements

In the normal course of business, the Bank makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the associated contractual arrangements. These commitments are obligations that represent a potential credit risk to the Bank, yet are not reflected in any form within the Company's consolidated balance sheets other than in a modest contingency reserve against those commitments. Total unused commitments to extend credit were $163.8 million at December 31, 2018, as compared to $159.8 million at December 31, 2017. Unused commitments represented 13.2% of outstanding gross loans at December 31, 2018 and 13.0% at December 31, 2017.

The effect on the Bank's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted, because there is no certainty that these lines of credit will ever be fully utilized, if at all. For more information regarding the Company's off-balance sheet arrangements, see Note 16 to the financial statements located elsewhere herein.

The following table presents the Bank's commitments to extend credit for the periods indicated:

	December 31, 2018	December 31, 2017
Commitments to extend credit	$163,802	$159,767
Letters of credit:		
Standby letters of credit	$55,418	$54,707
Commercial letters of credit	3,070	2,601
Total	$58,488	$57,308

Contractual Obligations

The Bank utilizes facilities, equipment and land under various operating leases with original terms ranging from 1 to 99 years. Some of these leases include scheduled rent increases. The total amount of the rent is being expensed on the straight-line method over the lease terms. The Bank has recorded a deferred obligation of $1.0 million and $988 thousand as of December 31, 2018 and 2017, respectively, which has been included within other liabilities, to reflect the excess of rent expense over cash paid on the leases.

At December 31, 2018, annual lease commitments under the above noncancelable operating leases were as follows:

Years ending December 31,	
2019	$2,366
2020	2,364
2021	2,156
2022	1,752
2023 and thereafter	19,983
Total lease commitments	$28,621

The Bank leases certain facilities from two separate entities in which two of its directors have separate ownership interests. Lease payments made to these entities during the years ended December 31, 2018, 2017 and 2016, approximated $350 thousand, $371 thousand and $379 thousand, respectively.

Additionally, the Bank leases office space to third parties, with original lease terms ranging from 3 to 5 years and option periods ranging up to 15 years. At December 31, 2018, minimum future rents to be received under non-cancelable operating sublease agreements were $38 thousand, $26 thousand, $0 thousand and $0 thousand for the years ending December 31, 2018 , 2019, 2020 and 2021, respectively. Although it is possible that one or more of these leases will be renewed, there is no certainty upon which to base an estimate.

A summary of rental activities for years ended December 31, 2018, 2017 and 2016, is as follows:

	For the Years Ended December 31,		
	2018	2017	2016
Rent expense	$3,038	$2,852	$2,673
Less: sublease rentals	123	193	291
Net rent expense	$2,915	$2,659	$2,382

Liquidity and Asset/Liability Management

Liquidity refers to the Bank's ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely and cost-effective fashion. At various times the Bank requires funds to meet short-term cash requirements brought about by loan growth or deposit outflows, the purchase of assets, or liability repayments. The Bank's large base of core deposits is an integral part of its ability to manage its liquidity position appropriately. These core deposits are generated by offering traditional banking services in its service areas and have, historically, been a stable source of funds. To manage liquidity needs properly, cash inflows must be timed to coincide with anticipated outflows, or other sufficient liquid resources must be available to meet varying demands. The Bank manages cash and investment securities in order to be able to meet unexpected, sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Bank's interest margin. In order to meet short-term liquidity needs, the Bank may utilize overnight

Federal Funds purchases and other borrowing arrangements with correspondent banks, and use interest rate pricing to attract new deposits from local sources; it also maintains collateralized lines of credit with the FHLB and the FRB. In addition, the Bank can obtain cash for temporary needs by selling securities that it classifies as Available-for-Sale.

At December 31, 2018, the Bank had an increase in gross loans of $8.7 million from December 31, 2017. One of the measures of liquidity is our loan-to-deposit ratio, based upon gross loans, which increased to 71.6% at December 31, 2018, compared to 67.7% at December 31, 2017. Each calendar quarter, the Bank performs a six-month cash flow analysis to ensure that it will have sufficient liquidity to meet all of its potential cash obligations under a worst-case scenario, and maintains more than adequate liquidity under those hypothetical conditions.

FHLB, FRB and Other Borrowings and Available Lines of Credit

The Bank has off-balance sheet liquidity in the form of Federal Funds purchase arrangements with correspondent banks, as well as collateralized borrowing arrangements with the FHLB and the FRB. The Bank can borrow from the FHLB on a short-term (typically overnight) or long-term (more than one year) basis. At December 31, 2018, the Bank had no long-term borrowings. The Bank had an available line of credit of $133.5 million with the FHLB of Des Moines at December 31, 2018.

The Bank can also borrow from the FRB’s discount window. It had $22.5 million of investment securities pledged to the FRB San Francisco as collateral on an available line of credit of $21.8 million at December 31, 2018, none of which credit was outstanding.

At December 31, 2018, the Bank had arrangements for Federal Funds purchases of up to a total of $17.0 million from three of its U.S. correspondent financial institutions. The Bank had no Federal Funds purchases outstanding at December 31, 2018 and 2017.

At December 31, 2018, the Company had no other borrowed funds.

Capital Resources

The Bank is subject to various regulatory capital requirements administered by the United States federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank’s consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities and certain off-balance-sheet items, as calculated under regulatory accounting practices.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, Tier 1 and common equity Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2018 and 2017, that the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2018, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank’s category. The Bank’s actual capital amounts and ratios as of December 31, 2018 and 2017, are also presented in the table.

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The new capital standards under the U.S. adoption of Basel III establish a capital conservation buffer, which must consist entirely of common equity Tier 1 capital. The capital conservation buffer is being phased-in over four years beginning on January 1, 2016. The buffer was 0.625% of risk-weighted assets for 2016, 1.25% for 2017, and is 1.875% for 2018, and will be 2.5% for 2019 and thereafter. Failure to meet these standards could result in restrictions on our ability to pay dividends and to pay discretionary bonuses to executive management.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
At December 31, 2018:						
Total capital (to Risk Weighted Assets)	$163,198	13.329%	$ 120,909	9.875 %	$ 122,440	10.000 %
Tier 1 capital (to Risk Weighted Assets)	$147,788	12.070%	$ 96,421	7.875 %	$ 97,952	8.000 %
Tier 1 capital (to Average Assets)	$147,788	7.768 %	$ 76,098	4.000 %	$ 95,123	5.000 %
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$142,788	11.662%	$ 78,055	6.375 %	$ 79,586	6.500 %
At December 31, 2017:						
Total capital (to Risk Weighted Assets)	$151,699	12.490%	$ 112,347	9.250 %	$ 121,456	10.000 %
Tier 1 capital (to Risk Weighted Assets)	$136,521	11.240%	$ 88,056	7.250 %	$ 97,165	8.000 %
Tier 1 capital (to Average Assets)	$136,521	6.968 %	$ 78,373	4.000 %	$ 97,967	5.000 %
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$131,521	10.829%	$ 69,837	5.750 %	$ 78,946	6.500 %

Market Risk

Market risk is the risk of loss of future earnings, fair values or cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is an attribute of all market risk sensitive financial instruments, including securities, loans, deposits and borrowings, as well as a company's role as a financial intermediary in customer-related transactions. The objective of market risk management is to avoid excessive exposure of the company's earnings and equity to loss, and to reduce the volatility inherent in certain types of financial instruments.

Interest Rate Risk Management

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Bank's market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to monitor and limit earnings and balance sheet exposure to changes in interest rates. The Bank does not engage in the trading of financial instruments, and has only nominal direct exposure to currency exchange rate risk, but has indirect exposure to exchange rate risk because of the dominant position of foreign tourism in its primary markets.

The principal objective of interest rate risk management (often referred to as "asset/liability management") is to manage the financial components of the Bank's balance sheet, as well as their characteristics, in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. The Bank's exposure to market risk is reviewed on a monthly basis by its Asset and Liability Committee. Interest rate risk is the potential for economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while simultaneously maximizing income. Management realizes certain risks are inherent, and that the goal is to identify and manage those risks. Management uses two methodologies to manage interest rate risk: (i) a standard GAP analysis; and (ii) an interest rate shock simulation model.

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent that the maturities of assets and liabilities do not match in a changing interest rate environment, the net interest margin may change over time. Even with perfectly matched re-pricing of assets and liabilities, risks remain in the form of prepayment risk for some loans and securities, or in the form of risks of delays in the adjustment of interest rates applying to either earning assets with floating rates or to interest bearing liabilities. The Bank has generally been able to control its exposure to changing interest rates by maintaining a substantial proportion of its portfolio in floating interest rate loans and a majority of its time deposits with relatively short maturities.

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity gap report may not provide a complete assessment of the exposure to changes in interest rates.

The Bank uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on its net interest margin, and to calculate the estimated fair values of the Bank's financial instruments under different interest rate scenarios. The program utilizes current balances, interest rates, maturity dates and re-pricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for those instruments to project the effects of a given interest rate change on the Bank's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Bank's investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down) and ramped (with incremental increases or decreases in rates over a specified time period), based on current trends and forecasts, including stable economic conditions.

The following table sets forth the estimated changes in the Bank's net interest income that would result from the designated instantaneous parallel shifts in interest rates noted, as of December 31, 2018. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results. (Please note that, in the current interest rate environment, the larger reductions in rates presented in the analysis are unlikely to occur.)

	Increase/(Decrease) in Estimated Net Interest Income			
	Amount		Percent	
	(Dollars in thousands)			
Change in Interest Rates (basis points)				
+400	$ 33,263		37.18	%
+300	$ 23,948		26.77	%
+200	$ 15,957		17.84	%
+100	$ 8,002		8.94	%
± 0	$ -		0.00	%
-100	$ (8,808	)	-9.84	%
-200	$ (16,447	)	-18.38	%
-300	$ (20,890	)	-23.35	%
-400	$ (23,720	)	-26.51	%

These data do not reflect any actions that we may undertake in response to changes in interest rates, such as changes in rates paid on certain deposit accounts based on local competitive factors, which could improve or attenuate the actual impact on net interest income.

As with any method of gauging interest rate risk, there are certain shortcomings inherent to the methodology noted above. The model assumes interest rate changes are instantaneous, and result in parallel shifts in the yield curve. In reality, rate changes are rarely instantaneous. The use of the simplifying assumption that short-term and long-term rates change by the same degree also disregards historic rate change patterns, which rarely show parallel yield curve shifts. Further, the model assumes that certain assets and liabilities of similar maturity or period to re-pricing will react in the same way to changes in rates. In reality, certain types of financial instruments may react in advance of changes in market rates, while the reaction of other types of financial instruments may lag significantly behind the change in general market rates. Additionally, the methodology noted above does not reflect the full impact of annual and lifetime restrictions on changes in rates for certain assets, such as adjustable rate loans. When interest rates change, actual loan prepayments and actual early withdrawals from time certificates may deviate significantly from the assumptions used in the model. Finally, this methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan clients' ability to service their debt. All of these factors are considered in less formulaic ways in monitoring the Bank's exposure to interest rate risk.

Critical Accounting Policies

General

The Company’s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (generally accepted accounting principles, or “GAAP”). The financial information contained within our consolidated financial statements is, to a significant extent, based on approximate measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained, either when earning income, recognizing an expense, recovering an asset or relieving a liability. In certain instances, we use a discount factor and prepayment assumptions to determine the present value of assets and liabilities. A change in the discount factor or prepayment speeds could increase or decrease the values of those assets and liabilities, which would result in either a beneficial or adverse impact to our financial results. We use historical loss factors as one factor in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use. Other estimates that we use are related to the realization of our deferred tax assets and the expected useful lives of our depreciable assets. In addition, GAAP itself may change from one previously acceptable method to another, although the economics of our transactions would remain the same.

Fair Value of Securities

In accordance with GAAP, the Bank revalues the Available-for-Sale component of its investment portfolio on a quarterly basis, and records any unrealized gain or loss as an adjustment to other comprehensive income in its equity accounts. Held-to-Maturity securities are recorded at their amortized book value. The Bank also evaluates whether any of its security holdings are Other Than Temporarily Impaired (“OTTI”), but has determined that, as of December 31, 2018, none of its securities are deemed to be OTTI.

Allowance for Loan Losses

The allowance for loan losses is an estimate of the potential losses in our loan portfolio. Our accounting for estimated loan losses was previously discussed in this Item 7 under the heading, “Allowance for Loan Losses.”

Deferred Tax Assets

Our net deferred income tax asset arises from temporary differences between the carrying amount of assets and liabilities reported in the financial statements and the amounts used for income tax return purposes. Our accounting for Deferred Tax Assets was previously discussed under the heading “Income Tax Expense”.

ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk

As a financial institution, the Bank’s primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Bank’s assets and liabilities and the market value of all interest-earning assets, other than those which have a short term to maturity. Based upon the nature of the Bank’s operations, the Bank is not subject to significant direct foreign exchange or commodity price risks. The Bank has no market risk sensitive instruments, or any other financial instruments, that are held for trading purposes. As of December 31, 2018, the Bank did not use interest rate derivatives to hedge its interest rate risk.

The information concerning quantitative and qualitative disclosure about market risk called for by Item 305 of Regulation S-K is included as part of Item 7 of this Annual Report.

ITEM 8. Financial Statements and Supplementary Data

The response to this item is submitted as a separate section of this Annual Report. See Part IV, Item 15.

ITEM 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosures

As previously disclosed by the Company, on April 12, 2018, the Company engaged Squar Milner LLP (“Squar Milner”) as its independent registered public accounting firm to audit the Company’s consolidated financial statements, replacing Crowe Horwath LLP (“Crowe Horwath”) who was dismissed on the same date. Crowe Horwath had served as the Company’s independent registered public accounting firm since April 7, 2017.

At the time of Crowe Horwath’s dismissal, in connection with the audit of the Company’s financial statements for the year ended December 31, 2017, the Company and Crowe Horwath had been unable to agree regarding the adequacy of the Company’s allowance and provision for loan and lease losses (“ALLL”), the sufficiency of the Company’s access and change management controls related to the core operating system, the completeness and accuracy of system reports, and various other operational controls.

The Company is accounting for its ALLL differently than Crowe Horwath apparently would have required. The Company is unable to state the effect on its financial statements if such transaction had been accounted for in the manner which Crowe Horwath apparently would have concluded was required.

ITEM 9A. Controls and Procedures

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, (the “Exchange Act”) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (the “SEC”), and that such information is accumulated and communicated to our management, including our Interim Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognized that any system of controls and procedures, no matter how well designed and operated, can provide only a reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures in selecting those that we adopted.

In accordance with SEC rules, an evaluation was performed under the supervision and with the participation of our Interim Chief Executive Officer and Chief Financial Officer of the effectiveness, as of December 31, 2018, of the Company’s disclosure controls and procedures pursuant to Exchange Act Rules 13a-15(e) and 15d-15(e). Based on such evaluation, and in light of the material weakness discussed below under “Management’s Assessment of Internal Control Over Financial Reporting,” our Interim Chief Executive Officer and our Chief Financial Officer concluded that, as of December 31, 2018, our disclosure controls and procedures were not effective at the reasonable assurance level.

