

WESTAMERICA BANCORPORATION  
Form 10-Q  
August 04, 2017

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 2017**

**or**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number: 001-09383**

**WESTAMERICA BANCORPORATION**

**(Exact Name of Registrant as Specified in Its Charter)**

CALIFORNIA 94-2156203  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

**1108 FIFTH AVENUE, SAN RAFAEL, CALIFORNIA 94901**

(Address of Principal Executive Offices) (Zip Code)

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

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

Yes No

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

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

Smaller reporting company Emerging growth company

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

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

Yes No

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

Title of Class Shares outstanding as of July 27, 2017

Common Stock, 26,305,907  
No Par Value

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## FORWARD-LOOKING STATEMENTS

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

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

Forward-looking statements speak only as of the date they are made. The Company undertakes no obligation to update any forward-looking statements in this Report to reflect circumstances or events that occur after the date forward looking statements are made, except as may be required by law. The reader is directed to the Company's annual report on Form 10-K for the year ended December 31, 2016, for further discussion of factors which could affect the Company's business and cause actual results to differ materially from those expressed in any forward-looking statement made in this report.

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

## WESTAMERICA BANCORPORATION

## CONSOLIDATED BALANCE SHEETS

(unaudited)

|  | At<br>At June 30,<br>2017 | At<br>December<br>31,<br>2016 |
|--|---------------------------|-------------------------------|
|  | (In thousands)            |                               |
| Assets:  |                           |                               |
| Cash and due from banks  | \$529,362                 | \$462,271                     |
| Investment securities available for sale   | 1,976,156                 | 1,890,758                     |
| Investment securities held to maturity, with fair values of: \$1,264,759 at June 30, 2017 and \$1,340,741 at December 31, 2016           | 1,261,321                 | 1,346,312                     |
| Loans  | 1,318,341                 | 1,352,711                     |
| Allowance for loan losses  | (24,103 )                 | (25,954 )                     |
| Loans, net of allowance for loan losses  | 1,294,238                 | 1,326,757                     |
| Other real estate owned  | 1,645                     | 3,095                         |
| Premises and equipment, net  | 35,564                    | 36,566                        |
| Identifiable intangibles, net  | 5,365                     | 6,927                         |
| Goodwill   | 121,673                   | 121,673                       |
| Other assets   | 168,026                   | 171,724                       |
| Total Assets   | \$5,393,350               | \$5,366,083                   |
| Liabilities:   |                           |                               |
| Noninterest-bearing deposits   | \$2,079,608               | \$2,089,443                   |
| Interest-bearing deposits  | 2,602,962                 | 2,615,298                     |
| Total deposits   | 4,682,570                 | 4,704,741                     |
| Short-term borrowed funds  | 75,769                    | 59,078                        |
| Other liabilities  | 39,417                    | 40,897                        |
| Total Liabilities  | 4,797,756                 | 4,804,716                     |
| Contingencies (Note 10)  |                           |                               |
| Shareholders' Equity:  |                           |                               |
| Common stock (no par value), authorized - 150,000 shares Issued and outstanding: 26,304 at June 30, 2017 and 25,907 at December 31, 2016 | 424,479                   | 404,606                       |
| Deferred compensation  | 1,533                     | 1,533                         |
| Accumulated other comprehensive loss   | (5,864 )                  | (10,074 )                     |

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|  |             |             |
|--|-------------|-------------|
| Retained earnings                          | 175,446     | 165,302     |
| Total Shareholders' Equity                 | 595,594     | 561,367     |
| Total Liabilities and Shareholders' Equity | \$5,393,350 | \$5,366,083 |

See accompanying notes to unaudited consolidated financial statements.

## WESTAMERICA BANCORPORATION

## CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

|  | For the Three<br>Months<br>Ended June 30, |           | For the Six Months |           |
|--|---|-----------|--------------------|-----------|
|  | 2017                                      | 2016      | 2017               | 2016      |
|  | (In thousands, except per share data)     |           |                    |           |
| Interest and Loan Fee Income:  |   |           |                    |           |
| Loans  | \$ 15,468                                 | \$ 17,583 | \$ 31,248          | \$ 35,936 |
| Investment securities available for sale                                     | 10,709                                    | 8,091     | 20,958             | 16,058    |
| Investment securities held to maturity                                       | 6,986                                     | 8,053     | 14,281             | 15,380    |
| Total Interest and Loan Fee Income   | 33,163                                    | 33,727    | 66,487             | 67,374    |
| Interest Expense:  |   |           |                    |           |
| Deposits   | 465                                       | 531       | 934                | 1,074     |
| Short-term borrowed funds  | 11  | 10        | 22                 | 19        |
| Total Interest Expense   | 476                                       | 541       | 956                | 1,093     |
| Net Interest and Loan Fee Income   | 32,687                                    | 33,186    | 65,531             | 66,281    |
| Reversal of Provision for Loan Losses  | (1,900 )                                  | -         | (1,900 )           | -         |
| Net Interest and Loan Fee Income After Reversal of Provision for Loan Losses | 34,587                                    | 33,186    | 67,431             | 66,281    |
| Noninterest Income:  |   |           |                    |           |
| Service charges on deposit accounts  | 4,945                                     | 5,239     | 9,868              | 10,487    |
| Merchant processing services   | 2,052                                     | 1,638     | 3,927              | 3,167     |
| Debit card fees  | 1,586                                     | 1,621     | 3,067              | 3,137     |
| Trust fees   | 716                                       | 657       | 1,418              | 1,318     |
| Other service fees   | 662                                       | 650       | 1,312              | 1,279     |
| ATM processing fees  | 654                                       | 603       | 1,229              | 1,261     |
| Financial services commissions   | 142                                       | 137       | 337                | 293       |
| Other noninterest income   | 1,366                                     | 1,157     | 2,622              | 2,489     |
| Total Noninterest Income   | 12,123                                    | 11,702    | 23,780             | 23,431    |
| Noninterest Expense:   |   |           |                    |           |
| Salaries and related benefits  | 12,981                                    | 12,887    | 26,051             | 26,004    |
| Occupancy  | 3,509                                     | 3,400     | 7,142              | 6,798     |
| Outsourced data processing services  | 2,188                                     | 2,130     | 4,327              | 4,260     |
| Furniture and equipment  | 1,267                                     | 1,187     | 2,521              | 2,400     |
| Amortization of identifiable intangibles                                     | 762                                       | 870       | 1,562              | 1,775     |
| Courier service  | 438                                       | 462       | 859                | 1,007     |
| Professional fees  | 410                                       | 758       | 1,021              | 1,490     |
| Other real estate owned  | (126 )                                    | (392 )    | (166 )             | (281 )    |
| Other noninterest expense  | 2,967                                     | 3,927     | 5,694              | 7,634     |
| Total Noninterest Expense  | 24,396                                    | 25,229    | 49,011             | 51,087    |
| Income Before Income Taxes   | 22,314                                    | 19,659    | 42,200             | 38,625    |
| Provision for income taxes   | 6,515                                     | 5,113     | 11,352             | 9,853     |



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|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Net Income                                | \$15,799 | \$14,546 | \$30,848 | \$28,772 |
| Average Common Shares Outstanding         | 26,299   | 25,586   | 26,235   | 25,516   |
| Average Diluted Common Shares Outstanding | 26,402   | 25,630   | 26,366   | 25,549   |
| Per Common Share Data:                    |          |          |          |          |
| Basic earnings                            | \$0.60   | \$0.57   | \$1.18   | \$1.13   |
| Diluted earnings                          | 0.60     | 0.57     | 1.17     | 1.13     |
| Dividends paid                            | 0.39     | 0.39     | 0.78     | 0.78     |

See accompanying notes to unaudited consolidated financial statements.

## WESTAMERICA BANCORPORATION

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

|   | For the Three<br>Months<br>Ended June 30, |          | For the Six Months |          |
|---|---|----------|--------------------|----------|
|   | 2017                                      | 2016     | 2017               | 2016     |
|   | (In thousands)                            |          |                    |          |
| Net income  | \$15,799                                  | \$14,546 | \$30,848           | \$28,772 |
| Other comprehensive income:   |   |          |                    |          |
| Changes in unrealized gains and losses on securities available for sale             | 6,160                                     | 9,070    | 7,234              | 19,311   |
| Deferred tax expense  | (2,590 )                                  | (3,813 ) | (3,042 )           | (8,119 ) |
| Changes in unrealized gains and losses on securities available for sale, net of tax | 3,570                                     | 5,257    | 4,192              | 11,192   |
| Post-retirement benefit transition obligation amortization                          | 15  | 15       | 30                 | 30       |
| Deferred tax expense  | (6 )                                      | (6 )     | (12 )              | (12 )    |
| Post-retirement benefit transition obligation amortization, net of tax              | 9   | 9        | 18                 | 18       |
| Total other comprehensive income  | 3,579                                     | 5,266    | 4,210              | 11,210   |
| Total comprehensive income  | \$19,378                                  | \$19,812 | \$35,058           | \$39,982 |

See accompanying notes to unaudited consolidated financial statements.

## WESTAMERICA BANCORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(unaudited)

|  | Common<br>Shares<br>Outstanding | Common<br>Stock | Deferred<br>Compensation | Accumulated<br>Other<br>Comprehensive<br>Income (loss) | Retained<br>Earnings | Total     |
|--|---------------------------------|-----------------|--------------------------|--|----------------------|-----------|
|  | (In thousands)                  |                 |                          |  |                      |           |
| Balance, December 31, 2015   | 25,528                          | \$378,858       | \$ 2,578                 | \$ 675   | \$150,094            | \$532,205 |
| Net income for the period  |                                 |                 |                          |  | 28,772               | 28,772    |
| Other comprehensive income   |                                 |                 |                          | 11,210   |                      | 11,210    |
| Exercise of stock options  | 225                             | 10,060          |                          |  |                      | 10,060    |
| Tax benefit increase upon exercise and expiration of stock options |                                 | 211             |                          |  |                      | 211       |
| Restricted stock activity  | 15                              | 1,798           | (1,045 )                 |  |                      | 753       |
| Stock based compensation   |                                 | 752             |                          |  |                      | 752       |
| Stock awarded to employees   | 1                               | 60              |                          |  |                      | 60        |
| Retirement of common stock   | (137 )                          | (2,059 )        |                          |  | (3,721 )             | (5,780 )  |
| Dividends  |                                 |                 |                          |  | (19,916 )            | (19,916 ) |
| Balance, June 30, 2016   | 25,632                          | \$389,680       | \$ 1,533                 | \$ 11,885  | \$155,229            | \$558,327 |
| Balance, December 31, 2016   | 25,907                          | \$404,606       | \$ 1,533                 | \$ (10,074 )   | \$165,302            | \$561,367 |
| Net income for the period  |                                 |                 |                          |  | 30,848               | 30,848    |
| Other comprehensive income   |                                 |                 |                          | 4,210  |                      | 4,210     |
| Exercise of stock options  | 389                             | 18,290          |                          |  |                      | 18,290    |
| Restricted stock activity  | 13                              | 707             |                          |  |                      | 707       |
| Stock based compensation   |                                 | 912             |                          |  |                      | 912       |
| Stock awarded to employees   | 1                               | 54              |                          |  |                      | 54        |
| Retirement of common stock   | (6 )                            | (90 )           |                          |  | (224 )               | (314 )    |
| Dividends  |                                 |                 |                          |  | (20,480 )            | (20,480 ) |
| Balance, June 30, 2017   | 26,304                          | \$424,479       | \$ 1,533                 | \$ (5,864 )  | \$175,446            | \$595,594 |

See accompanying notes to unaudited consolidated financial statements.

## WESTAMERICA BANCORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

|   | For the Six Months<br>Ended June 30, |           |
|---|--------------------------------------|-----------|
|   | 2017                                 | 2016      |
|   | (In thousands)                       |           |
| Operating Activities:   |                                      |           |
| Net income  | \$30,848                             | \$28,772  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                      |           |
| Depreciation and amortization   | 12,068                               | 8,618     |
| Reversal of provision for loan losses   | (1,900 )                             | -         |
| Net amortization of deferred loan cost (fees)                                     | 21                                   | (157 )    |
| (Increase) decrease in interest income receivable                                 | (415 )                               | 171       |
| Life insurance premiums paid  | (126 )                               | (126 )    |
| Increase (decrease) in income taxes payable                                       | 91                                   | (1,469 )  |
| Decrease in net deferred tax asset  | 262                                  | 2,066     |
| Tax benefit increase upon exercise and expiration of stock options                | -                                    | (211 )    |
| Decrease (increase) in other assets   | 1,155                                | (4,211 )  |
| Stock option compensation expense   | 912                                  | 752       |
| Increase in interest expense payable  | 33                                   | 46        |
| (Decrease) increase in other liabilities  | (2,553 )                             | 1,849     |
| Net writedown of premises and equipment   | 60                                   | 7         |
| Net gain on sale of foreclosed assets   | (72 )                                | (1,017 )  |
| Writedown of foreclosed assets  | -                                    | 758       |
| Net Cash Provided by Operating Activities   | 40,384                               | 35,848    |
| Investing Activities:   |                                      |           |
| Net repayments of loans   | 35,852                               | 104,975   |
| Net (payments) receipts under FDIC <sup>(1)</sup> indemnification agreements      | (63 )                                | 98        |
| Purchases of investment securities available for sale                             | (253,658)                            | (260,587) |
| Proceeds from sale/maturity/calls of securities available for sale                | 171,632                              | 344,393   |
| Purchases of investment securities held to maturity                               | -                                    | (246,956) |
| Proceeds from maturity/calls of securities held to maturity                       | 80,433                               | 82,059    |
| Purchases of premises and equipment   | (1,050 )                             | (991 )    |
| Net change in FRB <sup>(2)</sup> stock  | 24                                   | -         |
| Proceeds from sale of foreclosed assets   | 1,521                                | 5,848     |
| Net Cash Provided by Investing Activities   | 34,691                               | 28,839    |
| Financing Activities:   |                                      |           |
| Net change in deposits  | (22,171 )                            | (55,345 ) |
| Net change in short-term borrowings   | 16,691                               | 14,824    |
| Exercise of stock options   | 18,290                               | 10,060    |
| Tax benefit increase upon exercise and expiration of stock options                | -                                    | 211       |

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|  |           |           |
|--|-----------|-----------|
| Retirement of common stock                     | (314 )    | (5,780 )  |
| Common stock dividends paid                    | (20,480 ) | (19,916 ) |
| Net Cash Used in Financing Activities          | (7,984 )  | (55,946 ) |
| Net Change In Cash and Due from Banks          | 67,091    | 8,741     |
| Cash and Due from Banks at Beginning of Period | 462,271   | 433,044   |
| Cash and Due from Banks at End of Period       | \$529,362 | \$441,785 |

Supplemental Cash Flow Disclosures:

Supplemental disclosure of non cash activities:

|  |     |        |
|--|-----|--------|
| Loan collateral transferred to other real estate owned | \$- | \$488  |
| Securities purchases pending settlement                | 649 | 26,488 |

Supplemental disclosure of cash flow activities:

|                                    |        |       |
|------------------------------------|--------|-------|
| Interest paid for the period       | 955    | 1,046 |
| Income tax payments for the period | 10,998 | 9,922 |

See accompanying notes to unaudited consolidated financial statements.

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

(2) Federal Reserve Bank ("FRB")

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### Note 1: Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission and follow general practices within the banking industry. The results of operations reflect interim adjustments, all of which are of a normal recurring nature and which, in the opinion of Management, are necessary for a fair presentation of the results for the interim periods presented. The interim results for the three and six months ended June 30, 2017 are not necessarily indicative of the results expected for the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes as well as other information included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

### Note 2: Accounting Policies

The most significant accounting policies followed by the Company are presented in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, Management has identified the allowance for loan losses accounting to be the accounting area requiring the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available. A discussion of the factors affecting accounting for the allowance for loan losses is included in the "Provision for Loan Losses," "Loan Portfolio Credit Risk" and "Allowance for Loan Losses" discussion below. Certain amounts in prior periods have been reclassified to conform to the current presentation.

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

quoted market prices or are provided by other third-party sources, when available.

#### Recently Adopted Accounting Standards

FASB Accounting Standards Update (ASU) 2016-09, *Improvements to Employee Share-Based Payment Accounting*, was issued March 30, 2016. The provisions of the new standard changes several aspects of the accounting for share-based payment award transactions, including: (1) Accounting and Cash Flow Classification for Excess Tax Benefits, (2) Forfeitures, and (3) Tax Withholding Requirements and Cash Flow Classification. The Company adopted the ASU provisions effective January 1, 2017, which has the potential to create volatility in the book tax provision at the time nonqualified stock options are exercised or expire. During the first six months of 2017, 389 thousand shares were issued due to the exercise of nonqualified stock options resulting in a tax deduction exceeding related share based compensation by \$1.6 million. The first six months of 2017 income tax provision was \$666 thousand lower than would have been under accounting standards prior to the adoption of ASU 2016-09. The Company elected to account for forfeitures as they occur.

#### Recently Issued Accounting Standards

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

Approximately 73% of our revenue, including all of our net interest income and a portion of our noninterest income, is out of scope of the guidance. The contracts that are in scope of the guidance are primarily related to service charges and fees on deposit accounts, merchant processing fees, trust fees and other service charges, commissions and fees. We have created an implementation team that is analyzing the individual contracts in scope to determine if our current accounting will change. This review is expected to be completed in the fourth quarter of 2017.

The Company will be required to adopt the ASU on January 1, 2018. The Company intends to adopt the accounting standard during the first quarter of 2018, as required. The Company has not yet selected a transition method. The Company's preliminary analysis suggests that the adoption of this accounting standard is not expected to have a material impact on the Company's consolidated financial statements as substantially all of the Company's revenues are excluded from the scope of the new standard.

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

The Company will be required to adopt the ASU provisions on January 1, 2018. Management is evaluating the impact that the ASU will have on the Company's financial statements.

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

The Company will be required to adopt the ASU provisions January 1, 2019, utilizing the modified retrospective transition approach. Management is evaluating the impact that the ASU will have on the Company's financial statements. As of December 31, 2016, the Company leased 61 of its operating facilities; the remaining minimum lease payments were \$20.8 million. The Company does not expect a material change in noninterest expenses upon adoption of the new standard.

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



The Company will be required to adopt the ASU provisions on January 1, 2020. Management is evaluating the impact that the ASU will have on the Company's consolidated financial statements. The ultimate adjustment to the allowance for loan losses will be accomplished through an offsetting after-tax adjustment to shareholders' equity. Management expects the Company and the Bank to meet all regulatory capital adequacy requirements to which they are subject following adoption of the new standard. Economic conditions and the composition of the Company's loan portfolio at the time of adoption will influence the extent of the adopting accounting adjustment.

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

The Company will be required to adopt the ASU provisions on January 1, 2019. Management is evaluating the impact the ASU will have on the Company's financial statements.

**Note 3: Investment Securities**

An analysis of the amortized cost, gross unrealized gains and losses accumulated in other comprehensive income, and fair value of the available for sale investment securities portfolio follows:

| Investment Securities Available for Sale<br>At June 30, 2017 |                   |                              |                               |               |
|--|-------------------|------------------------------|-------------------------------|---------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| (In thousands)   |                   |                              |                               |               |
| Securities of U.S. Government sponsored entities             | \$122,274         | \$ 18                        | \$ (1,999 )                   | \$120,293     |
| Agency residential mortgage-backed securities (MBS)          | 719,638           | 841                          | (16,997 )                     | 703,482       |
| Non-agency residential MBS                                   | 183               | -                            | -                             | 183           |
| Agency commercial MBS  | 1,927             | -                            | (13 )                         | 1,914         |
| Non-agency commercial MBS                                    | 1,869             | -                            | (14 )                         | 1,855         |
| Obligations of states and political subdivisions             | 177,603           | 5,387                        | (2,103 )                      | 180,887       |
| FHLMC <sup>(1)</sup> and FNMA <sup>(2)</sup> stock           | 749               | 6,576                        | -                             | 7,325         |
| Corporate securities   | 959,997           | 2,600                        | (4,532 )                      | 958,065       |
| Other securities   | 2,003             | 337                          | (188 )                        | 2,152         |
| Total  | \$1,986,243       | \$ 15,759                    | \$ (25,846 )                  | \$1,976,156   |

<sup>(1)</sup> Federal Home Loan Mortgage Corporation

<sup>(2)</sup> Federal National Mortgage Association

An analysis of the amortized cost, gross unrecognized gains and losses, and fair value of the held to maturity investment securities portfolio follows:

| Investment Securities Held to Maturity<br>At June 30, 2017 |                   |                                |                                 |               |
|--|-------------------|--------------------------------|---------------------------------|---------------|
|  | Amortized<br>Cost | Gross<br>Unrecognized<br>Gains | Gross<br>Unrecognized<br>Losses | Fair<br>Value |
| (In thousands)   |                   |                                |                                 |               |
| Agency residential MBS                                     | \$605,983         | \$ 738                         | \$ (7,287 )                     | \$599,434     |
| Non-agency residential MBS                                 | 4,911             | 82                             | -                               | 4,993         |
| Agency commercial MBS                                      | 9,187             | 3                              | (103 )                          | 9,087         |
| Obligations of states and political subdivisions           | 641,240           | 11,188                         | (1,183 )                        | 651,245       |
| Total  | \$1,261,321       | \$ 12,011                      | \$ (8,573 )                     | \$1,264,759   |

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An analysis of the amortized cost, gross unrealized gains and losses accumulated in other comprehensive income, and fair value of the available for sale investment securities portfolio follows:

| Investment Securities Available for Sale           |                   |                              |                               |               |
|--|-------------------|------------------------------|-------------------------------|---------------|
| At December 31, 2016                               |                   |                              |                               |               |
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| (In thousands)                                     |                   |                              |                               |               |
| Securities of U.S. Government sponsored entities   | \$141,599         | \$ 35                        | \$(2,974 )                    | \$138,660     |
| Agency residential MBS                             | 711,623           | 921                          | (21,045 )                     | 691,499       |
| Non-agency residential MBS                         | 272               | -                            | (1 )                          | 271           |
| Non-agency commercial MBS                          | 2,041             | -                            | (16 )                         | 2,025         |
| Obligations of states and political subdivisions   | 182,230           | 5,107                        | (3,926 )                      | 183,411       |
| Asset-backed securities                            | 696               | -                            | (1 )                          | 695           |
| FHLMC <sup>(1)</sup> and FNMA <sup>(2)</sup> stock | 749               | 10,120                       | -                             | 10,869        |
| Corporate securities                               | 866,835           | 1,690                        | (7,668 )                      | 860,857       |
| Other securities                                   | 2,034             | 621                          | (184 )                        | 2,471         |
| Total  | \$1,908,079       | \$ 18,494                    | \$(35,815 )                   | \$1,890,758   |

<sup>(1)</sup> Federal Home Loan Mortgage Corporation

<sup>(2)</sup> Federal National Mortgage Association

An analysis of the amortized cost, gross unrecognized gains and losses, and fair value of the held to maturity investment securities portfolio follows:

| Investment Securities Held to Maturity           |                   |                                |                                 |               |
|--|-------------------|--------------------------------|---------------------------------|---------------|
| At December 31, 2016                             |                   |                                |                                 |               |
|  | Amortized<br>Cost | Gross<br>Unrecognized<br>Gains | Gross<br>Unrecognized<br>Losses | Fair<br>Value |
| (In thousands)                                   |                   |                                |                                 |               |
| Securities of U.S. Government sponsored entities | \$581             | \$ 1                           | \$ -                            | \$582         |
| Agency residential MBS                           | 668,235           | 1,122                          | (8,602 )                        | 660,755       |
| Non-agency residential MBS                       | 5,370             | 76                             | -                               | 5,446         |
| Agency commercial MBS                            | 9,332             | 11                             | (143 )                          | 9,200         |
| Obligations of states and political subdivisions | 662,794           | 6,031                          | (4,067 )                        | 664,758       |
| Total  | \$1,346,312       | \$ 7,241                       | \$(12,812 )                     | \$1,340,741   |

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

|                    | At June 30, 2017     |             | Securities Held |             |
|--------------------|----------------------|-------------|-----------------|-------------|
|                    | Securities Available |             | to Maturity     |             |
|                    | Amortized            | Fair        | Amortized       | Fair        |
|                    | Cost                 | Value       | Cost            | Value       |
|                    | (In thousands)       |             |                 |             |
| Maturity in years: |                      |             |                 |             |
| 1 year or less     | \$212,847            | \$213,262   | \$27,034        | \$27,849    |
| Over 1 to 5 years  | 760,615              | 758,384     | 287,607         | 290,554     |
| Over 5 to 10 years | 238,957              | 241,929     | 304,849         | 310,660     |
| Over 10 years      | 47,455               | 45,670      | 21,750          | 22,182      |
| Subtotal           | 1,259,874            | 1,259,245   | 641,240         | 651,245     |
| MBS                | 723,617              | 707,434     | 620,081         | 613,514     |
| Other securities   | 2,752                | 9,477       | -               | -           |
| Total              | \$1,986,243          | \$1,976,156 | \$1,261,321     | \$1,264,759 |

| At December 31, 2016 |                                  |               |                                |               |
|----------------------|----------------------------------|---------------|--------------------------------|---------------|
|                      | Securities Available<br>for Sale |               | Securities Held<br>to Maturity |               |
|                      | Amortized<br>Cost                | Fair<br>Value | Amortized<br>Cost              | Fair<br>Value |
| (In thousands)       |                                  |               |                                |               |
| Maturity in years:   |                                  |               |                                |               |
| 1 year or less       | \$ 154,693                       | \$ 154,835    | \$ 14,961                      | \$ 15,639     |
| Over 1 to 5 years    | 750,834                          | 745,219       | 292,024                        | 292,062       |
| Over 5 to 10 years   | 238,077                          | 239,153       | 318,580                        | 319,587       |
| Over 10 years        | 47,756                           | 44,416        | 37,810                         | 38,052        |
| Subtotal             | 1,191,360                        | 1,183,623     | 663,375                        | 665,340       |
| MBS                  | 713,936                          | 693,795       | 682,937                        | 675,401       |
| Other securities     | 2,783                            | 13,340        | -                              | -             |
| Total                | \$ 1,908,079                     | \$ 1,890,758  | \$ 1,346,312                   | \$ 1,340,741  |

Expected maturities of mortgage-related securities can differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties. In addition, such factors as prepayments and interest rates may affect the yield on the carrying value of mortgage-related securities. At June 30, 2017 and December 31, 2016, the Company had no high-risk collateralized mortgage obligations as defined by regulatory guidelines.