Internal Control Over Financial Reporting

Management’s Annual Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Internal control over financial reporting includes those written policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America;
- provide reasonable assurance that our receipts and expenditures are being made only in accordance with authorization of our management and Board of Directors; and,
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on our consolidated financial statements.

Internal control over financial reporting includes the controls themselves, monitoring and internal auditing practices, and actions taken to correct deficiencies as they are identified. Because of its inherent limitations, internal control over financial reporting may not prevent or detect all potential misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions or because the degree of compliance with the policies or procedures may deteriorate.

Management's Assessment of Internal Control Over Financial Reporting

Our management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2018, based on criteria for effective internal control over financial reporting described in "Internal Control – Integrated Framework (2013)" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management's assessment included an evaluation of the design and the testing of the operational effectiveness of the Company's internal control over financial reporting. Based on management's assessment, management concluded that the Company's internal control over financial reporting was not effective as of December 31, 2018, due to the material weakness identified below.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis. Based upon management's assessment, management believes that the following material weakness in our internal control over financial reporting existed as of December 31, 2018:

- While the Company's Information Security Officer monitors reports of the production environment to identify authorized and unauthorized usage, as well as employee access to key financial applications, the activity is not reviewed against supporting documentation to ensure that all changes are authorized, and one privileged user account was not adequately monitored.

Changes in Internal Control Over Financial Reporting

Other than efforts to remediate the material weakness noted in Item 9A. Controls and Procedures in our Annual Report on Form 10-K for the year ended December 31, 2017, there were no changes in our internal control over financial reporting during the year ended December 31, 2018, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

This Annual Report on Form 10-K does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to the rules of the SEC that permit the Company to provide only management's assessment in this Annual Report.

Remediation Plans

Management is dedicated to remediating the control deficiencies that gave rise to the material weakness in our internal control over financial reporting. In January 2019, we implemented a remediation plan with input from our independent auditors. Management must test and evaluate the new processes to determine whether they are designed and operating effectively. However, we cannot guarantee that the measures we have taken will remediate the identified material weakness or that any additional material weaknesses will not arise in the future.

ITEM 9B. Other Information

None.

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PART III

ITEM 10. Directors, Executive Officers and Corporate Governance

Pursuant to General Instruction G(3) of Form 10-K, the information required by this Item 10 is incorporated by reference from the information contained in our Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for our 2019 Annual Meeting of Stockholders (the "2019 Proxy Statement") under the sections entitled "Board of Directors – Nominees for Directors," "Executive Compensation – Executive Officers," "Board of Directors – Committees, Membership and Meetings," "Corporate Governance – Code of Ethics" and "Section 16(a) Beneficial Ownership Reporting Compliance."

ITEM 11. Executive Compensation

The information required by this Item 11 is incorporated by reference from the information contained in our 2019 Proxy Statement under the sections entitled "Board of Directors – Committees, Membership and Meetings," "Board of Directors – Director Compensation" and "Executive Compensation."

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item 12 is incorporated by reference from the information contained in our 2019 Proxy Statement under the sections entitled "Beneficial Ownership of Common Stock" and "Executive Compensation – Equity Compensation Plan Information."

ITEM 13. Certain Relationships and Related Transactions and Director Independence

The information required by this Item 13 is incorporated by reference from the information contained in our 2019 Proxy Statement under the sections entitled "Corporate Governance – Director Independence" and "Transactions with Related Persons."

ITEM 14. Principal Accountant Fees and Services

The information required by this Item 14 is incorporated by reference from the information contained in our 2019 Proxy Statement under the section entitled "Ratification of Selection of Independent Registered Public Accounting Firm."

PART IV

ITEM 15. Exhibits and Financial Statement Schedules
(a)(1) Financial Statements

The following financial statements are part of this report:

(a)(2) Financial Statement Schedules

All schedules to the Financial Statements are omitted because of the absence of the conditions under which they are required or because the required information is included in the Financial Statements or accompanying notes.

(b) Exhibits

The exhibit list required by this Item is incorporated by reference to the Exhibit Index included in this report.

ITEM 16. Form 10-K Summary
None.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report on Form 10-K to be signed on its behalf by the undersigned thereunto duly authorized.

BANKGUAM HOLDING COMPANY

BY: /s/ JOAQUIN P.L.G. COOK
Joaquin P.L.G. Cook
DATE: March 15, 2019 Interim President and Chief Executive Officer

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

Name	Title	Date
/s/ JOAQUIN P.L.G. COOK Joaquin P.L.G. Cook	Director, Interim President and Chief Executive Officer (Principal Executive Officer)	March 15, 2019
/s/ FRANCISCO M. ATALIG Francisco M. Atalig	Chief Financial Officer (Principal Financial Officer)	March 15, 2019
/s/ SYMON A. MADRAZO Symon A. Madrazo	Controller (Controller)	March 15, 2019
/s/ WILLIAM D. LEON GUERRERO William D. Leon Guerrero	Vice Chair of the Board, Executive Vice President, Chief Operating Officer and Director	March 15, 2019
/s/ MARIA EUGENIA H. LEON GUERRERO Maria Eugenia H. Leon Guerrero	Executive Vice President and Director	March 15, 2019
/s/ ROGER P. CROUTHAMEL Roger P. Crouthamel	Corporate Secretary and Director	March 15, 2019
/s/ MARTIN D. LEON GUERRERO Martin D. Leon Guerrero	Treasurer, Assistant Corporate Secretary and Director	March 15, 2019

/s/ PATRICIA P. ADA Patricia P. Ada	Director	March 15, 2019
/s/ FRANCES L.G. BORJA Frances L.G. Borja	Director	March 15, 2019
/s/ Keven F. CAMACHO Keven F. Camacho	Director	March 15, 2019
/s/ JOSEPH CRISOSTOMO Joseph Crisostomo	Director	March 15, 2019
/s/ Mark J. SABLAN Mark J. Sablan	Director	March 15, 2019
/s/ JOHN S. SAN AGUSTIN John S. San Agustin	Director	March 15, 2019

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors of BankGuam Holding Company.

Opinion on the Financial Statements

We have audited the accompanying consolidated statements of financial condition of BankGuam Holding Company and subsidiary (the Company) as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2018, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Squar Milner LLP

We have served as the Company's auditor since 2011.

San Diego, California

March 15, 2019

BankGuam Holding Company

Consolidated Statements of Financial Condition

(Dollar and Share Amounts in Thousands, Except Par Value)

	December 31, 2018	2017
ASSETS		
Cash and due from banks	$33,279	$29,033
Interest bearing deposits in banks	121,816	97,094
Total cash and cash equivalents	155,095	126,127
Restricted cash	400	400
Investment in unconsolidated subsidiary	3,291	3,167
Investment securities available-for-sale, at fair value	381,042	460,788
Investment securities held-to-maturity, at amortized cost (Fair Value $67,477 at 12/31/18 and $89,999 at 12/31/17, respectively)	68,088	89,677
Federal Home Loan Bank stock, at cost	2,356	2,303
Loans, net of allowance for loan losses ($23,774 and $17,279, respectively)	1,212,141	1,209,824
Accrued interest receivable	6,221	5,728
Premises and equipment, net	18,471	17,842
Other assets	44,597	50,090
Total assets	$1,891,702	$1,965,946
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Non-interest bearing	$538,168	$508,149
Interest bearing	1,190,655	1,307,983
Total deposits	1,728,823	1,816,132
Accrued interest payable	137	131
Other liabilities	14,447	11,536
Total liabilities	1,743,407	1,827,799
Commitments and contingencies (Note 16)		
Stockholders' equity:		
Common stock $0.2083 par value; 48,000 shares authorized; 9,679 and 9,446 shares issued and 9,646 and 9,414 shares outstanding at 12/31/18 and 12/31/17, respectively	2,017	1,969
Preferred stock $100 par value; 300 shares authorized; 9.8 shares issued	980	980

and outstanding		
Additional paid-in capital, Common stock	24,214	21,472
Additional paid-in capital, Preferred stock	8,803	8,803
Retained earnings	117,339	108,900
Accumulated other comprehensive loss	(4,768)	(3,687)
Common stock in treasury, at cost (32 shares)	(290)	(290)
Total stockholders’ equity	148,295	138,147
Total liabilities and stockholders’ equity	$1,891,702	$1,965,946

The accompanying notes are an integral part of the consolidated financial statements.

BankGuam Holding Company

Consolidated Statements of Income

(Dollar and Share Amounts in Thousands, Except Per Share Amounts)

	Years Ended December 31,		
	2018	2017	2016
Interest income:			
Loans	$79,158	$72,457	$69,914
Investment securities	9,682	8,217	5,142
Deposits with banks	1,202	1,009	493
Total interest income	90,042	81,683	75,549
Interest expense:			
Savings deposits	1,995	2,052	1,836
Time deposits	115	143	142
Other borrowed funds	10	-	165
Total interest expense	2,120	2,195	2,143
Net interest income	87,922	79,488	73,406
Provision for loan losses	12,862	7,519	3,900
Net interest income, after provision for loan losses	75,060	71,969	69,506
Non-interest income:			
Service charges and fees	6,550	6,616	5,824
(Loss) gain on sale of investment securities	(593)	4	401
Income from merchant services, net	2,385	2,422	2,108
Cardholders income, net	1,230	941	1,754
Trustee fees	2,548	3,429	911
Other income	3,599	3,151	2,894
Total non-interest income	15,719	16,563	13,892
Non-interest expense:			
Salaries and employee benefits	36,654	34,171	31,618
Occupancy	7,339	6,729	6,329
Equipment and depreciation	10,142	9,102	7,382
Insurance	1,759	1,665	1,625
Telecommunications	1,959	1,769	1,647
FDIC assessment	1,330	1,477	1,325
Professional services	2,686	1,876	1,999
Contract services	1,759	1,899	1,607
Other real estate owned	696	179	133
Stationery and supplies	855	790	926
Training and education	1,062	1,167	1,025
General, administrative and other	8,786	9,528	8,513
Total non-interest expense	75,027	70,352	64,129
Income before income taxes	15,752	18,180	19,269
Income tax expense	2,913	9,636	5,716
Net income	12,839	8,544	13,553

Preferred stock dividend	(546)	(552)	(49)
Net income attributable to common stockholders	$12,293	$7,992	$13,504
Earnings per common share:			
Basic	$1.28	$0.86	$1.46
Diluted	$1.28	$0.86	$1.46
Dividends declared per common share	$0.40	$0.40	$0.40
Basic weighted average common shares	9,614	9,291	9,251
Diluted weighted average common shares	9,614	9,291	9,251

The accompanying notes are an integral part of the consolidated financial statements.

BankGuam Holding Company

Consolidated Statements of Comprehensive Income

(Dollar Amounts in Thousands)

	Years Ended December 31,		
	2018	2017	2016
Net income	$12,839	$8,544	$13,553
Other comprehensive (loss) income:			
Unrealized holding (loss) gain on available-for-sale securities arising during the period, net of tax	(2,235)	(346)	169
Reclassification for loss (gain) realized on available-for-sale securities	593	(4)	(401)
Amortization of post-transfer unrealized holding loss on held-to-maturity securities during the period, net of tax	561	435	443
Total other comprehensive (loss) income	(1,081)	85	211
Total comprehensive income	$11,758	$8,629	$13,764

The accompanying notes are an integral part of the consolidated financial statements.

BankGuam Holding Company

Consolidated Statements of Stockholders' Equity

(Dollar Amounts in Thousands, Except Number of Shares)

	Number of Common Shares	Common Stock	Preferred Stock	Paid-in Capital - Common	Paid-in Capital - Preferred	Retained Earnings	Accumulated Other Comprehensive Income/(loss)	Treasury Stock	Total
Balances, January 1, 2016	9,240,887	$ 1,933	$ -	$ 19,659	$ -	$ 94,823	$ (3,983)	$ (290)	$ 112,142
Comprehensive income:									
Net income	-	-	-	-	-	13,553	-	-	13,553
Change in accumulated other comprehensive income:									
Unrealized loss on available-for-sale securities	-	-	-	-	-	-	211	-	211
Issuance of Restricted Stock	26,909	5	-	258	-	-	-	-	263
Common stock issued under Employee Stock Purchase Plan & Service Awards	-	-	980	-	8,803	-	-	-	9,783
Cash dividends on common stock	-	-	-	-	-	(3,701)	-	-	(3,701)
Cash dividends on preferred stock	-	-	-	-	-	(49)	-	-	(49)
Balances, December 31, 2016	9,267,796	1,938	980	19,917	8,803	104,626	(3,772)	(290)	132,202
Comprehensive income:									
Net income	-	-	-	-	-	8,544	-	-	8,544
Change in accumulated other comprehensive									

income:									
Unrealized gain on available-for-sale securities	-	-	-	-	-	-	85	-	85
Common stock issued under Employee Stock Purchase Plan & Service Awards	23,886	5	-	249	-	-	-	-	254
Common stock issued	122,276	26	-	1,306	-	-	-	-	1,332
Cash dividends on common stock	-	-	-	-	-	(3,718)	-	-	(3,718)
Cash dividends on preferred stock	-	-	-	-	-	(552)	-	-	(552)
Balances, December 31, 2017	9,413,958	1,969	980	21,472	8,803	108,900	(3,687)	(290)	138,147
Comprehensive income:									
Net income	-	-	-	-	-	-	-	-	12,839
Change in accumulated other comprehensive income:									
Unrealized gain on available-for-sale securities	-	-	-	-	-	-	(1,081)	-	(1,081)
Common stock issued under Employee Stock Purchase Plan & Service Awards	14,563	3	-	145	-	-	-	-	148
Common stock issued	217,823	45	-	2,597	-	-	-	-	2,642
Cash dividends on common stock	-	-	-	-	-	-	-	-	(3,854)
Cash dividends on preferred stock	-	-	-	-	-	-	-	-	(546)
Balances, December 31, 2018	9,646,344	$ 2,017	$ 980	$ 24,214	$ 8,803	$ -	$ (4,768)	$ (290)	$ 148,295

The accompanying notes are an integral part of the consolidated financial statements.