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

| Investment Securities Available for Sale               |                                      |                                   |                      |                                   |                                   |                      |                                   |                     |                      |
|--|--------------------------------------|-----------------------------------|----------------------|-----------------------------------|-----------------------------------|----------------------|-----------------------------------|---------------------|----------------------|
| At June 30, 2017                                       |                                      |                                   |                      |                                   |                                   |                      |                                   |                     |                      |
|  | No.<br>of<br>Investment<br>Positions | Less than 12 months<br>Fair Value | Unrealized<br>Losses | No. of<br>Investment<br>Positions | 12 months or longer<br>Fair Value | Unrealized<br>Losses | No. of<br>Investment<br>Positions | Total<br>Fair Value | Unrealized<br>Losses |
| (\$ in thousands)                                      |                                      |                                   |                      |                                   |                                   |                      |                                   |                     |                      |
| Securities of U.S.<br>Government<br>sponsored entities | 8                                    | \$ 118,210                        | \$(1,999 )           | -                                 | \$-                               | \$-                  | 8                                 | \$ 118,210          | \$(1,999 )           |
| Agency residential<br>MBS                              | 23                                   | 468,590                           | (12,775 )            | 29                                | 112,860                           | (4,222 )             | 52                                | 581,450             | (16,997 )            |
| Agency commercial<br>MBS                               | 1                                    | 1,914                             | (13 )                | -                                 | -                                 | -                    | 1                                 | 1,914               | (13 )                |
| Non-agency<br>commercial MBS                           | 2                                    | 1,126                             | (7 )                 | 1                                 | 729                               | (7 )                 | 3                                 | 1,855               | (14 )                |
| Obligations of states<br>and political<br>subdivisions | 53                                   | 57,306                            | (2,003 )             | 4                                 | 3,633                             | (100 )               | 57                                | 60,939              | (2,103 )             |
| Corporate securities                                   | 57                                   | 425,374                           | (3,717 )             | 23                                | 81,265                            | (815 )               | 80                                | 506,639             | (4,532 )             |

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|                  |     |             |            |    |           |           |     |             |            |
|------------------|-----|-------------|------------|----|-----------|-----------|-----|-------------|------------|
| Other securities | -   | -           | -          | 1  | 1,812     | (188 )    | 1   | 1,812       | (188 )     |
| Total            | 144 | \$1,072,520 | \$(20,514) | 58 | \$200,299 | \$(5,332) | 202 | \$1,272,819 | \$(25,846) |

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

Investment Securities Held to Maturity

At June 30, 2017

|  | No. of Investment Positions | Less than 12 months |                     | No. of Investment Positions | 12 months or longer |                     | No. of Investment Positions | Total      |                     |
|--|-----------------------------|---------------------|---------------------|-----------------------------|---------------------|---------------------|-----------------------------|------------|---------------------|
|  |                             | Fair Value          | Unrecognized Losses |                             | Fair Value          | Unrecognized Losses |                             | Fair Value | Unrecognized Losses |
| (\$ in thousands)                                |                             |                     |                     |                             |                     |                     |                             |            |                     |
| Agency residential MBS                           | 64                          | \$497,924           | \$(6,995)           | 6                           | \$12,895            | \$(292)             | 70                          | \$510,819  | \$(7,287)           |
| Agency commercial MBS                            | -                           | -                   | -                   | 1                           | 7,137               | (103)               | 1                           | 7,137      | (103)               |
| Obligations of states and political subdivisions | 85                          | 76,591              | (783)               | 13                          | 12,815              | (400)               | 98                          | 89,406     | (1,183)             |
| Total  | 149                         | \$574,515           | \$(7,778)           | 20                          | \$32,847            | \$(795)             | 169                         | \$607,362  | \$(8,573)           |

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

The Company does not intend to sell any investments and has concluded that it is more likely than not that it will not be required to sell the investments prior to recovery of the amortized cost basis. Therefore, the Company does not consider these investments to be other-than-temporarily impaired as of June 30, 2017.

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

As of June 30, 2017, \$795,007 thousand of investment securities were pledged to secure public deposits and short-term borrowed funds. As of December 31, 2016, \$768,845 thousand of investment securities were pledged to secure public deposits and short-term borrowed funds.

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

| Investment Securities Available for Sale         |                   |                     |                   |                   |                     |                   |                   |                   |                   |
|--|-------------------|---------------------|-------------------|-------------------|---------------------|-------------------|-------------------|-------------------|-------------------|
| At December 31, 2016                             |                   |                     |                   |                   |                     |                   |                   |                   |                   |
|  | No. of            | Less than 12 months | Unrealized        | No. of            | 12 months or longer | Unrealized        | No. of            | Total             | Unrealized        |
| Investment                                       | Investment        | Investment          | Investment        | Investment        | Investment          | Investment        | Investment        | Investment        | Investment        |
| Positions  | Positions         | Positions           | Positions         | Positions         | Positions           | Positions         | Positions         | Positions         | Positions         |
| Fair Value                                       | Fair Value        | Fair Value          | Fair Value        | Fair Value        | Fair Value          | Fair Value        | Fair Value        | Fair Value        | Fair Value        |
| (\$ in thousands)                                | (\$ in thousands) | (\$ in thousands)   | (\$ in thousands) | (\$ in thousands) | (\$ in thousands)   | (\$ in thousands) | (\$ in thousands) | (\$ in thousands) | (\$ in thousands) |
|  |                   | Losses              | Losses            |                   | Losses              | Losses            |                   | Losses            | Losses            |
| Securities of U.S. Government sponsored entities | 8                 | \$ 117,227          | \$(2,974 )        | -                 | \$-                 | \$-               | 8                 | \$ 117,227        | \$(2,974 )        |
| Agency residential MBS                           | 21                | 524,269             | (16,494 )         | 28                | 122,901             | (4,551 )          | 49                | 647,170           | (21,045 )         |
| Non-agency residential MBS                       | 2                 | 246                 | (1 )              | -                 | -                   | -                 | 2                 | 246               | (1 )              |
|  | 2                 | 1,253               | (9 )              | 1                 | 772                 | (7 )              | 3                 | 2,025             | (16 )             |





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

|  | For the Three<br>Months<br>Ended June 30, |          | For the Six Months |          |
|--|---|----------|--------------------|----------|
|  | 2017                                      | 2016     | 2017               | 2016     |
|  | (In thousands)                            |          |                    |          |
| Taxable  | \$12,481                                  | \$10,558 | \$24,627           | \$20,231 |
| Tax-exempt from regular federal income tax       | 5,214                                     | 5,586    | 10,612             | 11,207   |
| Total interest income from investment securities | \$17,695                                  | \$16,144 | \$35,239           | \$31,438 |

**Note 4: Loans and Allowance for Loan Losses**

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

|                              | At June 30,<br>2017 | At December 31, 2016 |
|------------------------------|---------------------|----------------------|
|                              | (In thousands)      |                      |
| Commercial                   | \$344,702           | \$ 354,697           |
| Commercial Real Estate       | 564,372             | 542,171              |
| Construction                 | 2,699               | 2,555                |
| Residential Real Estate      | 72,375              | 87,724               |
| Consumer Installment & Other | 334,193             | 365,564              |
| Total                        | \$1,318,341         | \$ 1,352,711         |

Total loans outstanding reported above include loans purchased from the FDIC of \$104,481 thousand and \$121,210 thousand at June 30, 2017 and December 31, 2016, respectively. Loans purchased from the FDIC were separately reported in prior periods and have been reclassified into their respective categories in the current presentation.

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

|  | For the<br>Six<br>Months<br>Ended | For the<br>Year Ended<br>December 31, 2016 |
|--|-----------------------------------|--|
|--|-----------------------------------|--|

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|  | June 30,<br>2017 |            |   |
|--|------------------|------------|---|
|  | (In thousands)   |            |   |
| Accretable yield:                              |                  |            |   |
| Balance at the beginning of the period         | \$1,237          | \$ 1,259   |   |
| Reclassification from nonaccretable difference | 1,209            | 3,912      |   |
| Accretion                                      | (1,462)          | (3,934)    | ) |
| Balance at the end of the period               | \$984            | \$ 1,237   |   |
| Accretion                                      | \$(1,462)        | \$ (3,934) | ) |
| Change in FDIC indemnification                 | 191              | 1,053      |   |
| (Increase) in interest income                  | \$(1,271)        | \$ (2,881) | ) |

The following summarizes activity in the allowance for loan losses:

|                                 | Allowance for Loan Losses                |             |              |             |             |             |          |
|---------------------------------|--|-------------|--------------|-------------|-------------|-------------|----------|
|                                 | For the Three Months Ended June 30, 2017 |             |              |             |             |             |          |
|                                 | Commercial                               | Commercial  | Construction | Residential | Consumer    | Unallocated | Total    |
|                                 | Real Estate                              | Real Estate |              | Real Estate | Installment |             |          |
|                                 |  |             |              |             | and Other   |             |          |
|                                 | (In thousands)                           |             |              |             |             |             |          |
| Allowance for loan losses:      |  |             |              |             |             |             |          |
| Balance at beginning of period  | \$8,593                                  | \$ 3,522    | \$ 112       | \$ 1,214    | \$ 6,984    | \$ 4,494    | \$24,919 |
| Additions:                      |  |             |              |             |             |             |          |
| (Reversal) provision            | (38 )                                    | (55 )       | (1,851 )     | (109 )      | 736         | (583 )      | (1,900 ) |
| Deductions:                     |  |             |              |             |             |             |          |
| Chargeoffs                      | (726 )                                   | -           | -            | -           | (1,158 )    | -           | (1,884 ) |
| Recoveries                      | 338                                      | 78          | 1,899        | -           | 653         | -           | 2,968    |
| Net loan (losses) recoveries    | (388 )                                   | 78          | 1,899        | -           | (505 )      | -           | 1,084    |
| Total allowance for loan losses | \$8,167                                  | \$ 3,545    | \$ 160       | \$ 1,105    | \$ 7,215    | \$ 3,911    | \$24,103 |

Allowance for Loan Losses  
For the Six Months Ended June 30, 2017

|                                 | Commercial | Commercial<br>Real Estate | Construction | Residential<br>Real Estate | Consumer<br>Installment<br>and Other | Unallocated | Total    |
|---------------------------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands)                  |            |                           |              |                            |                                      |             |          |
| Allowance for loan losses:      |            |                           |              |                            |                                      |             |          |
| Balance at beginning of period  | \$8,327    | \$ 3,330                  | \$ 152       | \$ 1,330                   | \$ 7,980                             | \$ 4,835    | \$25,954 |
| Additions:                      |            |                           |              |                            |                                      |             |          |
| Provision (reversal)            | 171        | 127                       | (1,891 )     | (225 )                     | 842                                  | (924 )      | (1,900 ) |
| Deductions:                     |            |                           |              |                            |                                      |             |          |
| Chargeoffs                      | (829 )     | -                         | -            | -                          | (2,897 )                             | -           | (3,726 ) |
| Recoveries                      | 498        | 88                        | 1,899        | -                          | 1,290                                | -           | 3,775    |
| Net loan (losses) recoveries    | (331 )     | 88                        | 1,899        | -                          | (1,607 )                             | -           | 49       |
| Total allowance for loan losses | \$8,167    | \$ 3,545                  | \$ 160       | \$ 1,105                   | \$ 7,215                             | \$ 3,911    | \$24,103 |

Allowance for Loan Losses  
For the Three Months Ended June 30, 2016

|                                 | Commercial | Commercial<br>Real Estate | Construction | Residential<br>Real Estate | Consumer<br>Installment<br>and Other | Unallocated | Total    |
|---------------------------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands)                  |            |                           |              |                            |                                      |             |          |
| Allowance for loan losses:      |            |                           |              |                            |                                      |             |          |
| Balance at beginning of period  | \$9,847    | \$ 4,237                  | \$ 187       | \$ 1,707                   | \$ 7,576                             | \$ 5,933    | \$29,487 |
| Additions:                      |            |                           |              |                            |                                      |             |          |
| Provision (reversal)            | 777        | (340 )                    | (20 )        | (71 )                      | 445                                  | (791 )      | -        |
| Deductions:                     |            |                           |              |                            |                                      |             |          |
| Chargeoffs                      | (764 )     | -                         | -            | -                          | (715 )                               | -           | (1,479 ) |
| Recoveries                      | 542        | 15                        | -            | -                          | 345                                  | -           | 902      |
| Net loan (losses) recoveries    | (222 )     | 15                        | -            | -                          | (370 )                               | -           | (577 )   |
| Total allowance for loan losses | \$10,402   | \$ 3,912                  | \$ 167       | \$ 1,636                   | \$ 7,651                             | \$ 5,142    | \$28,910 |

Allowance for Loan Losses  
For the Six Months Ended June 30, 2016

|                                 | Commercial | Commercial<br>Real Estate | Construction | Residential<br>Real Estate | Consumer<br>Installment<br>and Other | Unallocated | Total    |
|---------------------------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands)                  |            |                           |              |                            |                                      |             |          |
| Allowance for loan losses:      |            |                           |              |                            |                                      |             |          |
| Balance at beginning of period  | \$9,559    | \$ 4,212                  | \$ 235       | \$ 1,801                   | \$ 8,001                             | \$ 5,963    | \$29,771 |
| Additions:                      |            |                           |              |                            |                                      |             |          |
| Provision (reversal)            | 815        | (330 )                    | (68 )        | (165 )                     | 569                                  | (821 )      | -        |
| Deductions:                     |            |                           |              |                            |                                      |             |          |
| Chargeoffs                      | (1,935 )   | -                         | -            | -                          | (1,720 )                             | -           | (3,655 ) |
| Recoveries                      | 1,963      | 30                        | -            | -                          | 801                                  | -           | 2,794    |
| Net loan recoveries (losses)    | 28         | 30                        | -            | -                          | (919 )                               | -           | (861 )   |
| Total allowance for loan losses | \$10,402   | \$ 3,912                  | \$ 167       | \$ 1,636                   | \$ 7,651                             | \$ 5,142    | \$28,910 |

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

| Allowance for Loan Losses and Recorded Investment in Loans Evaluated for Impairment |            |                           |              |                               |                                      |             |             |
|---|------------|---------------------------|--------------|-------------------------------|--------------------------------------|-------------|-------------|
| At June 30, 2017  |            |                           |              |                               |                                      |             |             |
|   | Commercial | Commercial<br>Real Estate | Construction | Residential<br>Real<br>Estate | Consumer<br>Installment<br>and Other | Unallocated | Total       |
| (In thousands)  |            |                           |              |                               |                                      |             |             |
| Allowance for loan losses:  |            |                           |              |                               |                                      |             |             |
| Individually evaluated for impairment   | \$4,908    | \$ -                      | \$ -         | \$ -                          | \$ -                                 | \$ -        | \$4,908     |
| Collectively evaluated for impairment   | 3,259      | 3,545                     | 160          | 1,105                         | 7,215                                | 3,911       | 19,195      |
| Purchased loans with evidence of credit deterioration                               | -          | -                         | -            | -                             | -                                    | -           | -           |
| Total   | \$8,167    | \$3,545                   | \$ 160       | \$ 1,105                      | \$7,215                              | \$ 3,911    | \$24,103    |
| Carrying value of loans:  |            |                           |              |                               |                                      |             |             |
| Individually evaluated for impairment   | \$10,829   | \$ 14,009                 | \$ -         | \$ 214                        | \$ -                                 | \$ -        | \$25,052    |
| Collectively evaluated for impairment   | 333,846    | 549,820                   | 2,699        | 72,161                        | 333,877                              | -           | 1,292,403   |
| Purchased loans with evidence of credit deterioration                               | 27         | 543                       | -            | -                             | 316                                  | -           | 886         |
| Total   | \$344,702  | \$564,372                 | \$ 2,699     | \$72,375                      | \$334,193                            | \$ -        | \$1,318,341 |

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

At December 31, 2016

|   | Commercial     | Commercial<br>Real Estate | Construction | Residential<br>Real<br>Estate | Consumer<br>Installment<br>and Other | Unallocated | Total       |
|---|----------------|---------------------------|--------------|-------------------------------|--------------------------------------|-------------|-------------|
|   | (In thousands) |                           |              |                               |                                      |             |             |
| Allowance for loan losses:                            |                |                           |              |                               |                                      |             |             |
| Individually evaluated for impairment                 | \$5,048        | \$ -                      | \$ -         | \$ -                          | \$ -                                 | \$ -        | \$5,048     |
| Collectively evaluated for impairment                 | 3,279          | 3,330                     | 152          | 1,330                         | 7,980                                | 4,835       | 20,906      |
| Purchased loans with evidence of credit deterioration | -              | -                         | -            | -                             | -                                    | -           | -           |
| Total   | \$8,327        | \$3,330                   | \$152        | \$1,330                       | \$7,980                              | \$4,835     | \$25,954    |
| Carrying value of loans:                              |                |                           |              |                               |                                      |             |             |
| Individually evaluated for impairment                 | \$11,174       | \$12,706                  | \$ -         | \$835                         | \$ -                                 | \$ -        | \$24,715    |
| Collectively evaluated for impairment                 | 343,494        | 528,957                   | 2,555        | 86,889                        | 365,236                              | -           | 1,327,131   |
| Purchased loans with evidence of credit deterioration | 29             | 508                       | -            | -                             | 328                                  | -           | 865         |
| Total   | \$354,697      | \$542,171                 | \$2,555      | \$87,724                      | \$365,564                            | \$ -        | \$1,352,711 |

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

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

Credit Risk Profile by Internally Assigned Grade

At June 30, 2017

|  | Commercial     | Commercial<br>Real Estate | Construction | Residential<br>Real<br>Estate | Consumer<br>Installment<br>and Other | Total |
|--|----------------|---------------------------|--------------|-------------------------------|--------------------------------------|-------|
|  | (In thousands) |                           |              |                               |                                      |       |

## Grade:

|             |           |           |         |          |           |             |
|-------------|-----------|-----------|---------|----------|-----------|-------------|
| Pass        | \$331,343 | \$540,343 | \$2,699 | \$69,379 | \$331,571 | \$1,275,335 |
| Substandard | 13,359    | 24,029    | -       | 2,996    | 2,399     | 42,783      |
| Doubtful    | -         | -         | -       | -        | -         | -           |
| Loss        | -         | -         | -       | -        | 223       | 223         |
| Total       | \$344,702 | \$564,372 | \$2,699 | \$72,375 | \$334,193 | \$1,318,341 |

(1) Credit risk profile reflects internally assigned grade of purchased covered loans without regard to FDIC indemnification.

## Credit Risk Profile by Internally Assigned Grade

At December 31, 2016

|             | Commercial     | Commercial<br>Real Estate | Construction | Residential<br>Real<br>Estate | Consumer<br>Installment<br>and Other | Total       |
|-------------|----------------|---------------------------|--------------|-------------------------------|--------------------------------------|-------------|
|             | (In thousands) |                           |              |                               |                                      |             |
| Grade:      |                |                           |              |                               |                                      |             |
| Pass        | \$340,973      | \$515,045                 | \$2,555      | \$84,384                      | \$362,597                            | \$1,305,554 |
| Substandard | 13,724         | 25,830                    | -            | 3,340                         | 2,477                                | 45,371      |
| Doubtful    | -              | 1,296                     | -            | -                             | 10                                   | 1,306       |
| Loss        | -              | -                         | -            | -                             | 480                                  | 480         |
| Total       | \$354,697      | \$542,171                 | \$2,555      | \$87,724                      | \$365,564                            | \$1,352,711 |

(1) Credit risk profile reflects internally assigned grade of purchased covered loans without regard to FDIC indemnification.

The following tables summarize loans by delinquency and nonaccrual status:

Summary of Loans by Delinquency and Nonaccrual Status  
At June 30, 2017

|                                | Current and<br>Accruing | 30-59<br>Days Past<br>Due and<br>Accruing | 60-89<br>Days Past<br>Due and<br>Accruing | Past Due<br>90 Days<br>or More<br>and<br>Accruing | Nonaccrual | Total Loans  |
|--------------------------------|-------------------------|---|---|---|------------|--------------|
| (In thousands)                 |                         |   |   |   |            |              |
| Commercial                     | \$ 342,091              | \$ 1,987                                  | \$ 221                                    | \$ -  | \$ 403     | \$ 344,702   |
| Commercial real estate         | 557,707                 | 861                                       | 12  | -   | 5,792      | 564,372      |
| Construction                   | 2,699                   | -   | -   | -   | -          | 2,699        |
| Residential real estate        | 71,553                  | 209                                       | 308                                       | -   | 305        | 72,375       |
| Consumer installment and other | 330,604                 | 2,597                                     | 611                                       | 186   | 195        | 334,193      |
| Total                          | \$ 1,304,654            | \$ 5,654                                  | \$ 1,152                                  | \$ 186  | \$ 6,695   | \$ 1,318,341 |

Summary of Loans by Delinquency and Nonaccrual Status  
At December 31, 2016

|                                | Current and<br>Accruing | 30-59<br>Days Past<br>Due and<br>Accruing | 60-89<br>Days Past<br>Due and<br>Accruing | Past Due<br>90 Days<br>or More<br>and<br>Accruing | Nonaccrual | Total Loans  |
|--------------------------------|-------------------------|---|---|---|------------|--------------|
| (In thousands)                 |                         |   |   |   |            |              |
| Commercial                     | \$ 353,497              | \$ 966                                    | \$ 40                                     | \$ -  | \$ 194     | \$ 354,697   |
| Commercial real estate         | 533,377                 | 1,460                                     | 445                                       | -   | 6,889      | 542,171      |
| Construction                   | 2,329                   | 226                                       | -   | -   | -          | 2,555        |
| Residential real estate        | 86,098                  | 528                                       | 37  | -   | 1,061      | 87,724       |
| Consumer installment and other | 360,549                 | 3,288                                     | 989                                       | 497   | 241        | 365,564      |
| Total                          | \$ 1,335,850            | \$ 6,468                                  | \$ 1,511                                  | \$ 497  | \$ 8,385   | \$ 1,352,711 |

There were no commitments to lend additional funds to borrowers whose loans were on nonaccrual status at June 30, 2017 and December 31, 2016.