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BankGuam Holding Company

Consolidated Statements of Cash Flows

(Dollar Amounts in Thousands)

	Years Ended December 31,		
	2018	2017	2016
Cash flows from operating activities:			
Net income	$12,839	$8,544	$13,553
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	12,862	7,519	3,900
Depreciation	3,640	3,401	3,397
Amortization of fees, discounts and premiums	1,263	1,371	1,470
(Loss) gain on sales of other real estate owned, net	(34)	(49)	24
Proceeds from sales of loans held for sale	5,670	17,763	18,614
Origination of loans held for sale	(5,670)	(17,763)	(18,614)
Increase (decrease) in mortgage servicing rights	125	376	(65)
Realized loss (gain) on sale of available-for-sale securities	593	(4)	(401)
Realized gain on sale of premises and equipment	(9)	-	(18)
Income from equity investment in unconsolidated subsidiary	(527)	(423)	-
Dividends received from unconsolidated subsidiary	403	281	50
Net change in operating assets and liabilities:			
Accrued interest receivable	(493)	(970)	(659)
Other assets	5,250	(8,466)	(7,643)
Accrued interest payable	6	9	9
Other liabilities	2,911	977	1,199
Net cash provided by operating activities	38,829	12,566	14,816
Cash flows from investing activities:			
Acquisition of an unconsolidated subsidiary	-	-	(3,075)
Purchases of available-for-sale securities	(88,496)	(141,364)	(261,992)
Purchases of held-to-maturity securities	-	-	(4,036)
Proceeds from sales of available-for-sale securities	94,752	35,623	39,951
Maturities, prepayments and calls of available-for-sale securities	70,392	63,493	28,839
Maturities, prepayments and calls of held-to-maturity securities	21,750	6,548	8,389
Loan originations and principal collections, net	(15,297)	(59,074)	(107,430)
(Costs of) proceeds from FHLB stock (purchase) redemption	(53)	(448)	(93)
Proceeds from sales of other real estate owned	280	768	1,517
Proceeds from sales of premises and equipment	9	19	18
Purchases of premises and equipment	(4,279)	(3,433)	(3,347)
Net cash provided by (used in) investing activities	79,058	(97,868)	(301,259)
Cash flows from financing activities:			
Net (decrease) increase in deposits	(87,309)	37,462	355,999

Proceeds from issuance of common stock	2,790	1,586	263
Proceeds from issuance of preferred stock	-	-	9,783
Dividends paid	(4,400)	(4,270)	(3,750)
Net cash (used in) provided by financing activities	(88,919)	34,778	362,295
Net change in cash, cash equivalents and restricted cash	28,968	(50,524)	75,852
Cash, cash equivalents and restricted cash at beginning of period	126,527	177,051	101,199
Cash, cash equivalents and restricted cash at end of period	$155,495	$126,527	$177,051
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest	$2,103	$2,183	$1,971
Income taxes	3,979	7,549	7,040
Supplemental disclosure of noncash investing and financing activities:			
Net change in unrealized loss on held-to-maturity securities, net of tax	561	435	445
Net change in unrealized (loss) gain on available-for-sale securities, net of tax	(1,643)	(349)	(234)
Other real estate owned transferred from loans, net	-	569	821
Other real estate owned transferred to loans, net	(118)	(342)	(197)

The accompanying notes are an integral part of the consolidated financial statements.

BankGuam Holding Company

Notes to Consolidated Financial Statements

(In thousands, except per share data)

Note 1 – Nature of Business

Organization

The accompanying condensed consolidated financial statements include the accounts of BankGuam Holding Company ("Company") and its wholly-owned subsidiaries, Bank of Guam ("Bank") and BankGuam Investment Services ("BGIS") (formerly BankGuam Investment and Insurance Services). The Company is a Guam corporation organized on October 29, 2010, to act as the holding company of the Bank, a Guam banking corporation, a 22-branch bank serving the communities in Guam, the Commonwealth of the Northern Mariana Islands (CNMI), the Federated States of Micronesia (FSM), the Republic of the Marshall Islands (RMI), the Republic of Palau (ROP), and San Francisco, California. BankGuam Investment Services was incorporated in Guam in 2015 and initially capitalized during the first quarter of 2016. During July 2016, the Company executed an agreement to purchase 25% of ASC Trust Corporation.

Other than holding the shares of the Bank, BGIS and ASC Trust Corporation, the Company conducts no significant activities, although it is authorized, with the prior approval of its principal regulator, the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), to engage in a variety of activities related to the business of banking. Currently, substantially all of the Company's operations are conducted and substantially all of the assets are owned by the Bank, which accounts for substantially all of our consolidated revenues, expenses and operating income. The Bank provides a variety of financial services to individuals, businesses and governments through its branches. The Bank's headquarters is located in Hagåtña, Guam. The Bank currently has eleven branches in Guam, four in the CNMI, four in the FSM, one in the RMI, one in the ROP, and one in San Francisco, California. The Bank's primary deposit products are demand deposits, savings and time certificate accounts, and its primary lending products are consumer, commercial and real estate loans.

For ease of reference we will sometimes refer to the Company hereinafter as "we", "us" or "our."

Note 2 – Summary of Significant Accounting Policies

Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles in effect in the United States ("GAAP"), on a basis consistent with prior periods. Certain prior period amounts have been reclassified to conform to current year presentation.

The consolidated financial statements include the accounts of BankGuam Holding Company, the Bank, BGIS, and the Bank's wholly owned subsidiaries, BankGuam Properties, Inc. and BankGuam Insurance Underwriters, Ltd. All significant intercompany and inter-branch balances and transactions have been eliminated in consolidation.

Assets held by the Bank's Trust and Wealth Management departments in a fiduciary capacity are not assets of the Bank, and, accordingly, are not included in the accompanying consolidated financial statements.

The Company's investment in ASC Trust Corporation is accounted for under the equity method of accounting.

Use of Estimates

The preparation of consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the periods presented. Actual results could differ from those estimates.

Cash Flows

Net cash flows are reported for customer loan and deposit transactions, notes payable and other short term borrowings.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash on hand and balances due from banks, Federal Funds sold, cash items in transit and interest bearing deposits with other banks. The Bank is required by the Federal Reserve System to maintain cash reserves against certain of its deposit accounts. At December 31, 2018 and 2017, the required combined reserves totaled approximately $39.2 million and $32.2 million, respectively.

Restricted Cash

Interest-bearing deposits in banks that mature within one year are carried at cost. $150 thousand of these deposits are held by the Bank jointly under the names of Bank of Guam and the Guam Insurance Commissioner, and serve as a bond for the Bank of Guam Trust Department, and $250 thousand of these deposits are held by the Bank of Guam and are pledged for the Banker's Loan Processing (BLP) program with one of its correspondent banks in San Francisco.

Investment Securities

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as "held-to-maturity," and are recorded at amortized cost. Securities not classified as held-to-maturity, including equity securities with readily determinable fair value, are classified as "available-for-sale" and are recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. The Bank does not hold securities for trading purposes.

Declines in the fair value of securities below their cost that are other than temporary are reflected in earnings as realized losses. In determining other-than-temporary losses, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment, and is based on the information available to management at the time such a determination is made.

Federal Home Loan Bank Stock

The Bank is required to hold non-marketable equity securities, comprised of Federal Home Loan Bank of Des Moines ("FHLB") stock, as a condition of membership. These securities are accounted for at cost, which equals par or redemption value. Ownership is restricted and there is no market for these securities. These securities are redeemable at par by the issuing government supported institutions. The primary factor supporting the carrying value is the commitment of the FHLB to perform its obligations, which includes providing credit and other services to the Bank.

Mortgage Servicing Rights (MSR)

Mortgage servicing assets, included in other assets in the consolidated statements of financial condition, are recognized separately when rights are acquired through the sale of mortgage loans. Under the servicing assets and liabilities accounting guidance in ASC Topic 860, "Transfers and Servicing", servicing rights resulting from the sale of loans originated by the Bank are measured at fair value at the date of transfer. The Bank subsequently measures each class of servicing assets using the fair value method. Under the fair value method, the servicing rights are carried in the statements of financial condition at fair value and the changes in fair value are reported in earnings in the period in which the changes occur. Servicing fee income is recorded as fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal, and are recorded as income when earned.

Loans Held for Investment

Loans held for investment generally are reported at their outstanding unpaid principal balances, adjusted for charge-offs, an allowance for loan losses, and any deferred fees or costs on the originated loans, as well as unamortized premiums or discounts on purchased loans, except for certain purchased loans that fall under the scope of Accounting Standards Codification (ASC) Topic 310-30, "Accounting for Loans and Debt Securities Acquired with Deteriorated Credit Quality".

Interest income is accrued on the unpaid principal balance of loans. Loan origination fees, net of certain direct origination costs, are deferred and recognized as income using the effective interest method over the contractual life of the loans. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Credit card loans and other unsecured consumer loans are typically charged off no later than when they are 180 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on non-accrual or charged-off are reversed against current period interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loan Origination Fees and Costs

All loan origination fees and related direct costs are deferred and amortized to interest income as an adjustment to yield over the respective lives of the loans using the effective interest method, except for loans that are revolving or short-term in nature for which the straight line method is used, which approximates the interest method.

Allowance for Loan Losses, Impaired Loans and Troubled Debt Restructurings

The allowance for loan losses is established as losses are estimated to be likely, and is funded through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is first determined by analyzing all classified loans (Substandard and Doubtful) in non-accrual for loss exposure and establishing specific reserves, as needed. ASC 310-10 defines loan impairment as the existence of uncertainty concerning collection of all principal and interest per the contractual terms of a loan. For collateral-dependent loans, impairment is typically measured by comparing the loan amount to the fair value of collateral, less costs to sell, with a specific reserve established for the "shortfall" amount. Other methods can be used in estimating impairment (market price or present value of expected future cash flows discounted at the loan's original interest rate).

The allowance for loan losses is management's estimate of credit losses inherent in the loan portfolio at the balance sheet date. The Company has established a process to determine the appropriateness of the allowance for credit losses that assesses the losses inherent in the loan portfolio. The Company develops and documents its allowance methodology at the portfolio segment level – commercial loan, residential mortgage and consumer loan portfolios. While portions of the allowance are attributable to the respective commercial, residential mortgage and consumer portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

In situations where, for economic or legal reasons related to a borrower's financial difficulties, the Bank will grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a troubled debt restructuring (TDR). These modified terms may include rate reductions, principal forgiveness, term extensions, payment forbearance and other actions intended to minimize economic loss and to avoid foreclosure or repossession of the collateral, if applicable. For modifications where principal is forgiven, the entire amount of such principal forgiveness is immediately charged off. Loans classified as TDRs, including loans in trial payment periods (trial modifications), are considered impaired loans. Other than resolutions such as foreclosures, the Bank may remove loans held for investment from TDR classification, but only if they have been refinanced or restructured at market terms and qualify as a new loan.

Loans Held for Sale

In its normal course of business, the Bank originates mortgage loans held for sale to the Federal Home Loan Mortgage Corporation ("FHLMC" or "Freddie Mac"). The Bank has elected to measure its residential mortgage loans held for sale at the lower of cost or market. Origination fees and costs are recognized in earnings at the time of origination for newly originated loans held for sale, and the loans are sold to Freddie Mac at par. The Bank recognizes gains on the sale of loans sold to Freddie Mac only to the extent of MSRs retained in such sales.

During the years ended December 31, 2018, 2017 and 2016, the Bank originated and sold approximately $5.7 million, $17.8 million and $18.6 million, respectively, of the above-mentioned loans. At December 31, 2018, the Bank held 26 FHLMC loans in its inventory. Those loans with a total value of $5.7 million were sold to FHLMC by January 11, 2019.

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit and standby letters of credit. Such financial instruments are recorded as off-balance sheet items when the commitment is made, then recorded as balance sheet items if and when funded (See Note 16).

Premises and Equipment

Premises and equipment are reported at cost, less accumulated depreciation and amortization. Depreciation and amortization are computed on the straight-line method over the estimated useful lives of the related assets. Depreciation expense has been computed principally using estimated lives of 15 to 40 years for premises and 3 to 10 years for furniture and equipment. Leasehold improvements are depreciated over the estimated lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured.

Construction-in-progress consists of accumulated direct and indirect costs associated with the Bank's construction of premises and the purchase of equipment that has not yet been placed in service and, accordingly, has not yet been subjected to depreciation. Such assets begin depreciation over their estimated useful lives when completed and placed in service.

Premises and equipment are periodically evaluated for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of premises and equipment are less than their carrying amount. In that event, the Bank records a loss for the difference between the carrying amount and the estimated fair value of the asset based on appraised values or quoted prices.

Other Real Estate Owned

Properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the fair value of the property, reduced by estimated selling costs. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value, less the estimated cost to sell. Other real estate owned is estimated using the appraised value of the underlying collateral, discounted as necessary due to management's estimates of changes in economic conditions, less estimated costs to sell. A valuation allowance is increased by provisions charged to earnings. Subsequent write-downs, income and expenses incurred in connection with holding such assets, and gains and losses realized from the sale of such assets, are charged to the valuation allowance.

Goodwill

Goodwill is recorded in business combinations under the purchase method of accounting when the purchase price is greater than the fair value of net assets, including identifiable intangible assets. The Bank will assess goodwill for impairment at a reporting unit level on an annual basis or more frequently in certain circumstances. The Bank has the option of performing a qualitative assessment of goodwill, or to bypass the qualitative test and proceed directly to a quantitative test. If the Bank performs a qualitative assessment of goodwill to test for impairment and concludes it is more likely than not that a reporting unit's fair value is greater than its carrying amount, quantitative tests are not required. However, if it is determined it is more likely than not that a reporting unit's fair value is less than its carrying amount, then the Bank completes a quantitative assessment to determine if there is goodwill impairment. The Bank can apply various quantitative valuation methodologies, including discounted cash flow and earnings multiple approaches, to determine the estimated fair value, which is compared to the carrying value of each reporting unit. If the fair value is less than the carrying amount, an additional test is required to measure the amount of impairment. Based on the Bank's year-end evaluation, no goodwill impairment was recorded.

Income Taxes

Income taxes represent taxes recognized under laws of the Government of Guam, which generally conform to U.S. income tax laws. Foreign income taxes result from payments of taxes with effective rates ranging from 2% to 5% of gross income in the FSM, the RMI and the ROP to their respective government jurisdictions. U.S. Federal, California and the Commonwealth of the Northern Mariana Islands income taxes are reflected as foreign taxes for financial reporting purposes.

The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid for the period by applying the provisions of the enacted tax law to the taxable income. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term, “more likely than not,” means a likelihood of more than 50 percent; the terms, “examined,” and, “upon examination,” also include resolution of related appeals or litigation processes, if any. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Uncertain tax positions that meet the more likely than not recognition threshold are measured to determine the amount of benefit to recognize. An uncertain tax position is measured at the largest amount of benefit that management believes has a greater than 50% likelihood of realization upon settlement. The Company recognizes interest and penalties on income taxes as a component of income tax expense.

Earnings Per Common Share

Basic earnings per share represent income available to common stockholders (after deducting dividends on preferred stock) divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may have been issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

Fair Value of Financial Instruments/Fair Value Option

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 19. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect these estimates. In addition, the fair value option provides an option to elect fair value as an alternative measurement for selected financial assets, financial liabilities, unrecognized firm commitments and written loan commitments not previously carried at fair value. The Company and the Bank have elected the fair value option for its mortgage servicing rights. The election was made to better reflect the underlying economics and to mitigate operational complexities in risk management activities.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when, (i) the assets have been isolated from the Bank – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (ii) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (iii) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Contingencies

From time to time, the Company may become involved in disputes, litigation and other legal actions. In such event, the Company estimates the range of liability related to pending litigation where the amount and range of loss can be estimated and information available prior to the issuance of financial statements indicates such loss is considered probable. Where a liability is probable and there is a range of estimated loss with no best estimate in the range, the Company records a charge equal to at least the minimum amount in the range.

Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued (See Note 20). The Company recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the financial statements. The Company's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before financial statements are available to be issued.

The Company has evaluated subsequent events through the date that these consolidated financial statements are being filed with the Securities and Exchange Commission.

Note 3 – Recent Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers". Among other objectives, it is intended to provide more useful information to the users of financial statements by making the definition and recognition of revenue more comparable across reporting entities, industries, jurisdictions and capital markets. As deferred by ASU No. 2015-14, this Standard was effective January 1, 2018, upon which date we implemented it. The Company's revenue is primarily comprised of net interest income on financial assets less interest paid on financial liabilities, which are excluded from the scope of ASU No. 2014-09. The Company evaluated its various revenue streams and determined that "Service charges on deposit accounts" and "Online fees" are included in the scope of ASC 606. The fees charged from "Service charges on deposit accounts" are based on services provided or transactions performed, and the "Online fees" associated with business accounts are billed at the end of each month or upon occurrence. Neither revenue stream results in a difference from historic revenue recognition practices. The revenue earned from these services and its percentage of total revenue for the twelve months ended December 31, 2018 are $4.8 million, or 4.56%, and $822 thousand, or 0.78%, respectively. The Company has determined that the result of applying this ASU to the revenue streams affected has not been material to the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities", to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information and to address certain aspects of the recognition, measurement, presentation and disclosure of the fair value, including impairment assessments, of financial instruments. The Company has an equity investment in ASC Trust Corporation that is accounted for under the equity method and is excluded from the scope of ASU 2016-01. We adopted ASU 2016-01 on January 1, 2018, and it did not have a significant impact on the Company's consolidated financial statements as all of the Company's investment securities are classified as available-for-sale and held-to-maturity debt securities.

In March 2017, the FASB issued ASU 2017-07, "Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost". This update requires that the service cost component of the Bank's Supplemental Executive Retirement Program (SERP) be recorded and reported separately from the other cost components, in the same line item as other compensation costs related to services rendered by the beneficiary employees during the reporting period. The Company currently reports both the service cost and the other cost components as a portion of General, administrative and other expense, whereas this update will require that the service cost component be reported as a portion of Salaries and employee benefits. This update also requires that the details of the components of the SERP be reported for the interim periods, in addition to the annual reporting of these costs. We adopted ASU 2017-07 effective January 1, 2018, and have concluded that it has had no material impact on our financial statements.

In May 2017, the FASB issued ASU 2017-09, “Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting”, which clarifies the application of the guidance in Topic 718 on stock compensation in order to reduce the diversity in practice and to reduce the cost and complexity of applying the Topic to a change in the terms or conditions of a share-based payment award. Although this standard was adopted effective January 1, 2018, the Company has not issued any stock options or phantom stock options to date; accordingly, this update has had no impact on our consolidated financial position or results of operation at this time.

Recently Issued but Not Yet Adopted Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)”, a new Topic which, as modified by ASU 2018-10 and ASU 2018-12, will be effective beginning January 1, 2019, and is intended to increase transparency and comparability among organizations by recognizing right-of-use (ROU) assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements on the basis that it is important that users of financial statements have a complete and understandable picture of an entity’s leasing activities.

The new standard allows for several transition practical expedients. The Company elected the transition method to not restate the comparative periods. The Company has chosen to elect the package of practical expedients, which permits the Company to forgo reassessing lease identification, lease classification, and initial direct costs. The Company will apply the hindsight practical expedient when evaluating the lease term and assessing impairment for ROU assets. The Company also elected to combine the lease and non-lease components such as maintenance fees as a single lease component of bank premises and building space leases and elected to use the remaining lease term instead of total lease term in determining the Incremental Borrowing Rate. The Company has made an accounting policy election to not recognize lease liabilities and ROU assets for short-term leases, which are leases with initial terms of 12 months or less and for which there is not a purchase option that is reasonably certain to be exercised. All leases within the Company’s portfolio are classified as operating leases.

While the Company is in the process of finalizing the implementation of ASC 842, it believes the most significant impact will be the recognition of new ROU assets and lease liabilities on its balance sheet for its branch premises and building operating leases.

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326)”, to amend the standards for the measurement of credit losses on financial instruments by replacing the historical incurred loss impairment methodology of determining the level of the allowance for loan and lease losses (ALLL), including losses associated with held-to-maturity securities, with a more decision-useful methodology that reflects expected credit losses over the life of a financial instrument based upon historical experience, current conditions, and reasonable and supportable forecasts in determining the ALLL level, as well as the reserve for off-balance-sheet credit exposures. The Company is currently evaluating the provisions of ASU 2016-13 to determine the potential impact the new standard will have on our Consolidate Financial Statements, and has taken steps for the implementation when it becomes effective beginning January 1, 2020, such as gathering pertinent data, consulting with outside professionals and evaluating its current IT systems. Management expects to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the first reporting period in which the new standard is effective, but cannot yet estimate the magnitude of the one-time adjustment or the overall impact of the new guidance on the Company’s financial position, results of operations or cash flows.

Also in March 2017, the FASB issued ASU 2017-08, “Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities”. This update shortens the amortization period of a callable security that is held at a premium to the earliest call date of that security instead of the contractual life of the security. Although the Company does not currently hold any callable securities at a premium, we may do so in the future. Unless such securities are purchased by us, we do not believe that ASU 2017-08, which becomes effective January 1, 2019, will have an impact on our consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, “Income Statement – Reporting Comprehensive Income (Topic 220)”. This update allows a reclassification from accumulated other income to retained earnings for stranded tax effects related to the Tax Cuts and Jobs Act of December 22, 2017, and is intended to improve the usefulness of information reported to the users of financial statements. The effective date of this update is for fiscal years beginning after December 15, 2018. Although adoption of this standard is not required of the Company until January 1, 2020, early adoption is permitted, and we will adopt this Standard at March 31, 2019.

Note 4 – Interest-Bearing Deposits and Restricted Cash

The Company had $122.2 million and $97.5 million in interest bearing deposits, including restricted cash, at other financial institutions at December 31, 2018 and 2017, respectively. The weighted average percentage yields on these deposits were 2.40% and 1.50% at December 31, 2018 and 2017, respectively. Interest bearing deposits with financial institutions can be withdrawn by the Bank on demand, and are considered cash equivalents for purposes of the consolidated statements of financial condition and cash flows.

At both December 31, 2018 and December 31, 2017, we had $400 thousand of restricted cash, held in time deposits that were scheduled to mature within one year. Of these deposits, $150 thousand are held by the Bank jointly under the names of Bank of Guam and the Guam Insurance Commissioner, and serve as a bond for the Bank of Guam Trust Department, and $250 thousand are held by Bank of Guam, and are pledged for Banker's Loan Processing (BLP) program with Pacific Coast Bankers Bank in California. The weighted average percentage yields on these restricted cash deposits were 1.49% and 0.86% at December 31, 2018 and 2017, respectively.

Note 5 – Investment Securities

The amortized cost and estimated fair value of investment securities, with gross unrealized gains and losses, were as follows:

	December 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities Available-for-Sale				
U.S. government agency and government sponsored enterprise (GSE) debt securities	$100,497	$ -	$ (1,587)	$98,910
U.S. government agency pool securities	213,055	24	(1,707)	211,372
U.S. government agency or GSE residential mortgage-backed securities	72,735	-	(1,975)	70,760
Total	$386,287	$ 24	$ (5,269)	$381,042
Securities Held-to-Maturity				
U.S. government agency and government sponsored enterprise (GSE) debt securities	$38,445	$ 46	$ (88)	$38,403
U.S. government agency pool securities	9,089	3	(80)	9,012
U.S. government agency or GSE residential mortgage-backed securities	20,554	29	(521)	20,062
Total	$68,088	$ 78	$ (689)	$67,477

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities Available-for-Sale				
U.S. government agency and government sponsored enterprise (GSE) debt securities	$105,407	$ -	$ (1,380)	$104,027
U.S. government agency pool securities	283,611	51	(1,319)	282,343
U.S. government agency or GSE residential mortgage-backed securities	75,560	-	(1,142)	74,418

Total	$464,578	$ 51	$ (3,841)	$460,788
Securities Held-to-Maturity				
U.S. government agency and government sponsored				
enterprise (GSE) debt securities	$45,178	$ 505	$ (113)	$45,570
U.S. government agency pool securities	11,756	33	(35)	11,754
U.S. government agency or GSE residential				
mortgage-backed securities	32,743	243	(311)	32,675
Total	$89,677	$ 781	$ (459)	$89,999

At December 31, 2018 and 2017, investment securities with a carrying value of $285.9 million and $307.3 million, respectively, were pledged to secure various government deposits and other government requirements.

Proceeds and gross realized gains (losses) from the sales or calls of investment securities for the years ended December 31, 2018 and 2017, are shown below:

	Years Ended December 31,	
	2018	2017
Proceeds from sales	$94,752	$35,623
Gross realized gains from sales	$-	$21
Gross realized losses from sales	$(593)	$(17)

The amortized cost and estimated fair value of investment securities by contractual maturity at December 31, 2018 and 2017, are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or borrowers the right to prepay obligations with or without call or prepayment penalties. At December 31, 2018, obligations of U.S. government corporations and agencies with amortized costs totaling $454.4 million consist predominantly of Small Business Administration agency pool securities totaling $222.1 million and residential mortgage-backed securities totaling $93.3 million whose contractual maturity, or principal repayment, will follow the repayment of the underlying small business loans or mortgages. For purposes of the following table, the entire outstanding balance of these SBA Pools and mortgage-backed securities issued by U.S. government corporations and agencies is categorized based on final maturity date. At December 31, 2018, the Bank estimates the average remaining life of these SBA Pools and mortgage-backed securities to be approximately 3.8 years and 3.6 years, respectively.

	December 31, 2018			
	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Estimated Fair Value
	(Dollars in Thousands)			
Due within one year	$19,996	$19,739	$11,975	$ 11,911
Due after one but within five years	83,671	82,323	32,511	32,512
Due after five years but within ten years	98,465	97,339	13,995	13,769
Due after ten years	184,155	181,641	9,607	9,285
Total	$386,287	$381,042	$68,088	$ 67,477

	December 31, 2017			
	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Estimated Fair Value
	(Dollars in Thousands)			
Due within one year	$336	$336	$7,004	$ 6,978
Due after one but within five years	111,443	110,041	53,451	54,044
Due after five years but within ten years	51,861	51,450	18,336	18,262
Due after ten years	300,938	298,961	10,886	10,715
Total	$464,578	$460,788	$89,677	$ 89,999

For the years ended December 31, 2018, 2017 and 2016, proceeds from sales of available-for-sale securities amounted to $94.8 million, $35.6 million and $40.0 million, respectively; gross realized gains were $0, $21 thousand and $406 thousand, and gross realized losses were $593 thousand, $17 thousand and $5 thousand, respectively; gross unrealized gains were $24 thousand, $51 thousand and $166 thousand, respectively, and gross unrealized losses were $5.3 million, $3.8 million and $3.4 million, respectively.

Temporarily Impaired Securities

The following table indicates the gross unrealized losses and fair value of the Bank's investments, with unrealized losses that are not deemed to be OTTI, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2018 and 2017.

	December 31, 2018					
	Less Than Twelve Months		More Than Twelve Months		Total	
	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value
Securities Available for Sale						
U.S. government agency and government sponsored enterprise (GSE) debt securities	$ -	$ -	$ (1,587)	$ 98,910	$ (1,587)	$ 98,910
U.S. government agency pool securities	(217)	32,633	(1,490)	157,403	(1,707)	190,036
U.S. government agency or GSE residential mortgage-backed securities	(116)	12,679	(1,859)	58,081	(1,975)	70,760
Total	$ (333)	$ 45,312	$ (4,936)	$ 314,394	$ (5,269)	$ 359,706
Securities Held to Maturity						
U.S. government agency and government sponsored enterprise (GSE) debt securities	$ (12)	$ 4,918	$ (76)	$ 8,954	$ (88)	$ 13,872
U.S. government agency pool securities	(62)	6,609	(18)	2,232	(80)	8,841
U.S. government agency or GSE residential mortgage-backed securities	(25)	5,219	(496)	12,330	(521)	17,549
Total	$ (99)	$ 16,746	$ (590)	$ 23,516	$ (689)	$ 40,262

	December 31, 2017					
	Less Than Twelve Months		More Than Twelve Months		Total	
	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value
Securities Available for Sale						
U.S. government agency and government sponsored enterprise (GSE) debt securities	$ (273)	$ 29,582	$ (1,107)	$ 74,445	$ (1,380)	$ 104,027
U.S. government agency pool securities	(241)	91,519	(1,078)	168,164	(1,319)	259,683
U.S. government agency or GSE residential mortgage-backed securities	(321)	35,384	(821)	39,034	(1,142)	74,418
Total	$ (835)	$ 156,485	$ (3,006)	$ 281,643	$ (3,841)	$ 438,128
Securities Held to Maturity						

U.S. government agency and government sponsored enterprise (GSE) debt securities	$(33)	$4,002	$ (80)	$ 11,946	$(113)	$15,948
U.S. government agency pool securities	(10)	5,422	(25)	3,201	(35)	8,623
U.S. government agency or GSE residential mortgage-backed securities	(101)	8,478	(210)	5,371	(311)	13,849
Total	$(144)	$17,902	$ (315)	$ 20,518	$(459)	$38,420

The Bank does not believe that the investment securities that were in an unrealized loss position as of December 31, 2018, which comprised a total of 157 securities, were other than temporarily impaired. Specifically, the 157 securities are comprised of the following: 90 Small Business Administration (SBA) Pool securities, 19 mortgage-backed securities issued by Government National Mortgage Association (GNMA), 15 U.S. Treasuries, 19 mortgage-backed securities and 1 agency security issued by Federal National Mortgage Association (FNMA), 7 agency securities issued by Federal Home Loan Bank (FHLB) 4 mortgage-backed securities and 1 agency security issued by Federal Home Loan Mortgage Corporation (FHLMC), and 1 agency security issued by Federal Farm Credit Banks (FFCB).

Total gross unrealized losses were attributable to changes in interest rates, relative to when the investment securities were purchased, and not due to changes in the credit quality of the investment securities. The Bank does not intend to sell the investment securities that are in an unrealized loss position and it is not likely that, except as needed to fund our liquidity position, the Bank will be required to sell the investment securities before recovery of their amortized cost bases, which may be at maturity.

Investment in Unconsolidated Subsidiary

In May 2016, the Company entered into a Stock Purchase Agreement to acquire 25% of ASC Trust Corporation, a Guam trust company. In July 2016, subsequent to the approval of the Federal Reserve Bank of San Francisco in June 2016, the purchase was executed. The Company took on $3.5 million in subordinated debt in connection with the purchase to finance the transaction, which debt has since been retired. The Agreement provides for the acquisition of an additional 20% of the stock of ASC Trust Corporation in April 2019, which has been revised to July 2019, and another 25% in April 2021, with both future purchases subject to regulatory approval. The Agreement contains customary warranties, representations and indemnification provisions.