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The following summarizes impaired loans:

|  | Impaired Loans<br>At June 30, 2017 |                                |                      |
|--|------------------------------------|--------------------------------|----------------------|
|  | Recorded<br>Investment             | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
|  | (In thousands)                     |                                |                      |
| Impaired loans with no related allowance recorded: |                                    |                                |                      |
| Commercial   | \$1,356                            | \$1,422                        | \$ -                 |
| Commercial real estate                             | 14,827                             | 16,967                         | -                    |
| Construction                                       | -                                  | -                              | -                    |
| Residential real estate                            | 519                                | 549                            | -                    |
| Consumer installment and other                     | 511                                | 618                            | -                    |
| Impaired loans with an allowance recorded:         |                                    |                                |                      |
| Commercial   | 9,845                              | 9,845                          | 4,908                |
| Commercial real estate                             | -                                  | -                              | -                    |
| Construction                                       | -                                  | -                              | -                    |
| Residential real estate                            | -                                  | -                              | -                    |
| Consumer installment and other                     | -                                  | -                              | -                    |
| Total:   |                                    |                                |                      |
| Commercial   | \$11,201                           | \$11,267                       | \$ 4,908             |
| Commercial real estate                             | 14,827                             | 16,967                         | -                    |
| Construction                                       | -                                  | -                              | -                    |
| Residential real estate                            | 519                                | 549                            | -                    |
| Consumer installment and other                     | 511                                | 618                            | -                    |

|  | Impaired Loans<br>At December 31, 2016 |                                |                      |
|--|--|--------------------------------|----------------------|
|  | Recorded<br>Investment                 | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
|  | (In thousands)                         |                                |                      |
| Impaired loans with no related allowance recorded: |  |                                |                      |
| Commercial   | \$1,234                                | \$1,303                        | \$ -                 |
| Commercial real estate                             | 13,233                                 | 15,610                         | -                    |
| Construction                                       | -                                      | -                              | -                    |
| Residential real estate                            | 1,279                                  | 1,309                          | -                    |
| Consumer installment and other                     | 569                                    | 675                            | -                    |
| Impaired loans with an allowance recorded:         |  |                                |                      |
| Commercial   | 10,163                                 | 10,172                         | 5,048                |
| Commercial real estate                             | -                                      | -                              | -                    |
| Construction                                       | -                                      | -                              | -                    |

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|                                |          |          |          |
|--------------------------------|----------|----------|----------|
| Residential real estate        | -        | -        | -        |
| Consumer installment and other | -        | -        | -        |
| Total:                         |          |          |          |
| Commercial                     | \$11,397 | \$11,475 | \$ 5,048 |
| Commercial real estate         | 13,233   | 15,610   | -        |
| Construction                   | -        | -        | -        |
| Residential real estate        | 1,279    | 1,309    | -        |
| Consumer installment and other | 569      | 675      | -        |

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Impaired loans include troubled debt restructured loans. Impaired loans at June 30, 2017, included \$12,419 thousand of restructured loans, \$5,106 thousand of which were on nonaccrual status. Impaired loans at December 31, 2016, included \$12,381 thousand of restructured loans, \$5,302 thousand of which were on nonaccrual status.

|                                | Impaired Loans                      |                            |                             |                            |                                   |                            |                             |                            |
|--------------------------------|-------------------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------------|----------------------------|-----------------------------|----------------------------|
|                                | For the Three Months Ended June 30, |                            |                             |                            | For the Six Months Ended June 30, |                            |                             |                            |
|                                | 2017                                |                            | 2016                        |                            | 2017                              |                            | 2016                        |                            |
|                                | Average Recorded Investment         | Recognized Interest Income | Average Recorded Investment | Recognized Interest Income | Average Recorded Investment       | Recognized Interest Income | Average Recorded Investment | Recognized Interest Income |
|                                | (In thousands)                      |                            |                             |                            |                                   |                            |                             |                            |
| Commercial                     | \$11,194                            | \$ 118                     | \$14,094                    | \$ 135                     | \$11,243                          | \$ 236                     | \$13,752                    | \$ 268                     |
| Commercial real estate         | 15,297                              | 224                        | 18,639                      | 202                        | 14,898                            | 461                        | 19,744                      | 361                        |
| Construction                   | -                                   | -                          | 136                         | -                          | -                                 | -                          | 203                         | -                          |
| Residential real estate        | 368                                 | 5                          | 740                         | 5                          | 558                               | 9                          | 775                         | 9                          |
| Consumer installment and other | 514                                 | 7                          | 412                         | 6                          | 529                               | 14                         | 379                         | 12                         |
| Total                          | \$27,373                            | \$ 354                     | \$34,021                    | \$ 348                     | \$27,228                          | \$ 720                     | \$34,853                    | \$ 650                     |

The following table provides information on troubled debt restructurings:

| Troubled Debt Restructurings<br>At June 30, 2017 |                     |                                 |                           |  |
|--|---------------------|---------------------------------|---------------------------|--|
|  | Number of Contracts | Pre-Modification Carrying Value | Period-End Carrying Value | Period-End Individual Impairment Allowance |
|  | (\$ in thousands)   |                                 |                           |  |
| Commercial                                       | 7                   | \$ 2,418                        | \$ 1,195                  | \$ 49                                      |
| Commercial real estate                           | 11                  | 11,847                          | 11,010                    | -  |
| Residential real estate                          | 1                   | 241                             | 214                       | -  |
| Total  | 19                  | \$ 14,506                       | \$ 12,419                 | \$ 49                                      |

| Troubled Debt Restructurings<br>At December 31, 2016 |                     |                                 |                           |  |
|--|---------------------|---------------------------------|---------------------------|--|
|  | Number of Contracts | Pre-Modification Carrying Value | Period-End Carrying Value | Period-End Individual Impairment Allowance |
|  | (\$ in thousands)   |                                 |                           |  |
| Commercial   | 7                   | \$ 2,719                        | \$ 1,489                  | \$ 113                                     |
| Commercial real estate                               | 10                  | 11,257                          | 10,673                    | -  |
| Residential real estate                              | 1                   | 241                             | 219                       | -  |

|       |    |           |           |        |
|-------|----|-----------|-----------|--------|
| Total | 18 | \$ 14,217 | \$ 12,381 | \$ 113 |
|-------|----|-----------|-----------|--------|

During the three and six months ended June 30, 2017, the Company modified one loan with a carrying value of \$407 thousand and three loans with a carrying value of \$680 thousand, respectively, that were considered troubled debt restructurings. The three concessions granted in the first six months of 2017 consisted of modifications of payment terms to extend the maturity date to allow for deferred principal repayment and under-market terms. During the three and six months ended June 30, 2016, the Company modified one loan with a carrying value of \$242 thousand and four loans with a total carrying value of \$4,843 thousand, respectively, that were considered troubled debt restructurings. The concessions granted in the four restructurings completed in the first six months of 2016 consisted of three modifications of payment terms to extend the maturity date to allow for deferred principal repayment and under-market terms and one court order requiring under-market terms. There were no chargeoffs related to troubled debt restructurings made during the three and six months ended June 30, 2017 and June 30, 2016. During the three and six months ended June 30, 2017 and 2016, no troubled debt restructured loans defaulted within 12 months of the modification date. A troubled debt restructuring is considered to be in default when payments are ninety days or more past due.

There were no loans restricted due to collateral requirements at June 30, 2017 and December 31, 2016.

There were no loans held for sale at June 30, 2017 and December 31, 2016.

At June 30, 2017 and December 31, 2016, the Company held total other real estate owned (OREO) of \$1,645 thousand net of reserve of \$1,685 thousand and \$3,095 thousand net of reserve of \$1,816 thousand, respectively, of which \$-0- thousand was foreclosed residential real estate properties or covered OREO at both dates. The amount of consumer mortgage loans outstanding secured by residential real estate properties for which formal foreclosure proceedings were in process was \$195 thousand at June 30, 2017 and \$-0- thousand at December 31, 2016.

#### Note 5: Concentration of Credit Risk

Under the California Financial Code, credit extended to any one person owing to a commercial bank at any one time shall not exceed the following limitations: (a) unsecured loans shall not exceed 15 percent of the sum of the shareholders' equity, allowance for loan losses, capital notes, and debentures of the bank, or (b) secured and unsecured loans in all shall not exceed 25 percent of the sum of the shareholders' equity, allowance for loan losses, capital notes, and debentures of the bank. At June 30, 2017, Westamerica Bank did not have credit extended to any one entity exceeding these limits. At June 30, 2017, Westamerica Bank had 36 lending relationships each with aggregate loans exceeding \$5 million. The Company has significant credit arrangements that are secured by real estate collateral. In addition to real estate loans outstanding as disclosed in Note 4, the Company had loan commitments related to real estate loans of \$56,654 thousand and \$57,721 thousand at June 30, 2017 and December 31, 2016, respectively. The Company requires collateral on all real estate loans with loan-to-value ratios at origination generally no greater than 75% on commercial real estate loans and no greater than 80% on residential real estate loans. At June 30, 2017, Westamerica Bank held corporate bonds in 61 issuing entities that exceeded \$5 million for each issuer.

#### Note 6: Other Assets

Other assets consisted of the following:

|   | At June<br>30, 2017 | At December 31, 2016 |
|---|---------------------|----------------------|
|   | (In thousands)      |                      |
| Cost method equity investments:           |                     |                      |
| Federal Reserve Bank stock <sup>(1)</sup> | \$14,045            | \$ 14,069            |
| Other investments                         | 159                 | 201                  |
| Total cost method equity investments      | 14,204              | 14,270               |
| Life insurance cash surrender value       | 52,818              | 51,535               |
| Net deferred tax asset                    | 52,101              | 55,417               |
| Limited partnership investments           | 11,691              | 12,591               |
| Interest receivable                       | 21,904              | 21,489               |
| Prepaid assets                            | 4,065               | 4,825                |
| Other assets                              | 11,243              | 11,597               |
| Total other assets                        | \$168,026           | \$ 171,724           |

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

The Company invests in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for low-income housing tax credits. At June 30, 2017, this investment totaled \$11,691 thousand and \$2,299 thousand of this amount represents outstanding equity capital commitments that are included in other liabilities. At December 31, 2016, this investment totaled \$12,591 thousand and \$2,299 thousand of this amount represented outstanding equity capital commitments. At June 30, 2017, the \$2,299 thousand of outstanding equity capital commitments are expected to be paid as follows, \$722 thousand in 2020, \$131 thousand in 2023, \$90 thousand in 2024 and \$1,356 thousand in 2025 or thereafter.

The amounts recognized in net income for these investments include:

|  | For the<br>Three<br>Months<br>Ended<br>June 30,<br>2017 |       | For the Six<br>Months Ended<br>2016 |         |
|--|---|-------|-------------------------------------|---------|
|  | 2017  | 2016  | 2017                                | 2016    |
|  | (In thousands)  |       |                                     |         |
| Investment loss included in pre-tax income           | \$450   | \$675 | \$900                               | \$1,350 |
| Tax credits recognized in provision for income taxes | 462   | 511   | 925                                 | 1,109   |

#### Note 7: Goodwill and Identifiable Intangible Assets

The Company has recorded goodwill and other identifiable intangibles associated with purchase business combinations. Goodwill is not amortized, but is evaluated for impairment at least annually. The Company did not recognize impairment during the three and six months ended June 30, 2017 and year ended December 31, 2016. Identifiable intangibles are amortized to their estimated residual values over their expected useful lives. Such lives and residual values are also periodically reassessed to determine if any amortization period adjustments are indicated. During the three and six months ended June 30, 2017 and year ended December 31, 2016, no such adjustments were recorded.

The carrying values of goodwill were:

|          | At June<br>30, 2017 | At December 31, 2016 |
|----------|---------------------|----------------------|
|          | (In thousands)      |                      |
| Goodwill | \$121,673           | \$ 121,673           |

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

|                          | At June 30, 2017            |                             | At December 31, 2016        |                             |
|--------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                          | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |
|                          | (In thousands)              |                             |                             |                             |
| Core Deposit Intangibles | \$56,808                    | \$ (51,550 )                | \$56,808                    | \$ (50,074 )                |

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|                                      |          |              |          |              |
|--------------------------------------|----------|--------------|----------|--------------|
| Merchant Draft Processing Intangible | 10,300   | (10,193 )    | 10,300   | (10,107 )    |
| Total Identifiable Intangible Assets | \$67,108 | \$ (61,743 ) | \$67,108 | \$ (60,181 ) |

As of June 30, 2017, the current period and estimated future amortization expense for identifiable intangible assets was:

|   | Core<br>Deposit<br>Intangibles | Merchant<br>Draft<br>Processing<br>Intangible | Total   |
|---|--------------------------------|---|---------|
|   | (In thousands)                 |   |         |
| For the Six Months ended June 30, 2017 (actual)             | \$1,476                        | \$ 86   | \$1,562 |
| Estimate for the remainder of year ending December 31, 2017 | 1,437                          | 78  | 1,515   |
| Estimate for year ending December 31, 2018                  | 1,892                          | 29  | 1,921   |
| 2019  | 538                            | -   | 538     |
| 2020  | 287                            | -   | 287     |
| 2021  | 269                            | -   | 269     |
| 2022  | 252                            | -   | 252     |



**Note 8: Deposits and Borrowed Funds**

The following table provides additional detail regarding deposits.

|   | Deposits            |                      |
|---|---------------------|----------------------|
|   | At June 30,<br>2017 | At December 31, 2016 |
|   | (In thousands)      |                      |
| Noninterest-bearing                                 | \$2,079,608         | \$ 2,089,443         |
| Interest-bearing:                                   |                     |                      |
| Transaction   | 885,516             | 865,701              |
| Savings   | 1,470,978           | 1,493,427            |
| Time deposits less than \$100 thousand              | 127,401             | 133,712              |
| Time deposits \$100 thousand through \$250 thousand | 80,940              | 84,925               |
| Time deposits more than \$250 thousand              | 38,127              | 37,533               |
| Total deposits                                      | \$4,682,570         | \$ 4,704,741         |

Demand deposit overdrafts of \$959 thousand and \$2,679 thousand were included as loan balances at June 30, 2017 and December 31, 2016, respectively. Interest expense for aggregate time deposits with individual account balances in excess of \$100 thousand was \$105 thousand and \$211 thousand for the three and six months ended June 30, 2017, respectively and \$135 thousand and \$271 thousand for the three and six months ended June 30, 2016, respectively.