Note 6 – Loans

The Bank provides commercial and industrial, commercial mortgage, commercial construction, automobile and other consumer loans in each of the markets it serves. It also offers residential mortgage, home equity and certain U.S. government guaranteed loans in Guam, the Northern Mariana Islands and California. The Bank has two commercial agricultural loans outstanding in Guam.

Outstanding loan balances are presented net of unearned income, net deferred loan fees, and unamortized discount and premium totaling $2.6 million at December 31, 2018 and $2.8 million at December 31, 2017.

The loan portfolio consisted of the following at:

	December 31, 2018 Amount	Percent	2017 Amount	Percent
	(Dollars in thousands)			
Commercial				
Commercial & industrial	$243,465	19.7 %	$256,022	20.8 %
Commercial mortgage	560,827	45.3 %	553,125	45.0 %
Commercial construction	39,408	3.2 %	10,157	0.8 %
Commercial agriculture	688	0.1 %	716	0.1 %
Total commercial	844,388	68.2 %	820,020	66.7 %
Consumer				
Residential mortgage	138,923	11.2 %	137,962	11.2 %
Home equity	1,325	0.1 %	545	0.0 %
Automobile	26,686	2.2 %	30,490	2.5 %
Other consumer loans[1]	227,242	18.3 %	240,863	19.6 %
Total consumer	394,176	31.8 %	409,860	33.3 %
Gross loans	1,238,564	100.0 %	1,229,880	100.0 %
Deferred loan (fees) costs, net	(2,649)		(2,777)	
Allowance for loan losses	(23,774)		(17,279)	
Loans, net	$1,212,141		$1,209,824	

[1] Comprised of other revolving credit, installment, and overdrafts.

At December 31, 2018, total gross loans increased by $8.7 million, to $1.24 billion, up from $1.23 billion at December 31, 2017. The growth in loans was largely attributed to (i) an increase of $29.3 million in the commercial construction loan category, from $10.2 million to $39.4 million, (ii) an increase of $7.7 million commercial mortgage loans, from $553.1 million to $560.8 million, (iii) a $961 thousand increase in residential mortgage loans, to $138.9 million from $138.0 million, due to new loans, and (iv) an increase of $780 thousand in home equity loans, from $545 thousand to $ 1.3 million. These were partially offset by (i) a $13.6 million decrease in other consumer loans, to $ 227.2 million from $ 240.9 million, due primarily to payoffs and paydowns, (ii) a $12.6 million decrease in commercial & industrial loan category due to payoffs and paydowns, and (iii) a $3.8 million decrease in automobile loans outstanding.

Allowance for Loan Losses

The allowance for loan losses is evaluated on a regular basis by management, and is based upon management's periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The portion of the allowance that covers unimpaired loans is based on historical charge-off experience and expected loss, given the default probability derived from the Bank's internal risk rating process. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

Our loss migration analysis tracks a certain number of quarters of loan loss history and industry loss factors to determine historical losses by classification category for each loan type, except certain consumer loans. These calculated loss factors are then applied to outstanding loan balances for all loans on accrual designated as "Pass," "Special Mention," "Substandard" or "Doubtful" ("classification categories"). Additionally, a qualitative factor that is determined utilizing external economic factors and internal assessments is applied to each homogeneous loan pool. We also conduct individual loan review analyses as part of the allowance for loan loss allocation process, applying specific monitoring policies and procedures in analyzing the existing loan portfolios.

Credit Quality Indicators

The Bank uses several credit quality indicators to manage credit risk, including an internal credit risk rating system that categorizes loans into pass, special mention, substandard, doubtful or loss categories. Credit risk ratings are applied individually to those classes of loans that have significant or unique credit characteristics and that benefit from a case-by-case evaluation. These are typically loans to businesses or individuals in the classes which comprise the commercial portfolio segment. Groups of loans that are underwritten and structured using standardized criteria and characteristics, such as statistical models (e.g., credit scoring or payment performance), are typically risk-rated and monitored collectively. These are typically loans to individuals in the classes which comprise the consumer portfolio segment.

The following are the definitions of the Bank's credit quality indicators:

Pass (A): Exceptional: Essentially risk-free credit. These are loans of the highest quality that pose virtually no risk of loss to the Bank. This includes loans fully collateralized by means of a savings account(s) and time certificate(s) of deposit, and by at least 110% of the loan amount. Borrowers should have strong financial statements, good liquidity and excellent credit.

Pass (B): Standard: Multiple "strong sources of repayment." Loans to strong borrowers with a demonstrated history of financial and managerial performance. Risk of loss is considered to be low. Loans are well structured, with clearly identified primary and readily available secondary sources of repayment. Loans may be secured by an equal amount of funds in a savings account or time certificate of deposit. Loans may be secured by marketable collateral whose value can be reasonably determined through outside appraisals. Very strong cash flow and relatively low leverage.

Pass (C): Acceptable: "Good" primary and secondary sources of repayment. Loans to borrowers of average financial strength, stability and management expertise. Borrower should be a well-established individual or company with adequate financial resources to weather short-term fluctuations in the marketplace. Financial ratios and trends are favorable. The loans may be unsecured or supported by non-real estate collateral for which the value is more difficult to determine, reasonable credit risk and requiring an average amount of account officer attention. Unsecured credit is to be of unquestionable strength.

Pass (D): Monitor: "Sufficient" primary source of repayment and acceptable secondary source of repayment. Acceptable business or individual credit, but the borrower's operations, cash flow or financial conditions evidence moderate to average levels of risk. Loans are considered to be collectable in full, but may require a greater-than-average amount of loan officer attention. Borrowers are capable of absorbing normal setbacks without failure.

Special Mention: A special mention asset has potential weaknesses that deserve close monitoring. These potential weaknesses may result in a deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Special Mention should neither be a compromise between a pass grade and substandard, nor should it be a "catch all" grade to identify any loan that has a policy exception.

Substandard: A substandard asset is inadequately protected by the current sound worth and payment capacity of the obligor or the collateral pledged. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Assets are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Formula Classified: Formula classified loans are all loans and credit cards delinquent 90 days and over which have yet to be formally classified Special Mention, Substandard or Doubtful by the Bank's Loan Committee. In most instances, the monthly formula total is comprised primarily of residential real estate and consumer loans and credit cards. Commercial loans are typically formally classified by the Loan Committee no later than their 90-day delinquency, and thus usually do not become part of the formula classification. Real estate loans 90 days delinquent are in the foreclosure process and are typically completed within another 60 days, and thus are not formally classified during this period.

Doubtful: A loan with weaknesses well enough defined that eventual repayment in full, on the basis of currently existing facts, conditions and values, is highly questionable, even though certain factors may be present which could improve the status of the loan. The probability of some loss is extremely high, but because of certain known factors, which may work to the advantage of strengthening of the assets (i.e. capital injection, perfecting liens on additional collateral, refinancing plans, etc.), its classification as an estimated loss is deferred until its more exact status can be determined.

Loss: Loans classified as "Loss" are considered uncollectible, and are either unsecured or are supported by collateral that is of little to no value. As such, their continuance as recorded assets is not warranted. While this classification does not mandate that a loan has no ultimate recovery value, losses should be taken in the period these loans are deemed to be uncollectible. Loans identified as loss are immediately approved for charge off. The Bank may refer loans to outside collection agencies, attorneys, or its internal collection division to continue collection efforts. Any subsequent recoveries are credited to the Allowance for Loan Losses.

Set forth below is a summary of the Company's activity in the allowance for loan losses during the years ended December 31, 2018, 2017 and 2016:

	December 31,		
	2018	2017	2016
	(Dollars in thousands)		
Balance, beginning of period	$17,279	$15,435	$14,159
Provision for loan losses	12,862	7,519	3,900
Recoveries on loans previously charged off	1,834	1,604	3,007
Charged off loans	(8,201)	(7,279)	(5,631)
Balance, end of period	$23,774	$17,279	$15,435

The $6.5 million increase in the allowance for loan losses is primarily due to an increase in classified loans, consumer loan delinquency rates and as a result of the bankruptcy filing of a large commercial loan borrower, which bankruptcy was filed in January 2019, along with management's reassessment of economic conditions and prospects. The allowance will change in the future in response to changes in the size, composition and quality of the loan portfolio, as well as periodic reassessments of prospective economic conditions. The borrower filing for bankruptcy was evaluated under ASC 450 – "Contingencies", and the Bank holds $4.7 million in deposits for which the Court has approved a right of offset. The Bank also has assigned a specific allowance of $5.2 million to the outstanding debt. The outstanding loans under bankruptcy have been classified as substandard, but are still accruing interest and the scheduled payments on the loans remain current.

Set forth below is information regarding gross loan balances and the related allowance for loan losses, by portfolio type, for the years ended December 31, 2018, 2017 and 2016.

	Commercial	Residential Mortgages	Consumer	Total
	(Dollars in thousands)			
Year Ended December 31, 2018				
Allowance for loan losses:				
Balance at beginning of period	$7,623	$1,409	$8,247	$17,279
Charge-offs	(356)	(9)	(7,836)	$(8,201)
Recoveries	39	7	1,788	$1,834
Provision	7,581	241	5,040	$12,862
Balance at end of period	$14,887	$1,648	$7,239	$23,774
Allowance balance at end of year related to:				
Loans individually evaluated for impairment	$5,204	$104	$1,518	$6,826
Loans collectively evaluated for impairment	9,683	1,544	5,721	$16,948
Ending balance	$14,887	$1,648	$7,239	$23,774
Loan balances at end of year:				
Loans individually evaluated for impairment	$18,328	$4,925	$1,746	$24,999
Loans collectively evaluated for impairment	826,060	135,323	252,182	1,213,565
Ending balance	$844,388	$140,248	$253,928	$1,238,564
Year Ended December 31, 2017				
Allowance for loan losses:				
Balance at beginning of year	$7,264	$1,773	$6,398	$15,435
Charge-offs	(172)	(145)	(6,962)	(7,279)
Recoveries	47	6	1,551	1,604
Provision	484	(225)	7,260	7,519
Balance at end of year	$7,623	$1,409	$8,247	$17,279
Allowance balance at end of year related to:				
Loans individually evaluated for impairment	$28	$90	$1,747	$1,865
Loans collectively evaluated for impairment	7,595	1,319	6,500	$15,414
Ending balance	$7,623	$1,409	$8,247	$17,279
Loan balances at end of year:				
Loans individually evaluated for impairment	$7,094	$5,442	$2,237	$14,773
Loans collectively evaluated for impairment	812,926	133,065	269,116	1,215,107
Ending balance	$820,020	$138,507	$271,353	$1,229,880
Year Ended December 31, 2016				
Allowance for loan losses:				
Balance at beginning of year	$6,890	$1,853	$5,416	$14,159
Charge-offs	(276)	(121)	(5,234)	$(5,631)

Recoveries	1,691	6	1,310	$3,007
Provision	(1,041)	35	4,906	$3,900
Balance at end of year	$7,264	$ 1,773	$6,398	$15,435
Allowance balance at end of year related to:				
Loans individually evaluated for impairment	$157	$ 137	$1,858	$2,152
Loans collectively evaluated for impairment	7,107	1,636	4,540	$13,283
Ending balance	$7,264	$ 1,773	$6,398	$15,435
Loan balances at end of year:				
Loans individually evaluated for impairment	$7,577	$ 6,208	$1,897	$15,682
Loans collectively evaluated for impairment	799,922	138,223	222,180	$1,160,325
Ending balance	$807,499	$ 144,431	$224,077	$1,176,007

Impairment is measured on a loan-by-loan basis for commercial and real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral (if the loan is collateral dependent). Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment and are not immediately written-off, but a portion of the allowance is allocated to these loans based on the evaluation. The Bank performs direct write-downs of impaired loans with a charge to the allocated component of the allowance, therefore reducing the allocated component of the reserve to zero at the end of each reporting period.

The following table provides a summary of the delinquency status of the Bank's gross loans by portfolio type:

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Greater Non-Accrual	90 Days and Greater Still Accruing	Total Past Due	Current	Total Loans Outstanding
	(Dollars in thousands)						
December 31, 2018							
Commercial							
Commercial & industrial	$310	$ -	$ 14	$ 530	$ 854	$242,611	$243,465
Commercial mortgage	419	-	1,287	184	1,890	558,937	560,827
Commercial construction	300	-	-	-	300	39,108	39,408
Commercial agriculture	-	-	-	-	-	688	688
Total commercial	1,029	-	1,301	714	3,044	841,344	844,388
Consumer							
Residential mortgage	4,565	3,847	1,805	12	10,229	128,694	138,923
Home equity	-	91	-	-	91	1,234	1,325
Automobile	1,095	290	-	135	1,520	25,166	26,686
Other consumer [1]	3,505	1,583	335	1,123	6,546	220,696	227,242
Total consumer	9,165	5,811	2,140	1,270	18,386	375,790	394,176
Total	$10,194	$ 5,811	$ 3,441	$ 1,984	$ 21,430	$1,217,134	$1,238,564
December 31, 2017							
Commercial							
Commercial & industrial	$155	$ 546	$ -	$ 20	$ 721	$255,301	$256,022
Commercial mortgage	-	803	364	-	1,167	551,958	553,125
Commercial construction	-	-	-	-	-	10,157	10,157
Commercial agriculture	-	-	-	-	-	716	716
Total commercial	155	1,349	364	20	1,888	818,132	820,020
Consumer							
Residential mortgage	5,804	3,046	2,373	-	11,223	126,739	137,962
Home equity	7	96	-	-	103	442	545
Automobile	1,512	415	-	201	2,128	28,362	30,490
Other consumer 1	3,513	2,157	257	1,725	7,652	233,211	240,863
Total consumer	10,836	5,714	2,630	1,926	21,106	388,754	409,860

Total	$10,991	$ 7,063	$ 2,994	$ 1,946	$ 22,994	$1,206,886	$1,229,880

[1] Comprised of other revolving credit, installment loans, and overdrafts.

Generally, the accrual of interest on a loan is discontinued when principal or interest payments become more than 90 days past due, unless management believes the loan is adequately collateralized and it is in the process of collection. When a loan is placed on non-accrual status, previously accrued but unpaid interest is reversed against current income. Subsequent collections of cash are applied as principal reductions when received, except when the ultimate collectability of principal is probable, in which case interest payments are credited to income. Non-accrual loans may be restored to accrual status when principal and interest become current and full repayment is expected. The following table provides information as of December 31, 2018 and 2017, with respect to loans on non-accrual status, by portfolio type:

	December 31, 2018	December 31, 2017
	(Dollars in thousands)	
Non-accrual loans:		
Commercial		
Commercial & industrial	$ 310	$ 426
Commercial mortgage	6,909	6,554
Commercial construction	-	-
Commercial agriculture	-	-
Total commercial	7,219	6,980
Consumer		
Residential mortgage	4,795	6,063
Home equity	91	-
Automobile	-	-
Other consumer [1]	278	311
Total consumer	5,164	6,374
Total non-accrual loans	$ 12,383	$ 13,354

[1] Comprised of other revolving credit, installment loans, and overdrafts.

The Company classifies its loan portfolios using internal credit quality ratings, as discussed above under Allowance for Loan Losses. The following table provides a summary of loans by portfolio type and the Company's internal credit quality ratings as of December 31, 2018 and 2017.

	December 31,		
	2018	2017	Increase (Decrease)
	(Dollars in thousands)		
Pass:			
Commercial & industrial	$204,805	$222,662	$ (17,857)
Commercial mortgage	515,764	511,702	4,062
Commercial construction	39,408	10,157	29,251
Commercial agriculture	688	716	(28)
Residential mortgage	133,766	131,743	2,023
Home equity	1,235	538	697
Automobile	26,550	30,289	(3,739)
Other consumer	225,632	238,827	(13,195)
Total pass loans	$1,147,848	$1,146,634	$ 1,214
Special Mention:			
Commercial & industrial	$8,732	$20,528	$ (11,796)
Commercial mortgage	8,990	32,723	(23,733)
Commercial construction	-	-	-
Commercial agriculture	-	-	-
Residential mortgage	-	139	(139)
Home equity	-	-	-
Automobile	-	-	-
Other consumer	-	-	-
Total special mention loans	$17,722	$53,390	$ (35,668)
Substandard:			
Commercial & industrial	$29,924	$12,810	$ 17,114
Commercial mortgage	36,073	8,700	27,373
Commercial construction	-	-	-
Commercial agriculture	-	-	-
Residential mortgage	705	645	60
Home equity	-	-	-
Automobile	-	-	-
Other consumer	-	-	-
Total substandard loans	$66,702	$22,155	$ 44,547
Formula Classified:			
Commercial & industrial	$4	$22	$ (18)
Commercial mortgage	-	-	-
Commercial construction	-	-	-
Commercial agriculture	-	-	-
Residential mortgage	4,452	5,435	(983)
Home equity	91	7	84
Automobile	135	201	(66)
Other consumer	1,610	2,036	(426)
Total formula classified loans	$6,292	$7,701	$ (1,409)

Doubtful:			
Commercial & industrial	$-	$-	$ -
Commercial mortgage	-	-	-
Commercial construction	-	-	-
Commercial agriculture	-	-	-
Residential mortgage	-	-	-
Home equity	-	-	-
Automobile	-	-	-
Other consumer	-	-	-
Total doubtful loans	$-	$-	$ -
Total outstanding loans, gross	$1,238,564	$1,229,880	$ 8,684

As the above table indicates, the Company's total loans approximated $1.24 billion at December 31, 2018, up from $1.23 billion at December 31, 2017. The disaggregation of the portfolio by risk rating in the table reflects the following changes between December 31, 2017, and December 31, 2018:

- Loans rated "pass" totaled $1.15 billion at December 31, 2018, an increase of $1.2 million from $1.15 billion at December 31, 2017, due primarily to the increases of $29.3 million in commercial construction loans, $4.1 million in commercial mortgage loans and $2.0 million in residential mortgage loans. The increase in commercial construction loans is concentrated in two new loans. The commercial mortgage loan increase of $4.1 million and the residential mortgage loan increase of $2.0 million were due to net new loans being made. These increases were offset by the decreases of $17.9 million in commercial & industrial loans, $13.2 million in other consumer loans and $3.7 million in automobile loans. The decrease in commercial & industrial loans was due to two loan relationships totaling $5.1 million moved from "pass" to "special mention" and five loan relationships of $1.0 million moved from "pass" to "substandard" in addition to payoffs and pay downs. The decreases in other consumer and automobile loans were due to payoffs, pay downs and charge-offs, partially offset by the addition of new consumer loan and automobile loan bookings.
- The "special mention" category decreased by $35.7 million to $17.7 million at December 31, 2018. The commercial mortgage loan category decreased to $23.7 million, due to the three loan relationships totaling $27.6 million being reassigned from "special mention" to "substandard." The commercial & industrial loan category decreased by $11.8 million, due primarily to two loan relationships totaling $18.0 million moved from "special mention" to "substandard."
- Loans classified as "substandard" increased by $44.5 million, to $ 66.7 million at December 31, 2018. Substandard commercial and industrial loans increased by $17.1 million, to $29.9 million, due primarily to the downgrade of two loan relationships, and commercial mortgage loans increased by $27.4 million, to $36.1 million, primarily due to three loan relationships totaling $28.8 million that were downgraded from "special mention" to "substandard." In addition, three loan relationships totaling $372 thousand downgraded from "pass" to "substandard."
- The "formula classified" category decreased by $1.4 million during the period, to $6.3 million, primarily because of the decrease of $983 thousand in residential mortgages in this classification, due to regular loan pay downs and payoffs, and the decrease of $426 thousand in the other consumer loan category.

Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Impaired loans include loans that are in non-accrual status and other loans that have been modified in Troubled Debt Restructurings (TDRs), where economic concessions have been granted to borrowers experiencing financial difficulties. These concessions typically result from the Company's loss mitigation actions, and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions taken with the intention to maximize collections.

The following table sets forth information regarding non-accrual loans and restructured loans, at December 31, 2018 and December 31, 2017:

	December 31, 2018	2017
	(Dollars in thousands)	
Impaired loans:		
Restructured loans:		
Non-accruing restructured loans	$5,653	$5,265
Accruing restructured loans	254	305
Total restructured loans	5,907	5,570
Other impaired loans	19,092	9,203
Total impaired loans	$24,999	$14,773
Impaired loans less than 90 days delinquent and included in total impaired loans	$19,287	$6,651

The table below contains additional information with respect to impaired loans, by portfolio type, for the years ended December 31, 2018, 2017 and 2016:

	Recorded Investment	Unpaid Principal Balance	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)			
December 31, 2018, with no related allowance recorded:				
Commercial & industrial	$11,110	$11,110	$ 3,206	$ 51
Commercial mortgage	7,016	7,026	6,759	4
Commercial construction	-	-	-	-
Commercial agriculture	-	-	-	-
Residential mortgage	27	27	27	-
Home equity	-	-	-	-
Automobile	-	-	-	-
Other consumer	-	-	-	-
Total impaired loans with no related allowance	$18,153	$18,163	$ 9,992	$ 55
December 31, 2018, with an allowance recorded:				
Commercial & industrial	$126	$300	$ 181	$ -
Commercial mortgage	77	93	272	1
Commercial construction	-	-	-	-
Commercial agriculture	-	-	-	-
Residential mortgage	4,807	4,857	4,933	2
Home equity	91	91	24	-
Automobile	135	135	97	2
Other consumer	1,610	1,401	1,903	19
Total impaired loans with related allowance recorded	$6,846	$6,877	$ 7,410	$ 24
December 31, 2017, with no related allowance recorded:				
Commercial & industrial	$515	$515	$ 532	$ 1
Commercial mortgage	6,192	6,192	5,767	-
Commercial construction	-	-	-	-
Commercial agriculture	-	-	-	-
Residential mortgage	-	-	-	-
Home equity	-	-	-	-
Automobile	-	-	-	-
Other consumer	-	-	-	-
Total impaired loans with no related allowance	$6,707	$6,707	$ 6,299	$ 1
December 31, 2017, with an allowance recorded:				
Commercial & industrial	$180	$351	$ 113	$ 1
Commercial mortgage	208	233	264	-
Commercial construction	-	-	-	-
Commercial agriculture	-	-	-	-

Residential mortgage	5,435	5,448	5,644	-
Home equity	7	7	7	-
Automobile	201	211	108	3
Other consumer	2,035	2,035	1,629	17
Total impaired loans with related allowance recorded	$8,066	$8,285	$ 7,765	$ 21
December 31, 2016, with no related allowance recorded:				
Commercial & industrial	$1,274	$2,904	$ 1,135	$ -
Commercial mortgage	6,073	6,299	7,052	-
Commercial construction	-	-	-	-
Commercial agriculture	-	-	-	-
Residential mortgage	250	250	252	-
Home equity	-	-	-	-
Automobile	-	-	-	-
Other consumer	-	-	-	-
Total impaired loans with no related allowance	$7,597	$9,453	$ 8,439	$ -
December 31, 2016, with an allowance recorded:				
Commercial & industrial	$6	$10	$ 57	$ -
Commercial mortgage	224	224	233	-
Commercial construction	-	-	-	-
Commercial agriculture	-	-	-	-
Residential mortgage	5,923	5,934	6,519	2
Home equity	35	35	35	-
Automobile	84	84	73	2
Other consumer	1,812	1,813	1,613	17
Total impaired loans with related allowance recorded	$8,084	$8,100	$ 8,530	$ 21

Impairment is measured on a loan-by-loan basis for commercial and real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. The Bank performs direct write-downs of impaired loans with a charge to the allocated component of the allowance, thereby reducing the allocated component of the reserve to zero at the end of each reporting period.

Troubled Debt Restructurings

The Bank had $5.9 million and $5.6 million of troubled debt restructurings (TDRs) as of December 31, 2018 and 2017, respectively. The restructured loans recorded by the Bank represent financing receivables, modified for the purpose of alleviating temporary impairments to the borrower's financial condition. The modifications that the Bank has extended to borrowers have come in the form of a change in the amortization terms, a reduction in the interest rate, interest only payments and, in limited cases, a concession to the outstanding loan balance. The workout plans between the borrower and Bank are designed to provide a bridge for the cash flow shortfalls in the near term. As the borrower works through the near-term issues, in most cases, the original contractual terms will be reinstated.

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Outstanding Balance December 31, 2018	2017
	(Dollars in thousands)				
Performing					
Residential mortgage	1	$ 27	$ 27	$27	$-
Commercial mortgage	2	369	369	226	305
Automobile	-	-	-	-	-
Consumer	-	-	-	-	-
Total performing	3	396	396	253	305
Nonperforming					
Residential mortgage	-	$ -	$ -	$-	$-
Commercial mortgage	12	8,776	8,776	5,654	5,265
Automobile	-	-	-	-	-
Consumer	-	-	-	-	-
Total nonperforming	12	$ 8,776	$ 8,776	$5,654	$5,265
Total troubled debt restructurings (TDRs)	15	$ 9,172	$ 9,172	$5,907	$5,570

Note 7 – Premises and Equipment

A summary of premises and equipment at December 31, 2018 and 2017 follows:

	December 31, 2018		
	Cost	Accumulated Depreciation	Net Book Value
Buildings	$28,268	$ (20,461)	$7,807
Furniture and equipment	24,516	(18,424)	6,092
Automobiles and mobile facilities	1,588	(948)	640
Leasehold improvements	5,687	(3,929)	1,758
	60,059	(43,762)	16,297
Construction in progress	2,174	-	2,174
	$62,233	$ (43,762)	$18,471

	December 31, 2017		
	Cost	Accumulated Depreciation	Net Book Value
Buildings	$27,741	$ (19,667)	$8,074
Furniture and equipment	23,106	(16,479)	6,627
Automobiles and mobile facilities	1,432	(866)	566
Leasehold improvements	5,056	(3,651)	1,405
	57,335	(40,663)	16,672
Construction in progress	1,170	-	1,170
	$58,505	$ (40,663)	$17,842

For the years ended December 31, 2018, 2017 and 2016, depreciation expense was $3.6 million, $3.4 million and $3.4 million, respectively.

Note 8 – Other Assets

A summary of other assets at December 31, 2018 and 2017, follows:

	At December 31,	
	2018	2017
Bank Owned Life Insurance	$19,881	$19,411
Prepaid income tax	1	1,566
Prepaid expenses	7,081	5,676
Other real estate owned, net (Note 9)	1,510	2,369
Deferred tax asset, net (Note 13)	6,942	5,463

Mortgage servicing rights (Note 19)	1,778	1,903
Goodwill	783	783
Other	6,621	12,919
Total other assets	$44,597	$50,090

Note 9 – Other Real Estate Owned

Other real estate owned is presented net of an allowance for losses. A summary of the changes in other real estate owned is as follows:

	2018	2017	2016
Balance at beginning of year	$2,369	$2,669	$3,323
Additions	-	569	821
Sales	(238)	(702)	(1,456)
	2,131	2,536	2,688
Write-downs and loss on sales, net	(685)	(147)	(79)
Change in valuation allowances	64	(20)	60
Balance at end of year	$1,510	$2,369	$2,669

Note 10 – Deposits

A summary of deposits at December 31, 2018 and 2017, follows:

	December 31, 2018	December 31, 2017
	(Dollars in Thousands)	
Non-interest bearing deposits	$538,168	$508,149
Interest bearing deposits:		
Demand deposits	281,582	288,977
Regular savings	670,640	713,802
Time deposits:		
$250,000 or more	14,201	16,528
Less than $250,000	21,986	23,832
Other interest bearing deposits	202,246	264,844
Total interest bearing deposits	1,190,655	1,307,983
Total Deposits	$1,728,823	$1,816,132

At December 31, 2018, the scheduled maturities of time deposits were as follows:

Years ending December 31,	
2019	$30,306
2020	2,163
2021	1,075
2022	855
2023 and thereafter	1,788
Total	$36,187

Note 11 – Borrowings

Federal Reserve Discount Window

At December 31, 2018, and December 31, 2017 the Bank had investment securities with a market value of $22.5 million and $21.5 million, respectively, pledged to the FRB Discount Window supporting a borrowing capacity of $21.8 million and $20.8 million, respectively, based on the Federal Reserve margin of 97%. The Bank had no outstanding borrowings through the discount window at December 31, 2018 or 2017.

Federal Home Loan Bank (FHLB) Advances

The Bank has a credit line with the FHLB of Des Moines equal to 35% of total Bank assets. At December 31, 2018 and 2017, the Bank did not have outstanding advances against this credit line under Blanket Agreements for Advances and Security Agreements ("the Agreements"). The Agreements enable the Bank to borrow funds from the FHLB to fund mortgage loan programs and to satisfy certain other funding needs.

Overnight Fed Funds Lines

At December 31, 2018 and 2017, the Bank had $17.0 million in Federal Funds lines of credit available with its correspondent banks. No borrowings were outstanding as of December 31, 2018.

Note 12 – Transactions with Board of Directors

The Directors of the Company and the Bank, and certain of the businesses with which they are associated, conduct banking transactions with the Company in the ordinary course of business. The following is a summary of loan transactions with the Board of Directors of the Company and certain of their associated businesses:

	Years Ended December 31,	
	2018	2017
	(Dollars in thousands)	
Beginning balance	$ 9,466	$ 8,832
Undisbursed commitments	400	250
New loans granted	655	998
Principal repayments	(698)	(614)
Ending balance of term loans	9,823	9,466
Year-end balance of revolving accounts	1,994	3,610
Total term loans and revolving accounts	$ 11,817	$ 13,076

In addition, the Bank leases certain facilities from two separate entities in which two of its directors have separate ownership interests. Lease payments made to these entities during the years ended December 31, 2018, 2017 and 2016, approximated $350 thousand, $371 thousand and $379 thousand, respectively.