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

|  | Repurchase Agreements (Sweep)                    |                      |
|--|--|----------------------|
|  | Accounted for as Secured Borrowings              |                      |
|  | Remaining Contractual Maturity of the Agreements |                      |
|  | Overnight and Continuous                         |                      |
|  | At June 30, 2017                                 | At December 31, 2016 |
|  | (In thousands)                                   |                      |
| Repurchase agreements:                           |  |                      |
| Collateral securing borrowings:                  |  |                      |
| Securities of U.S. Government sponsored entities | \$ 74,695  | \$ 74,031            |
| Agency residential MBS                           | 61,612   | 63,277               |
| Corporate securities                             | 100,934  | 90,554               |
| Total collateral carrying value                  | \$ 237,241                                       | \$ 227,862           |
| Total short-term borrowed funds                  | \$ 75,769  | \$ 59,078            |

**Note 9: Fair Value Measurements**

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

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

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

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

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

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

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

The Company regularly reviews the valuation techniques and assumptions used by its vendors and determines which valuation techniques are utilized based on observable market inputs for the type of securities being measured. The Company uses the information to determine the placement in the fair value hierarchy as level 1, 2 or 3. When the Company changes its valuation assumptions for measuring financial assets and financial liabilities at fair value, either due to changes in current market conditions or other factors, or reevaluates the valuation techniques and assumptions used by its vendors, it may need to transfer those assets or liabilities to another level in the hierarchy based on the new information. The Company recognizes these transfers at the end of the reporting period that the transfers occur. For the six months ended June 30, 2017 and year ended December 31, 2016, there were no transfers in or out of levels 1, 2 or 3.

#### **Assets Recorded at Fair Value on a Recurring Basis**

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

| At June 30, 2017 |                     |                      |                             |
|------------------|---------------------|----------------------|-----------------------------|
| Fair Value       | Quoted<br>Prices in | Significant<br>Other | Significant<br>Unobservable |

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|  |                | Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Observable<br>Inputs<br>(Level 2) | Inputs<br>(Level 3) |
|--|----------------|--|-----------------------------------|---------------------|
|  | (In thousands) |  |                                   |                     |
| Securities of U.S. Government sponsored entities | \$ 120,293     | \$ -   | \$ 120,293                        | \$ -                |
| Agency residential MBS                           | 703,482        | -  | 703,482                           | -                   |
| Non-agency residential MBS                       | 183            | -  | 183                               | -                   |
| Agency commercial MBS                            | 1,914          | -  | 1,914                             | -                   |
| Non-agency commercial MBS                        | 1,855          | -  | 1,855                             | -                   |
| Obligations of states and political subdivisions | 180,887        | -  | 180,887                           | -                   |
| FHLMC and FNMA stock                             | 7,325          | 10   | 7,315                             | -                   |
| Corporate securities                             | 958,065        | -  | 958,065                           | -                   |
| Other securities                                 | 2,152          | 340  | 1,812                             | -                   |
| Total securities available for sale              | \$ 1,976,156   | \$ 350   | \$ 1,975,806                      | \$ -                |

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|  | At December 31, 2016  |   |  |      |
|--|---|---|--|------|
| Fair Value                                       | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |      |
|  | (In thousands)  |   |  |      |
| Securities of U.S. Government sponsored entities | \$ 138,660  | \$ -  | \$ 138,660   | \$ - |
| Agency residential MBS                           | 691,499   | -   | 691,499  | -    |
| Non-agency residential MBS                       | 271   | -   | 271  | -    |
| Non-agency commercial MBS                        | 2,025   | -   | 2,025  | -    |
| Obligations of states and political subdivisions | 183,411   | -   | 183,411  | -    |
| Asset-backed securities                          | 695   | -   | 695  | -    |
| FHLMC and FNMA stock                             | 10,869  | 17  | 10,852   | -    |
| Corporate securities                             | 860,857   | -   | 860,857  | -    |
| Other securities                                 | 2,471   | 656   | 1,815  | -    |
| Total securities available for sale              | \$ 1,890,758  | \$ 673  | \$ 1,890,085                                       | \$ - |

#### Assets Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower-of-cost or fair-value accounting of individual assets. For assets measured at fair value on a nonrecurring basis that were recorded in the balance sheet at June 30, 2017 and December 31, 2016, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related assets at period end.

|   | At June 30, 2017                    |            |            |            | For the<br>Six<br>Months<br>Ended<br>June 30,<br>2017 |
|---|-------------------------------------|------------|------------|------------|---|
|   | Carrying<br>Value<br>(In thousands) | Level<br>1 | Level<br>2 | Level<br>3 | Total<br>Losses                                       |
| Other real estate owned                                     | \$ 1,645                            | \$ -       | \$ -       | \$ 1,645   | \$ -  |
| Impaired loans  | 9,222                               | -          | -          | 9,222      | -   |
| Total assets measured at fair value on a nonrecurring basis | \$ 10,867                           | \$ -       | \$ -       | \$ 10,867  | \$ -  |

For the

|   | At December 31, 2016 |            |            |          | Year<br>Ended<br>December<br>31, 2016 |
|---|----------------------|------------|------------|----------|---------------------------------------|
|   | Carrying<br>Value    | Level<br>1 | Level<br>2 | Level 3  | Total<br>Losses                       |
|   | (In thousands)       |            |            |          |                                       |
| Other real estate owned                                     | \$3,095              | \$ -       | \$ -       | \$3,095  | \$ (705 )                             |
| Impaired loans  | 9,525                | -          | -          | 9,525    | -                                     |
| Total assets measured at fair value on a nonrecurring basis | \$12,620             | \$ -       | \$ -       | \$12,620 | \$ (705 )                             |

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

## Disclosures about Fair Value of Financial Instruments

The following section describes the valuation methodologies used by the Company for estimating fair value of financial instruments not recorded at fair value in the balance sheet.

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

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

**Loans** Loans were separated into two groups for valuation. Variable rate loans, except for those described below, which reprice frequently with changes in market rates were valued using historical cost. Fixed rate loans and variable rate loans that have reached their minimum contractual interest rates were valued by discounting the future cash flows expected to be received from the loans using current interest rates charged on loans with similar characteristics. Additionally, the allowance for loan losses of \$24,103 thousand at June 30, 2017 and \$25,954 thousand at December 31, 2016 was applied against the estimated fair values to recognize estimated future defaults of contractual cash flows. The Company does not consider these values to be a liquidation price for the loans.

**Deposit Liabilities** Deposits with no stated maturity such as checking accounts, savings accounts and money market accounts can be readily converted to cash or used to settle transactions at face value through the broad financial system operated by the Federal Reserve Bank and financial institutions. The fair value of deposits with no stated maturity is equal to the amount payable on demand. The fair values of time deposits were estimated by discounting estimated future contractual cash flows using current market rates for financial instruments with similar characteristics.

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

The table below is a summary of fair value estimates for financial instruments and the level of the fair value hierarchy within which the fair value measurements are categorized, excluding financial instruments recorded at fair value on a

recurring basis. The values assigned do not necessarily represent amounts which ultimately may be realized for assets or paid to settle liabilities. In addition, these values do not give effect to adjustments to fair value which may occur when financial instruments are sold or settled in larger quantities. The carrying amounts in the following table are recorded in the balance sheet under the indicated captions.

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

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At June 30, 2017

|  | Carrying<br>Amount | Estimated<br>Fair Value | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2 ) | Significant<br>Unobservable<br>Inputs<br>(Level 3 ) |
|--|--------------------|-------------------------|---|--|---|
| Financial Assets: (In thousands)       |                    |                         |   |  |   |
| Cash and due from banks                | \$529,362          | \$529,362               | \$529,362   | \$-  | \$-   |
| Investment securities held to maturity | 1,261,321          | 1,264,759               | -   | 1,264,759  | -   |
| Loans                                  | 1,294,238          | 1,299,025               | -   | -  | 1,299,025   |
| Financial Liabilities:                 |                    |                         |   |  |   |
| Deposits                               | \$4,682,570        | \$4,680,373             | \$-   | \$4,436,102  | \$ 244,271  |
| Short-term borrowed funds              | 75,769             | 75,769                  | -   | 75,769   | -   |

At December 31, 2016

|  | Carrying<br>Amount | Estimated<br>Fair Value | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2 ) | Significant<br>Unobservable<br>Inputs<br>(Level 3 ) |
|--|--------------------|-------------------------|---|--|---|
| Financial Assets: (In thousands)       |                    |                         |   |  |   |
| Cash and due from banks                | \$462,271          | \$462,271               | \$462,271   | \$-  | \$-   |
| Investment securities held to maturity | 1,346,312          | 1,340,741               | -   | 1,340,741  | -   |
| Loans                                  | 1,326,757          | 1,337,774               | -   | -  | 1,337,774   |
| Financial Liabilities:                 |                    |                         |   |  |   |
| Deposits                               | \$4,704,741        | \$4,702,797             | \$-   | \$4,448,571  | \$ 254,226  |
| Short-term borrowed funds              | 59,078             | 59,078                  | -   | 59,078   | -   |

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

#### Note 10: Commitments and Contingent Liabilities

Loan commitments are agreements to lend to a customer provided there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future funding requirements. Loan commitments are subject to the Company's normal credit policies and collateral requirements. Unfunded loan commitments were \$293,481 thousand and \$304,508 thousand at June 30, 2017 and December 31, 2016, respectively. Standby letters of credit commit the Company to make payments on behalf of customers when certain specified future events occur. Standby letters of credit are primarily issued to support customers' short-term financing requirements and must meet the Company's normal credit policies and collateral requirements. Financial and performance standby letters of credit outstanding totaled \$20,042 thousand and \$21,732 thousand at June 30, 2017 and December 31, 2016, respectively. The Company had no commitments outstanding for commercial and similar letters of credit at June 30, 2017 and December 31, 2016. The Company had a reserve for unfunded commitments of \$2,308 thousand at June 30, 2017 and \$2,408 thousand at December 31, 2016, included in other liabilities.

Due to the nature of its business, the Company is subject to various threatened or filed legal cases. Based on the advice of legal counsel, the Company does not expect such cases will have a material, adverse effect on its financial position or results of operations. Legal liabilities are accrued when obligations become probable and the amount can be reasonably estimated.

**Note 11: Earnings Per Common Share**

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

|   | For the Three<br>Months<br>Ended June 30, |          | For the Six Months |          |
|---|---|----------|--------------------|----------|
|   | 2017                                      | 2016     | 2017               | 2016     |
|   | (In thousands, except per share data)     |          |                    |          |
| Net income applicable to common equity (numerator)                              | \$15,799                                  | \$14,546 | \$30,848           | \$28,772 |
| Basic earnings per common share   |   |          |                    |          |
| Weighted average number of common shares outstanding - basic<br>(denominator)   | 26,299                                    | 25,586   | 26,235             | 25,516   |
| Basic earnings per common share   | \$0.60                                    | \$0.57   | \$1.18             | \$1.13   |
| Diluted earnings per common share   |   |          |                    |          |
| Weighted average number of common shares outstanding - basic                    | 26,299                                    | 25,586   | 26,235             | 25,516   |
| Add common stock equivalents for options  | 103                                       | 44       | 131                | 33       |
| Weighted average number of common shares outstanding - diluted<br>(denominator) | 26,402                                    | 25,630   | 26,366             | 25,549   |
| Diluted earnings per common share   | \$0.60                                    | \$0.57   | \$1.17             | \$1.13   |

For the three and six months ended June 30, 2017, options to purchase 352 thousand and 326 thousand shares of common stock, respectively, were outstanding but not included in the computation of diluted earnings per common share because the option exercise price exceeded the fair value of the stock such that their inclusion would have had an anti-dilutive effect.

For the three and six months ended June 30, 2016, options to purchase 779 thousand and 1,038 thousand shares of common stock, respectively, were outstanding but not included in the computation of diluted earnings per common share because the option exercise price exceeded the fair value of the stock such that their inclusion would have had an anti-dilutive effect.