Note 13 – Income Taxes

The Bank pays income taxes in Guam and the Commonwealth of the Northern Mariana Islands under a territorial "mirror" of the U.S. Internal Revenue Code, with payments made to the respective territorial governments instead of the U.S. Treasury; there is no equivalent of a state income tax in either of these jurisdictions. The Bank also pays taxes to the governments of the Republic of Palau, the Federated States of Micronesia, the Republic of the Marshall Islands and the State of California.

The income tax provision includes the following components:

	For the Years		
	2018	2017	2016
Government of Guam tax expense (benefit):			
Current	$3,200	$4,983	$4,686
Deferred	(1,675)	2,807	(961)
Foreign income taxes (including U.S. income taxes)	1,388	1,846	1,991
Total income tax expense	$2,913	$9,636	$5,716

The reasons for the differences between the statutory federal income tax rate and the effective tax rates are summarized as follows:

	2018	2017	2016
Statutory Guam income tax rate	21.00 %	35.00 %	34.00 %
Permanent differences	-3.02 %	-3.38 %	-4.54 %
Other	0.52 %	21.38 %	0.20 %
Total income tax expense	18.50 %	53.00 %	29.66 %

The difference between effective income tax expense and income tax expense computed at the Guam statutory rate was due to nontaxable interest income earned on loans to the Government of Guam for each of the years ended December 31, 2018, 2017 and 2016. There was a one-time impact on total income tax expense and the effective tax rate in 2017 due to an adjustment of $3.5 million in the valuation allowance of the Company's deferred tax asset in response to the lowering of the maximum corporate tax rate from 35% to 21% by the Tax Cuts and Jobs Act of December 22, 2017.

The components of deferred income taxes are as follows:

	2018	2017	2016
Deferred loan origination fees	$28	$273	$(123)
Mortgage servicing rights	(27)	(115)	23
Loan loss provision	(1,430)	1,600	(447)
Deferred rent	(10)	106	(18)
Other real estate owned valuation	14	5	21
Fixed assets	15	(357)	23
Stock-based compensation	-	1,142	(65)
SERP	(246)	(365)	(343)
Accrued bonus	(19)	22	(32)
Securities available-for-sale	-	496	-
Net operating loss	(2,188)	1,221	(461)
Change in valuation allowance	2,188	(1,221)	461
Deferred tax (benefit) provision	$(1,675)	$2,807	$(961)

The components of the net deferred tax asset are as follows:

	2018	2017
Deferred tax asset:		
Allowance for loan losses	$5,170	$3,740
Net operating loss	2,188	1,973
Loan origination fees	573	602
Stock-based compensation	1,335	-
Net unrealized gain on securities held-to-maturity	-	8
Net unrealized gain on securities available-for-sale	606	793
Deferred rent	224	214
Accruals not currently deductible	64	1,148
Total deferred tax asset	10,160	8,478
Deferred tax liability:		
Fixed assets	(645)	(630)
Mortgage servicing rights	(385)	(412)
Total deferred tax liability	(1,030)	(1,042)
Valuation allowance	(2,188)	(1,973)
Net deferred tax asset	$6,942	$5,463

A valuation allowance of $2.2 million and $2.0 million have been provided at December 31, 2018 and 2017, respectively, to reduce the deferred tax asset because, in management’s opinion, it is more likely than not that less than the entire amount will be realized. This is primarily due to the operating losses in the CNMI region.

We record as a "deferred tax asset" on our balance sheet an amount equal to the tax credit and tax loss carry-forwards and tax deductions ("tax benefits") that we believe will be available to us to offset or reduce the amounts of our income taxes in future periods. Under applicable federal and state income tax laws and regulations, such tax benefits will expire if not used within specified periods of time. Accordingly, the ability to fully use our deferred tax asset depends on the amount of taxable income that we generate during those time periods. At least once each year, or more frequently, if warranted, we make estimates of future taxable income that we believe we are likely to generate during those future periods. If we conclude, on the basis of those estimates and the amount of the tax benefits available to us, that it is more likely than not that we will be able to fully utilize those tax benefits prior to their expiration, we recognize the deferred tax asset in full on our balance sheet. On the other hand, if we conclude on the basis of those estimates and the amount of the tax benefits available to us that it has become more likely than not that we will be unable to utilize those tax benefits in full prior to their expiration, then we would establish (or increase any existing) valuation allowance to reduce the deferred tax asset on our balance sheet to the amount which we believe we are more likely than not to be able to utilize. Such a reduction is implemented by recognizing a non-cash charge that would have the effect of increasing the provision, or reducing any credit, for income taxes that we would otherwise have recorded in our statements of operations. The determination of whether and the extent to which we will be able to utilize our deferred tax asset involves significant management judgments and assumptions that are subject to period-to-period changes as a result of changes in tax laws, changes in the market, or economic conditions that could affect our operating results or variances between our actual operating results and our projected operating results, as well as other factors.

The Bank is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2012.

Note 14 – Employee Benefit Plans

Stock Purchase Plan

The Bank's 2011 Employee Stock Purchase Plan (the "2011 Plan") was adopted by the Bank's Board of Directors and approved by the Bank's Stockholders on May 2, 2011. The 2011 Plan is open to all employees of the Company and the Bank who have met certain eligibility requirements.

Under the 2011 Plan, as amended and restated as of July 1, 2012, eligible employees can purchase, through payroll deductions, shares of common stock at a discount. The right to purchase stocks is granted to eligible employees during a period of time that is established from time to time by the Board of Directors of the Company. Eligible employees cannot accrue the right to purchase more than $25 thousand worth of stock at the fair market value at the beginning of each offer period. Eligible employees also may not purchase more than one thousand five hundred (1,500) shares of stock in any one offer period. The shares are purchased at 85% of the fair market price of the stock on the enrollment date. The Bank recognized $11 thousand, $30 thousand and $28 thousand in compensation expense in 2018, 2017 and 2016, respectively.

Employee Retirement Savings Plan

The Bank has a 401(k) Plan whereby substantially all employees, with at least one year of continuous service, are eligible to participate in the Plan. Effective March 1, 2008, the Bank makes matching contributions equal to 100% of an employee's deferrals, up to 1% of the employee's compensation, plus 50% of the employee's deferrals that exceed

1% but are less than 6% of the employee's compensation. Effective March 1, 2008, matching contributions become 100% vested to the employee after two years of service. For the years ended December 31, 2018, 2017 and 2016, the expense attributable to the Plan was $721 thousand, $591 thousand and $543 thousand, respectively.

Supplemental Executive Retirement Plan ("SERP")

In April 2011, the Bank established an unfunded Supplemental Executive Retirement Plan (the "SERP") for its Executive Officers and Senior Vice Presidents. The SERP provides that, subject to meeting certain vesting requirements, they will become entitled to receive 12 equal successive monthly retirement payments totaling $50,000 per annum for Senior Vice Presidents, $100,000 for the Executive Vice Presidents, and $150,000 for the President and CEO for the 15 years immediately following the date of their retirement or other termination of their employment.

The Company follows FASB ASC 715-30-35, which requires us to recognize in our balance sheet the funded status of any post-retirement plans that we maintain, and to recognize, in other comprehensive income, changes in the funded status of any such plans in any year in which changes occur.

The changes in the projected benefit obligation of other benefits under the Plan during 2018 and 2017, its funded status at December 31, 2018 and 2017, and the amounts recognized in the balance sheet at December 31, 2018 and 2017, were as follows:

	At December 31,	
	2018	2017
Change in benefit obligation:		
Benefit obligation at beginning of period	$4,958	$3,903
Service cost	901	886
Interest cost	215	169
Participant contributions	-	-
Plan amendments	-	-
Combination/divestiture/curtailment/settlement/termination	-	-
Actuarial loss/(gain)	-	-
(Benefits paid)	-	-
Benefit obligation at end of period	$6,074	$4,958
Funded status:		
Amounts recognized in the Statement of Financial Condition		
Unfunded accrued SERP liability—current	$6,074	$4,958
Unfunded accrued SERP liability—noncurrent	-	-
Total unfunded accrued SERP liability	$6,074	$4,958
Net amount recognized in accumulated other comprehensive income		
Prior service cost/(benefit)	$-	$-
Net actuarial loss/(gain)	-	-
Total net amount recognized in accumulated other comprehensive income	-	-
Accumulated benefit obligation	$6,074	$4,958
Components of net periodic SERP cost:		
Service cost	$5,355	$4,454
Interest cost	719	504
Expected return on plan assets	-	-
Amortization of prior service cost/(benefit)	-	-
Amortization of net actuarial loss/(gain)	-	-
Net periodic SERP cost	$6,074	$4,958
Recognized in other comprehensive income:		
Prior service cost/(benefit)	$-	$-
Net actuarial loss/(gain)	-	-
Amortization of prior service cost/(benefit)	-	-
Amortization of net actuarial loss/(gain)	-	-
Total recognized year to date in other comprehensive income	$-	$-

Assumptions as of December 31:		
Assumed discount rate	4.33 %	4.33 %
Rate of compensation increase	0.00 %	0.00 %

As of December 31, 2018, $1.1 million in benefits are expected to be paid in the next five years. During 2019, $1.2 million is expected to be recognized in net periodic benefit cost.

Note 15 – Earnings Per Common Share

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Bank relate solely to shares for which employees' funds have been collected but not issued under the Employee Stock Purchase Plan for 2018, 2017 and 2016, and are determined using the treasury stock method.

Earnings per common share have been computed based on reported net income and the following share data:

	Years Ended December 31,		
	2018	2017	2016
Net income	$12,839	$8,544	$13,553
less preferred stock dividends	(546)	(552)	(49)
Net income available for common stockholders	12,293	7,992	13,504
Weighted average number of common shares outstanding	9,614	9,291	9,251
Effect of dilutive options	-	-	-
Weighted average number of common shares outstanding -			
used to calculate diluted earnings per common share	9,614	9,291	9,251
Income per common share:			
Basic	$1.28	$0.86	$1.46
Diluted	$1.28	$0.86	$1.46

Note 16 – Commitments and Contingencies

The Bank is a party to credit-related financial instruments with off-balance-sheet risk, in the normal course of business, to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount reflected in the consolidated financial statements.

The Bank's exposure to credit loss, in the event of nonperformance by the other parties to financial instruments for loan commitments and letters of credit, is represented by the contractual amount of these instruments. The Bank follows the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

A summary of financial instruments with off-balance-sheet risk at December 31, 2018 and 2017, is as follows:

	December 31,	
	2018	2017
Commitments to extend credit	$163,802	$159,767

Letters of credit:		
Standby letters of credit	$55,418	$54,707
Commercial letters of credit	3,070	2,601
Total	$58,488	$57,308

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 the payment of a fee. The commitments for certain lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the customer. The Bank had recorded $30 thousand in reserve liabilities associated with these commitments at December 31, 2018.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party or the shipment of merchandise from a third party. Those letters of credit are primarily issued to support government and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting these commitments.

The Bank considers its standby letters of credit to be guarantees. At December 31, 2018, the maximum undiscounted future payments that the Bank could be required to make was $58.5 million. All of these arrangements mature within one year. The Bank generally has recourse to recover from the customer any amounts paid under these guarantees. Most of the guarantees are fully collateralized; however, some are unsecured. The Bank recorded $30.0 thousand in reserve liabilities associated with these guarantees at December 31, 2018.

Mortgage loans serviced for others are not included in the accompanying consolidated statements of condition. The unpaid principal balances of mortgage loans serviced for others were $189.6 million and $205.5 million at December 31, 2018 and 2017, respectively. At December 31, 2018 and 2017, the Bank recorded mortgage servicing rights at their fair value of $1.8 million and $1.9 million, respectively.

The Bank utilizes facilities, equipment and land under various operating leases with terms ranging from 1 to 99 years. Some of these leases include scheduled rent increases. The total amount of the rent is being debited to expense under the straight-line method over the lease terms. The Bank has recorded a deferred obligation of $1.0 million and $874 thousand as of December 31, 2018 and 2017, respectively, which has been included within other liabilities, to reflect the excess of rent expense over cash paid on the leases.

At December 31, 2018, annual lease commitments under the above noncancelable operating leases were as follows:

Years ending December 31,	
2019	$2,366
2020	2,364
2021	2,156
2022	1,752
2023 and thereafter	19,983
Total lease commitments	$28,621

The Bank leases certain facilities from two separate entities in which two of its directors have separate ownership interests. Lease payments made to these entities during the years ended December 31, 2018, 2017 and 2016 approximated $350 thousand, $371 thousand and $379 thousand, respectively.

Additionally, the Bank leases office space to third parties, with original lease terms ranging from 3 to 5 years with option periods ranging up to 15 years. At December 31, 2018, minimum future rents to be received under noncancelable operating sublease agreements were $38 thousand, $26 thousand, $0 thousand and $0 thousand for the years ending December 31, 2019, 2020, 2021 and 2022, respectively.

A summary of rental activities for the years ended December 31, 2018, 2017 and 2016, is as follows:

	For the Years Ended December 31,		
	2018	2017	2016
Rent expense	$3,038	$2,852	$2,673
Less: sublease rentals	123	193	291
Net rent expense	$2,915	$2,659	$2,382

Legal Contingencies

The Bank is involved in certain legal actions and claims that arise in the ordinary course of business. Management believes that, as a result of its legal defenses and insurance arrangements, none of these matters are expected to have a material adverse effect on the Bank’s financial position, results of operations or cash flows.

Note 17 – Minimum Regulatory Capital Requirements

The Bank is subject to various regulatory capital requirements administered by the United States federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items, as calculated under regulatory accounting practices.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, Tier 1 capital and common equity Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). As of December 31, 2018 and 2017, the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2018, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, common equity Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables.

There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios as of December 31, 2018 and 2017, are also presented in the table.

	Actual Amount	Ratio	For Capital Adequacy Purposes Amount	Ratio	To Be Well Capitalized Under Prompt Corrective Action Provisions Amount	Ratio
At December 31, 2018:						
Total capital (to Risk Weighted Assets)	$163,198	13.329%	$ 120,909	9.875 %	$ 122,440	10.000 %
Tier 1 capital (to Risk Weighted Assets)	$147,788	12.070%	$ 96,421	7.875 %	$ 97,952	8.000 %
Tier 1 capital (to Average Assets)	$147,788	7.768 %	$ 76,098	4.000 %	$ 95,123	5.000 %
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$142,788	11.662%	$ 78,055	6.375 %	$ 79,586	6.500 %
At December 31, 2017:						
Total capital (to Risk	$151,699	12.490%	$ 112,347	9.250 %	$ 121,456	10.000 %

Weighted Assets)									
Tier 1 capital (to Risk Weighted Assets)	$	136,521	11.240	%	$ 88,056	7.250	%	$ 97,165	8.000	%
Tier 1 capital (to Average Assets)	$	136,521	6.968	%	$ 78,373	4.000	%	$ 97,967	5.000	%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$	131,521	10.829	%	$ 69,837	5.750	%	$ 78,946	6.500	%

In early July 2013, the Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The final rules took effect for community banks on January 1, 2015, subject to a transition period for certain parts of the rules. Also effective January 1, 2015, a new Basel III capital adequacy standard was implemented. The Bank exceeds the adequately capitalized and the well capitalized standards under these measures. Management believes the Company and the Bank will remain adequately capitalized and well-capitalized under the standards.