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

## WESTAMERICA BANCORPORATION

## FINANCIAL SUMMARY

|   | For the Three Months<br>Ended June 30, |             | For the Six Months |             |    |
|---|--|-------------|--------------------|-------------|----|
|   | 2017                                   | 2016        | 2017               | 2016        |    |
|   | (In thousands, except per share data)  |             |                    |             |    |
| Net Interest and Loan Fee Income (FTE) <sup>(1)</sup> | \$35,764                               | \$36,495    | \$71,794           | \$72,942    |    |
| Reversal of Provision for Loan Losses                 | (1,900 )                               | -           | (1,900 )           | -           |    |
| Noninterest Income                                    | 12,123                                 | 11,702      | 23,780             | 23,431      |    |
| Noninterest Expense                                   | 24,396                                 | 25,229      | 49,011             | 51,087      |    |
| Income Before Income Taxes (FTE) <sup>(1)</sup>       | 25,391                                 | 22,968      | 48,463             | 45,286      |    |
| Income Tax Provision (FTE) <sup>(1)</sup>             | 9,592                                  | 8,422       | 17,615             | 16,514      |    |
| Net Income  | \$15,799                               | \$14,546    | \$30,848           | \$28,772    |    |
| Average Common Shares Outstanding                     | 26,299                                 | 25,586      | 26,235             | 25,516      |    |
| Average Diluted Common Shares Outstanding             | 26,402                                 | 25,630      | 26,366             | 25,549      |    |
| Common Shares Outstanding at Period End               | 26,304                                 | 25,632      |                    |             |    |
| Per Common Share:                                     |  |             |                    |             |    |
| Basic Earnings  | \$0.60                                 | \$0.57      | \$1.18             | \$1.13      |    |
| Diluted Earnings                                      | 0.60                                   | 0.57        | 1.17               | 1.13        |    |
| Book Value  | \$22.64                                | \$21.78     |                    |             |    |
| Financial Ratios:                                     |  |             |                    |             |    |
| Return on Assets                                      | 1.18                                   | % 1.13      | % 1.15             | % 1.12      | %  |
| Return on Common Equity                               | 10.69                                  | % 10.87     | % 10.58            | % 10.86     | %  |
| Net Interest Margin (FTE) <sup>(1)</sup>              | 3.12                                   | % 3.27      | % 3.13             | % 3.30      | %  |
| Net Loan (Recoveries) Losses to Average Loans         | (0.33                                  | %) 0.16     | %) (0.01           | %) 0.12     | %) |
| Efficiency Ratio <sup>(2)</sup>                       | 50.9                                   | % 52.3      | % 51.3             | % 53.0      | %  |
| Average Balances:                                     |  |             |                    |             |    |
| Assets  | \$5,385,085                            | \$5,184,409 | \$5,390,404        | \$5,179,607 |    |
| Earning Assets  | 4,598,296                              | 4,473,700   | 4,609,089          | 4,427,507   |    |
| Loans   | 1,333,135                              | 1,455,050   | 1,344,132          | 1,477,833   |    |
| Deposits  | 4,669,424                              | 4,531,751   | 4,681,021          | 4,534,650   |    |
| Shareholders' Equity                                  | 593,028                                | 537,987     | 587,736            | 532,582     |    |
| Period End Balances:                                  |  |             |                    |             |    |
| Assets  | \$5,393,350                            | \$5,179,085 |                    |             |    |
| Earning Assets  | 4,555,818                              | 4,433,952   |                    |             |    |
| Loans   | 1,318,341                              | 1,429,560   |                    |             |    |

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|                                    |           |   |           |        |        |   |    |   |
|------------------------------------|-----------|---|-----------|--------|--------|---|----|---|
| Deposits                           | 4,682,570 |   | 4,485,314 |        |        |   |    |   |
| Shareholders' Equity               | 595,594   |   | 558,327   |        |        |   |    |   |
| Capital Ratios at Period End:      |           |   |           |        |        |   |    |   |
| Total Risk Based Capital           | 16.69     | % | 14.76     | %      |        |   |    |   |
| Tangible Equity to Tangible Assets | 8.90      | % | 8.48      | %      |        |   |    |   |
| Dividends Paid Per Common Share    | \$0.39    |   | \$0.39    | \$0.78 | \$0.78 |   |    |   |
| Common Dividend Payout Ratio       | 65        | % | 68        | %      | 67     | % | 69 | % |

The above financial summary has been derived from the Company's unaudited consolidated financial statements. This information should be read

in conjunction with those statements, notes and the other information included elsewhere herein. Percentages under the heading "Financial Ratios"

are annualized with the exception of the efficiency ratio.

(1) Yields on securities and certain loans have been adjusted upward to an FTE basis in order to reflect the effect of income which is exempt from federal income taxation at the current statutory tax rate.

(2) The efficiency ratio is defined as noninterest expense divided by total revenue (net interest income on an FTE basis and noninterest income).

## Financial Overview

Westamerica Bancorporation and subsidiaries' (the "Company") principal source of revenue is net interest and loan fee income, which represents interest and fees earned on loans and investment securities ("earning assets") reduced by interest paid on deposits and other borrowings ("interest-bearing liabilities"). Market interest rates declined considerably following the recession of 2008 and 2009. Interest rates remained historically low through 2016 as the Federal Open Market Committee's ("FOMC") monetary policy was highly accommodative. During this period, Management avoided originating long-dated, low-yielding loans given the potential impact of such assets on forward earning potential; as a result, loans declined and investment securities increased. The changing composition of the earning assets and low market interest rates has pressured the net interest margin to lower levels. The FOMC's first post-recession increase in the federal funds rate occurred in December 2015, although longer-term rates declined. The FOMC's successive post-recession increases in the federal funds rate occurred between December 2016 and June 2017, although longer-term rates have not increased by a similar magnitude. The more recent increase in rates has resulted in competitive loan yields which are more appealing from a profitability perspective, in Management's opinion.

The funding of the Company's earning assets is primarily customer deposits. The Company's long-term strategy includes maximizing checking and savings deposits as these types of deposits are lower-cost and less sensitive to changes in interest rates compared to time deposits. The first half of 2017 average volume of checking and savings deposits was 95 percent of average total deposits.

Credit quality improved during the first half of 2017 with nonperforming assets declining \$3 million to \$9 million at June 30, 2017. The Company realized net recoveries of loan losses of \$1.1 million in the second quarter 2017. The Company recorded a reversal of the provision for loan losses of \$1.9 million in the second quarter 2017.

The Company's long-term strategy also includes controlling operating costs, or "noninterest expense." Noninterest expense of \$49.0 million for the first half of 2017 was \$2.1 million lower than for the first half of 2016.

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

The Company's significant accounting policies (see Note 1 ("Summary of Significant Accounting Policies") to Financial Statements in the Company's 2016 Form 10-K) are fundamental to understanding the Company's results of operations

and financial condition. The Company adopted the FASB ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting* effective January 1, 2017.

The Company reported net income of \$15.8 million or \$0.60 diluted earnings per common share for the second quarter 2017 and net income of \$30.8 million or \$1.17 diluted earnings per common share for the six months ended June 30, 2017. Second quarter 2017 results included a \$1.9 million reversal of provision for loan losses which accounted for \$0.04 of the quarter's diluted earnings per common share. Second quarter and first half of 2017 results reflect the Company's prospective adoption of ASU 2016-09; first quarter 2017 diluted earnings per common share measured \$0.02 higher than would have been measured under accounting standards applied in 2016. The adoption of ASU 2016-09 did not affect second quarter 2017 results by a meaningful amount. Second quarter and first half of 2017 results compare to net income of \$14.5 million or \$0.57 diluted earnings per common share for the second quarter 2016 and net income of \$28.8 million or \$1.13 diluted earnings per common share for the six months ended June 30, 2016.

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**Net Income**

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

|  | For the Three Months<br>Ended June 30, |             | For the Six Months |             |
|--|--|-------------|--------------------|-------------|
|  | 2017                                   | 2016        | 2017               | 2016        |
|  | (In thousands, except per share data)  |             |                    |             |
| Net interest and loan fee income (FTE)                         | \$35,764                               | \$36,495    | \$71,794           | \$72,942    |
| Reversal of Provision for loan losses                          | (1,900 )                               | -           | (1,900 )           | -           |
| Noninterest income   | 12,123                                 | 11,702      | 23,780             | 23,431      |
| Noninterest expense  | 24,396                                 | 25,229      | 49,011             | 51,087      |
| Income before taxes (FTE)                                      | 25,391                                 | 22,968      | 48,463             | 45,286      |
| Income tax provision (FTE)                                     | 9,592                                  | 8,422       | 17,615             | 16,514      |
| Net income   | \$15,799                               | \$14,546    | \$30,848           | \$28,772    |
| Average diluted common shares                                  | 26,402                                 | 25,630      | 26,366             | 25,549      |
| Diluted earnings per common share                              | \$0.60                                 | \$0.57      | \$1.17             | \$1.13      |
| Average total assets   | \$5,385,085                            | \$5,184,409 | \$5,390,404        | \$5,179,607 |
| Net income to average total assets (annualized)                | 1.18                                   | % 1.13      | % 1.15             | % 1.12      |
| Net income to average common shareholders' equity (annualized) | 10.69                                  | % 10.87     | % 10.58            | % 10.86     |

Net income for the second quarter of 2017 was \$1.3 million more than the same quarter of 2016, the net result of a reversal of provision for loan losses, higher noninterest income and lower noninterest expense, partially offset by lower net interest and fee income (FTE) and higher income tax provision (FTE). Net interest and loan fee income (FTE) decreased in the second quarter 2017 compared with second quarter 2016 mostly attributable to lower average balances of loans and lower yield on those loans, partially offset by higher average balances of investments. The Company recorded a \$1.9 million reversal of provision for loan losses, reflecting Management's evaluation of losses inherent in the loan portfolio. Noninterest income increased primarily due to higher merchant processing services fees. Noninterest expense decreased due to reductions in professional fees, correspondent service charges, insurance premiums, limited partnership operating losses, intangible amortization and other expenses. Second quarter 2017 tax provision (FTE) was higher than second quarter 2016 primarily due to higher pre-tax income, reduced levels of federally tax-exempt income on interest-earning assets relative to pre-tax income, and lower tax credits. The ASU 2016-09 did not affect second quarter 2017 results by a meaningful amount.

Comparing the first half of 2017 with the first half of 2016, net income increased \$2.1 million due to a reversal of provision for loan losses, higher noninterest income and lower noninterest expense, partially offset by lower net interest and fee income (FTE) and higher income tax provision (FTE). Net interest and loan fee income (FTE) decreased in the first half of 2017 compared with first half of 2016 mostly attributable to lower average balances of loans and lower yield on those loans, partially offset by higher average balances of investments. The Company

recorded a \$1.9 million reversal of provision for loan losses, reflecting Management's evaluation of losses inherent in the loan portfolio. Noninterest income increased primarily due to higher merchant processing services fees. Noninterest expense decreased due to reductions in professional fees, correspondent service charges, courier service charges, insurance premiums, limited partnership operating losses, intangible amortization and other expenses. The tax provision (FTE) for the first half of 2017 was higher than in the first half of 2016 primarily due to higher pre-tax income, reduced levels of federally tax-exempt income on interest-earning assets relative to pre-tax income, and lower tax credits. The first six months of 2017 income tax provision was \$666 thousand lower than would have been under accounting standards prior to the adoption of ASU 2016-09.

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**Net Interest and Loan Fee Income (FTE)**

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

|  | For the Three Months |             | For the Six Months |             |
|--|----------------------|-------------|--------------------|-------------|
|  | Ended June 30,       |             | 2017               | 2016        |
|  | 2017                 | 2016        | 2017               | 2016        |
|  | (\$ in thousands)    |             |                    |             |
| Interest and loan fee income           | \$33,163             | \$33,727    | \$66,487           | \$67,374    |
| Interest expense                       | 476                  | 541         | 956                | 1,093       |
| FTE adjustment                         | 3,077                | 3,309       | 6,263              | 6,661       |
| Net interest and loan fee income (FTE) | \$35,764             | \$36,495    | \$71,794           | \$72,942    |
| Average earning assets                 | \$4,598,296          | \$4,473,700 | \$4,609,089        | \$4,427,507 |
| Net interest margin (FTE) (annualized) | 3.12                 | % 3.27      | % 3.13             | % 3.30      |

Net interest and loan fee income (FTE) decreased \$731 thousand in the second quarter 2017 compared with second quarter 2016 mostly attributable to lower average balances of loans (down \$122 million) and lower yield on those loans (down 0.21%), partially offset by higher average balances of investments (up \$247 million).

Comparing the first half of 2017 with the first half of 2016, net interest and loan fee income (FTE) decreased \$1.1 million mostly due to lower average balances of loans (down \$134 million) and lower yield on those loans (down 0.21%), partially offset by higher average balances of investments (up \$315 million).

Yields on interest-earning assets declined due to relatively low interest rates prevailing in the market. The annualized net interest margin (FTE) was 3.12% in the second quarter 2017 and 3.13% in the first half of 2017 compared with 3.27% in the second quarter 2016 and 3.30% in the first half of 2016. The volume of older-dated higher-yielding loans and municipal bonds declined due to principal maturities and paydowns. The Company, in anticipation of rising interest rates, has been purchasing shorter-duration investment securities with lower yields than longer-duration securities to increase liquidity. The Company's high levels of liquidity will provide an opportunity to invest in higher yielding assets assuming market interest rates increase to levels higher than yields on maturing securities and security paydowns.