Since the formation of the Company in 2011, our assets have grown by 71.4% ($788.5 million), while our stockholders' equity has grown by 67.1% ($59.6 million, including $45.4 million in retained earnings). The growth in equity has helped to increase our capital ratios, and those ratios remain well above the well capitalized standards. To provide sufficient capital resources to expand our holdings, the Board approved the issuance of an additional $5.0 million in common stock during 2015, of which $2.9 million in was issued that year, and an additional $10.0 million in non-cumulative perpetual preferred stock, of which $9.8 million was issued during 2016. During the fourth quarter of 2017 and the first quarter of 2018, the Company issued an additional $4.2 million in common stuck in an SEC-registered public offering at a purchase price of $12.25 per common share.

Non-Cumulative Perpetual Preferred Stock

Commencing September 15, 2016, the Company offered a private placement of securities for the issuance and sale of an aggregate of 10,000 shares of its new Series A Non-Cumulative Perpetual Preferred Stock. This offer carried a subscription price of $1,000.00 per share and a yield of 5.5% (the "Series A Preferred Stock") to various accredited and a limited number of non-accredited investors for total proceeds of up to $10 million (the "Offering"). Each subscriber could purchase a minimum number of Series A Preferred Stock equivalent to at least $250,000 (250 shares). The Offering agreement contains customary warranties, representations and indemnification provisions, and expired on December 31, 2016. At December 31, 2016, 9,800 of these shares were issued and outstanding.

In addition, the Company's actual capital amounts and ratios as of December 31, 2018, and December 31, 2017, are also presented in the table below.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
At December 31, 2018						
Total capital (to Risk Weighted Assets)	$167,732	13.662%	$ 121,239	9.875 %	$ 122,774	10.000 %
Tier 1 capital (to Risk Weighted Assets)	$152,281	12.403%	$ 96,684	7.875 %	$ 98,219	8.000 %
Tier 1 capital (to Average Assets)	$152,281	7.991 %	$ 76,229	4.000 %	$ 95,287	5.000 %
Common Equity Tier 1 Capital (to Risk Weighted Assets)	$142,498	11.607%	$ 78,268	6.375 %	$ 79,803	6.500 %
At December 31, 2017						
Total capital (to Risk Weighted Assets)	$156,300	12.834%	$ 112,648	9.250 %	$ 121,781	10.000 %
Tier 1 capital (to Risk Weighted Assets)	$141,052	11.582%	$ 88,291	7.250 %	$ 97,425	8.000 %
Tier 1 capital (to Average Assets)	$141,052	7.187 %	$ 78,504	4.000 %	$ 98,130	5.000 %

Common Equity Tier 1 Capital (to Risk Weighted Assets)	$131,269	10.779%	$ 70,024	5.750 %	$ 79,158	6.500 %

Note 18 – Parent Company Only Information

Condensed Statements of Financial Condition

(Dollars in thousands)

	December 31, 2018	2017
Assets		
Due from subsidiaries	$1,158	$1,248
Investment in subsidiaries	147,147	136,895
Other assets	-	4
Total assets	$148,305	$138,147
Liabilities and stockholders’ equity		
Liabilities	$10	$-
Stockholders’ equity	148,295	138,147
Total liabilities and stockholders’ equity	$148,305	$138,147

Condensed Statements of Income

(Dollars in thousands)

	December 31,		
	2018	2017	2016
Dividend income	$4,134	$3,993	$3,918
Interest expense	-	-	165
Other expenses	362	302	400
Equity in undistributed income of subsidiary	9,067	4,853	10,200
Net income	$12,839	$8,544	$13,553

Condensed Statements of Cash Flows

(Dollars in thousands)

	December 31,		
	2018	2017	2016
Cash flows from operating activities:			
Net income	$12,839	$8,544	$13,553
Adjustments to reconcile net income to net cash provided by operating activities:			
Undistributed (earnings) losses of subsidiary	(9,067)	(4,853)	(10,200)
Net change in operating assets and liabilities:			
Other assets	14	5	
Net cash provided by operating activities	3,786	3,696	3,353
Cash flows from investing activities:			
Payments for investments in and advances to subsidiaries	(2,640)	(1,498)	(5,300)
Acquisition of an unconsolidated subsidiary	-	-	(3,075)
Dividends received from unconsolidated subsidiary	402	281	50
Other	-	-	19
Net cash used in investing activities	(2,238)	(1,217)	(8,306)
Cash flows from financing activities:			
Cash dividends paid	(4,401)	(4,269)	(3,750)
Proceeds from issuance of common stock	2,763	1,584	225
Proceeds from issuance of preferred stock	-	-	9,783
Net cash (used in) provided by financing activities	(1,638)	(2,685)	6,258
Net change in cash and cash equivalents	(90)	(206)	1,305
Cash and Cash Equivalents, beginning of period	1,248	1,454	149
Cash and Cash Equivalents, end of period	$1,158	$1,248	$1,454

Note 19 – Fair Value Measurements

The Bank uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with ASC Topic 820, “Fair Value Measurements and Disclosures”, the fair value of a financial instrument is the price that would be received in selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Bank’s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, the Bank groups its financial assets and financial liabilities, generally measured at fair value, in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1: Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market, as well as certain U.S. Treasury securities that are highly liquid and are actively traded in over-the-counter markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2: Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active.

Level 3: Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Financial assets measured at fair value on a recurring basis as of December 31, 2018 and 2017, are as follows:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
At December 31, 2018				
U.S. treasury notes and bonds	$ 54,160	$ -	$ -	$54,160
U.S. government agency and government sponsored enterprise (GSE) debt securities	-	44,750	-	44,750
U.S. government agency pool securities	-	211,372	-	211,372
U.S. government agency or GSE	-	70,760	-	70,760
Other assets:				

MSRs	-	-	1,778	1,778
Total fair value	$ 54,160	$ 326,882	$ 1,778	$ 382,820
At December 31, 2017				
U.S. treasury notes and bonds	$ 59,169	$ -	$ -	$ 59,169
U.S. government agency and government sponsored enterprise (GSE) debt securities	-	44,858	-	44,858
U.S. government agency pool securities	-	282,343	-	282,343
U.S. government agency or GSE	-	74,418	-	74,418
Other assets:				
MSRs	-	-	1,903	1,903
Total fair value	$ 59,169	$ 401,619	$ 1,903	$ 462,691

There were no liabilities measured at fair value on a recurring basis as of December 31, 2018 and 2017.

During the periods ended December 31, 2018, 2017 and 2016, the changes in Level 3 assets (consisting solely of MSRs) measured at fair value on a recurring basis are as follows:

	Twelve Months Ended December 31,		
	2018	2017	2016
Beginning balance	$1,903	$1,527	$1,462
Realized and unrealized net gains:			
Included in net income	(125)	376	64
Included in other comprehensive income	-	-	-
Purchases, issuance and settlements			
Purchases	-	-	-
Issuances	-	-	1
Settlements	-	-	-
Ending balance	$1,778	$1,903	$1,527

The valuation technique used for Level 3 MSRs is their discounted cash flow. Inputs considered in determining Level 3 pricing include the anticipated prepayment rates, discount rates, and cost to service. Significant increases or decreases in any of those inputs in isolation would result in a significantly lower or higher fair value measurement.

The following table presents quantitative information about the valuation technique and unobservable inputs applied to Level 3 fair value measurements for financial instruments measured at fair value on a recurring basis:

	Estimated Fair Value	Valuation Technique	Unobservable Inputs	Range of Inputs	Weighted Average Rate
December 31, 2018					
Financial instrument:					
MSRs	$ 1,778	Discounted Cash Flow	Discount Rate	8.39% - 9.12%	8.50%
			Weighted Average Prepayment Rate (Public Securities Association)	125%	

There were no transfers into or out of the Bank's Level 3 financial instruments for the periods ended December 31, 2018, and December 31, 2017.

The valuation techniques for assets measured at fair value on a recurring basis are as follows:

Investment Securities

When quoted prices are available in an active market, the Bank classifies the securities within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid U.S. Government debt, equity securities, Treasury notes and bonds.

If quoted market prices are not available, the Bank estimates fair values using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, include GSE obligations, corporate bonds, and other securities. Mortgage-backed securities are included in Level 2 if observable inputs are available. In certain cases where there is limited activity or less transparency around inputs to the valuation, the Bank would classify those securities in Level 3. At December 31, 2018 and 2017, the Bank did not have any Level 3 investment securities.

Mortgage Servicing Rights

The fair value measurement of mortgage servicing rights is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques that incorporate assumptions that market participants would use in estimating the fair value of servicing rights. The most important of these assumptions is the interest rate used in discounting the future cash flows into their present value. Other assumptions might include estimates of prepayment speeds, costs to service, escrow account earnings, contractual servicing fee income, prepayment and late fees, among other considerations. The Bank’s mortgage servicing rights are considered a Level 3 measurement at December 31, 2018 and 2017.

Assets Measured at Fair Value on a Nonrecurring Basis

Under certain circumstances the Bank makes adjustments to fair value for assets and liabilities even though they are not measured at fair value on an ongoing basis. The following table presents the financial instruments carried on the consolidated statements of condition by caption and by level in the fair value hierarchy at December 31, 2018 and 2017, for which a nonrecurring change in fair value has been recorded:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
December 31, 2018				
Financial assets:				
Loans, net				
Impaired loans	$ -	$ -	$ -	$-
Other assets				
Other real estate owned	$ -	$ -	$ 1,543	$1,543
December 31, 2017				
Financial assets:				
Loans, net				
Impaired loans	$ -	$ -	$ -	$-
Other assets				
Other real estate owned	$ -	$ -	$ 2,466	$2,466

During the year ended December 31, 2018, no loan was written down as being collateral deficient from its carrying value during the year. The fair value of loans subject to write downs is estimated using the appraised value of the underlying collateral, discounted as necessary due to management's estimates of changes in economic conditions, less the estimated costs of selling the assets.

Additionally, the Bank may make fair value adjustments to nonfinancial assets and liabilities in certain circumstances (such as impairments) though such nonfinancial assets and liabilities are not measured at fair value on recurring basis. The Bank does not have nonfinancial assets or liabilities for which a nonrecurring fair value has been recorded during the periods ended December 31, 2018 and 2017.

Fair Value of Other Financial Instruments

The estimated fair values of the Bank's other financial instruments, excluding those assets recorded at fair value on a recurring basis on the Bank's consolidated statements of condition, are as follows:

		Estimated fair value		
	Carrying Amount	Level 1	Level 2	Level 3
December 31, 2018	(Dollars in thousands)			
Financial assets:				
Cash and cash equivalents	$155,095	$155,095	$-	$-
Restricted cash	400	400	-	-
Federal Home Loan Bank stock	2,356	-	2,356	-
Investment securities held-to-maturity	68,088	-	67,477	-
Loans	1,212,141	-	-	1,212,289
Total	$1,438,080	$155,495	$69,833	$1,212,289
Financial liabilities:				
Deposits	1,728,823	-	-	1,731,830
Total	$1,728,823	$-	$-	$1,731,830
December 31, 2017				
Financial assets:				
Cash and cash equivalents	$126,127	$126,127	$-	$-
Restricted cash	400	400	-	-
Federal Home Loan Bank stock	2,303	-	2,303	-
Investment securities held-to-maturity	89,677	-	89,999	-
Loans	1,209,824	-	-	1,202,817
Total	$1,428,331	$126,527	$92,302	$1,202,817
Financial liabilities:				
Deposits	$1,816,132	$-	$-	$1,816,773
Total	$1,816,132	$-	$-	$1,816,773

During the periods ended December 31, 2018, 2017 and 2016, the changes in Level 3 loans and deposits measured at fair value on a non-recurring basis are as follows:

	Twelve Months Ended December 31,		
	2018	2017	2016
Beginning loan balance	$1,202,817	$1,149,937	$1,046,589
Net issuances	9,472	52,879	103,348
Ending loan balance	$1,212,289	$1,202,817	$1,149,937

	Twelve Months Ended December 31,		
	2018	2017	2016
Beginning deposit balance	$1,816,773	$1,767,345	$1,416,843
Net deposits	(84,944)	49,428	350,502

Ending deposit balance	$1,731,830	$1,816,773	$1,767,345

The valuation technique used for Level 3 loans and deposits is their discounted cash flow. Inputs considered in determining Level 3 pricing include the respective discount rates. Significant increases or decreases in those inputs in isolation would result in a significantly lower or higher fair value measurement.

The following table presents quantitative information about the valuation technique and unobservable inputs applied to Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis:

	Estimated Fair Value	Valuation Technique	Unobservable Inputs	Range of Inputs	Weighted Average Rate
December 31, 2018					
Financial instrument:					
Loans	$1,212,289	Discounted Cash Flow	Discount Rate	6.88% - 7.68%	7.28%
Deposits	$1,731,830	Discounted Cash Flow	Discount Rate	0.13% - 0.88%	0.16%
December 31, 2017					
Financial instrument:					
Loans	$1,202,817	Discounted Cash Flow	Discount Rate	6.25% - 7.51%	7.26%
Deposits	$1,816,773	Discounted Cash Flow	Discount Rate	0.14% - 1.25%	0.16%

The following methods were used by the Company in estimating fair value for its financial instruments not previously disclosed:

Cash, Cash Equivalents and Restricted Cash, including Interest Bearing Deposits in Banks

The carrying amount of cash and short-term instruments approximates fair value based on the short-term nature of the assets. Fair values for interest-bearing deposits that reprice frequently are based upon carrying value. Fair values of other interest bearing deposits with longer terms are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Loans

For variable-rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Deposit Liabilities

The fair values disclosed for demand deposits (for example, interest and non-interest checking, passbook savings and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates currently on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits.

Short-Term Borrowings

The carrying amounts of Federal Funds purchased and FHLB advances maturing within ninety days approximate their fair values. We had no outstanding short-term borrowings at December 31, 2017 or 2018.

Long-Term Borrowings

Fair value of FHLB advances maturing after ninety days is determined based on expected present value techniques based on current market rates for advances with similar terms and remaining maturities. We had no outstanding long-term borrowings at December 31, 2017 or 2018.

Accrued Interest

The carrying amount of accrued interest approximates fair value due to its short-term nature.

Note 20 – Subsequent Events

At January 16, 2019, one large commercial loan customer with an outstanding relationship of $10.1 million in unsecured loans sought bankruptcy protection in order to reorganize under Chapter 11 of Title 11 of the United States Code. The borrower filing for bankruptcy was evaluated under ASC 450 – "Contingencies", and the Bank holds $4.7 million in deposits for which the Court has approved a right of offset. The Bank also has assigned a specific allowance of $5.2 million to the outstanding debt. The outstanding loans under bankruptcy have been classified as substandard, but are still accruing interest and the scheduled payments on the loans remain current.