The Company has been replacing higher-cost funding sources with low-cost deposits and interest expense has declined to offset some of the decline in interest income. Average balances of time deposits declined \$29 million from the first half of 2016 to first half of 2017 while lower-cost checking and savings deposits grew 4% in the same period. Average balances of checking and saving deposits accounted for 94.6% of average total deposits in the first half of 2017 compared with 93.8% in the first half of 2016.

**Net Interest Margin (FTE)**

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

|   | For the Three<br>Months<br>Ended June 30, |       | For the Six<br>Months |       |
|---|---|-------|-----------------------|-------|
|   | 2017                                      | 2016  | 2017                  | 2016  |
| Yield on earning assets (FTE)                 | 3.16%                                     | 3.32% | 3.17%                 | 3.35% |
| Rate paid on interest-bearing liabilities     | 0.07%                                     | 0.08% | 0.07%                 | 0.08% |
| Net interest spread (FTE)                     | 3.09%                                     | 3.24% | 3.10%                 | 3.27% |
| Impact of noninterest-bearing demand deposits | 0.03%                                     | 0.03% | 0.03%                 | 0.03% |
| Net interest margin (FTE)                     | 3.12%                                     | 3.27% | 3.13%                 | 3.30% |

During 2016 and through the second quarter 2017, the net interest margin (FTE) was affected by historically low market interest rates. The changing composition of interest-earning assets and low market rates has pressured the net interest margin. Rates on interest-bearing liabilities were kept low by reducing the volume of higher-cost time deposits and increasing balances of checking and savings deposits, which earn relatively low interest rates and are less volatile than time deposits during periods of rising market interest rates.

**Summary of Average Balances, Yields/Rates and Interest Differential**

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

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

|  | For the Three Months Ended<br>June 30, 2017 |                                |                  |
|--|---|--------------------------------|------------------|
|  | Average<br>Balance                          | Interest<br>Income/<br>Expense | Yields/<br>Rates |
|  | (\$ in thousands)                           |                                |                  |
| <b>Assets</b>                                |   |                                |                  |
| Investment securities:                       |   |                                |                  |
| Taxable                                      | \$2,447,248                                 | \$12,481                       | 2.04%            |
| Tax-exempt <sup>(1)</sup>                    | 817,913                                     | 8,012                          | 3.92%            |
| Total investments <sup>(1)</sup>             | 3,265,161                                   | 20,493                         | 2.51%            |
| Loans:                                       |   |                                |                  |
| Taxable                                      | 1,269,852                                   | 14,949                         | 4.72%            |
| Tax-exempt <sup>(1)</sup>                    | 63,283                                      | 798                            | 5.06%            |
| Total loans <sup>(1)</sup>                   | 1,333,135                                   | 15,747                         | 4.74%            |
| Total Interest-earning assets <sup>(1)</sup> | 4,598,296                                   | 36,240                         | 3.16%            |
| Other assets                                 | 786,789                                     |                                |                  |
| Total assets                                 | \$5,385,085                                 |                                |                  |
| <b>Liabilities and shareholders' equity</b>  |   |                                |                  |
| Noninterest-bearing demand                   | \$2,048,155                                 | \$-                            | - %              |
| Savings and interest-bearing transaction     | 2,371,753                                   | 279                            | 0.05%            |
| Time less than \$100,000                     | 138,754                                     | 81                             | 0.23%            |
| Time \$100,000 or more                       | 110,762                                     | 105                            | 0.38%            |
| Total interest-bearing deposits              | 2,621,269                                   | 465                            | 0.07%            |
| Short-term borrowed funds                    | 71,178                                      | 11                             | 0.06%            |
| Total interest-bearing liabilities           | 2,692,447                                   | 476                            | 0.07%            |
| Other liabilities                            | 51,455                                      |                                |                  |
| Shareholders' equity                         | 593,028                                     |                                |                  |
| Total liabilities and shareholders' equity   | \$5,385,085                                 |                                |                  |

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|  |                |
|--|----------------|
| Net interest spread <sup>(1) (2)</sup>                             | 3.09%          |
| Net interest and fee income and interest margin <sup>(1) (3)</sup> | \$35,764 3.12% |

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

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

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

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

|  | For the Three Months Ended<br>June 30, 2016 |                                |                  |
|--|---|--------------------------------|------------------|
|  | Average<br>Balance<br>(\$ in thousands)     | Interest<br>Income/<br>Expense | Yields/<br>Rates |
| <b>Assets</b>  |   |                                |                  |
| Investment securities:   |   |                                |                  |
| Taxable  | \$2,182,962                                 | \$10,558                       | 1.93 %           |
| Tax-exempt <sup>(1)</sup>  | 835,688                                     | 8,581                          | 4.11 %           |
| Total investments <sup>(1)</sup>                                   | 3,018,650                                   | 19,139                         | 2.53 %           |
| Loans:   |   |                                |                  |
| Taxable  | 1,386,677                                   | 16,999                         | 4.93 %           |
| Tax-exempt <sup>(1)</sup>  | 68,373                                      | 898                            | 5.28 %           |
| Total loans <sup>(1)</sup>   | 1,455,050                                   | 17,897                         | 4.95 %           |
| Total Interest-earning assets <sup>(1)</sup>                       | 4,473,700                                   | 37,036                         | 3.32 %           |
| Other assets   | 710,709                                     |                                |                  |
| Total assets   | \$5,184,409                                 |                                |                  |
| <b>Liabilities and shareholders' equity</b>                        |   |                                |                  |
| Noninterest-bearing demand   | \$1,994,803                                 | \$-                            | - %              |
| Savings and interest-bearing transaction                           | 2,260,054                                   | 292                            | 0.05 %           |
| Time less than \$100,000   | 157,419                                     | 104                            | 0.27 %           |
| Time \$100,000 or more   | 119,475                                     | 135                            | 0.45 %           |
| Total interest-bearing deposits                                    | 2,536,948                                   | 531                            | 0.08 %           |
| Short-term borrowed funds  | 61,920                                      | 10                             | 0.07 %           |
| Total interest-bearing liabilities                                 | 2,598,868                                   | 541                            | 0.08 %           |
| Other liabilities  | 52,751                                      |                                |                  |
| Shareholders' equity   | 537,987                                     |                                |                  |
| Total liabilities and shareholders' equity                         | \$5,184,409                                 |                                |                  |
| Net interest spread <sup>(1) (2)</sup>                             |   |                                | 3.24 %           |
| Net interest and fee income and interest margin <sup>(1) (3)</sup> |   | \$36,495                       | 3.27 %           |

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

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

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

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

|  | For the Six Months Ended<br>June 30, 2017 |                                |                  |
|--|---|--------------------------------|------------------|
|  | Average<br>Balance<br>(\$ in thousands)   | Interest<br>Income/<br>Expense | Yields/<br>Rates |
| <b>Assets</b>  |   |                                |                  |
| Investment securities:   |   |                                |                  |
| Taxable  | \$2,440,496                               | \$24,627                       | 2.02 %           |
| Tax-exempt <sup>(1)</sup>  | 824,461                                   | 16,307                         | 3.96 %           |
| Total investments <sup>(1)</sup>                                     | 3,264,957                                 | 40,934                         | 2.51 %           |
| Loans:   |   |                                |                  |
| Taxable  | 1,279,917                                 | 30,191                         | 4.76 %           |
| Tax-exempt <sup>(1)</sup>  | 64,215                                    | 1,625                          | 5.10 %           |
| Total loans <sup>(1)</sup>   | 1,344,132                                 | 31,816                         | 4.77 %           |
| Total Interest-earning assets <sup>(1)</sup>                         | 4,609,089                                 | 72,750                         | 3.17 %           |
| Other assets   | 781,315                                   |                                |                  |
| Total assets   | \$5,390,404                               |                                |                  |
| <b>Liabilities and shareholders' equity</b>                          |   |                                |                  |
| Noninterest-bearing demand   | \$2,052,483                               | \$-                            | - %              |
| Savings and interest-bearing transaction<br>Time less than \$100,000 | 2,377,021                                 | 559                            | 0.05 %           |
| Time \$100,000 or more   | 140,070                                   | 164                            | 0.24 %           |
| Total interest-bearing deposits                                      | 2,628,538                                 | 934                            | 0.07 %           |
| Short-term borrowed funds  | 69,888                                    | 22                             | 0.06 %           |
| Total interest-bearing liabilities                                   | 2,698,426                                 | 956                            | 0.07 %           |
| Other liabilities  | 51,759                                    |                                |                  |
| Shareholders' equity   | 587,736                                   |                                |                  |
| Total liabilities and shareholders' equity                           | \$5,390,404                               |                                |                  |
| Net interest spread <sup>(1) (2)</sup>                               |   |                                | 3.10 %           |
| Net interest and fee income and interest margin <sup>(1) (3)</sup>   |   | \$71,794                       | 3.13 %           |

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

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

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

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

|  | For the Six Months Ended<br>June 30, 2016 |                                |                  |
|--|---|--------------------------------|------------------|
|  | Average<br>Balance<br>(\$ in thousands)   | Interest<br>Income/<br>Expense | Yields/<br>Rates |
| <b>Assets</b>  |   |                                |                  |
| <b>Investment securities:</b>  |   |                                |                  |
| Taxable  | \$2,114,700                               | \$20,231                       | 1.91 %           |
| Tax-exempt <sup>(1)</sup>  | 834,974                                   | 17,218                         | 4.12 %           |
| Total investments <sup>(1)</sup>                                     | 2,949,674                                 | 37,449                         | 2.54 %           |
| <b>Loans:</b>  |   |                                |                  |
| Taxable  | 1,407,891                                 | 34,725                         | 4.96 %           |
| Tax-exempt <sup>(1)</sup>  | 69,942                                    | 1,861                          | 5.35 %           |
| Total loans <sup>(1)</sup>   | 1,477,833                                 | 36,586                         | 4.98 %           |
| Total Interest-earning assets <sup>(1)</sup>                         | 4,427,507                                 | 74,035                         | 3.35 %           |
| Other assets   | 752,100                                   |                                |                  |
| Total assets   | \$5,179,607                               |                                |                  |
| <b>Liabilities and shareholders' equity</b>                          |   |                                |                  |
| Noninterest-bearing demand   | \$1,994,395                               | \$-                            | - %              |
| Savings and interest-bearing transaction<br>Time less than \$100,000 | 2,259,867                                 | 585                            | 0.05 %           |
| Time \$100,000 or more   | 158,805                                   | 218                            | 0.28 %           |
| Total interest-bearing deposits                                      | 121,583                                   | 271                            | 0.45 %           |
| Short-term borrowed funds  | 2,540,255                                 | 1,074                          | 0.08 %           |
| Total interest-bearing liabilities                                   | 59,883                                    | 19                             | 0.07 %           |
| Other liabilities  | 2,600,138                                 | 1,093                          | 0.08 %           |
| Shareholders' equity   | 52,492                                    |                                |                  |
| Total liabilities and shareholders' equity                           | 532,582                                   |                                |                  |
| Net interest spread <sup>(1) (2)</sup>                               | \$5,179,607                               |                                | 3.27 %           |
| Net interest and fee income and interest margin <sup>(1) (3)</sup>   |   | \$72,942                       | 3.30 %           |

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

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

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

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

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

#### Summary of Changes in Interest Income and Expense

|   | For the Three Months Ended<br>June 30, 2017 |            |          |
|---|---|------------|----------|
|   | Compared with                               |            |          |
|   | For the Three Months Ended<br>June 30, 2016 |            |          |
|   | Volume                                      | Yield/Rate | Total    |
|   | (In thousands)                              |            |          |
| Increase (decrease) in interest and loan fee income:          |   |            |          |
| Investment securities:  |   |            |          |
| Taxable   | \$1,278                                     | \$ 645     | \$1,923  |
| Tax-exempt <sup>(1)</sup>                                     | (183 )                                      | (386 )     | (569 )   |
| Total investments <sup>(1)</sup>                              | 1,095                                       | 259        | 1,354    |
| Loans:  |   |            |          |
| Taxable   | (1,384)                                     | (666 )     | (2,050)  |
| Tax-exempt <sup>(1)</sup>                                     | (65 )                                       | (35 )      | (100 )   |
| Total loans <sup>(1)</sup>                                    | (1,449)                                     | (701 )     | (2,150)  |
| Total decrease in interest and loan fee income <sup>(1)</sup> | (354 )                                      | (442 )     | (796 )   |
| Increase (decrease) in interest expense:                      |   |            |          |
| Deposits:   |   |            |          |
| Savings and interest-bearing transaction                      | 15  | (28 )      | (13 )    |
| Time less than \$100,000                                      | (12 )                                       | (11 )      | (23 )    |
| Time \$100,000 or more  | (10 )                                       | (20 )      | (30 )    |
| Total interest-bearing deposits                               | (7 )  | (59 )      | (66 )    |
| Short-term borrowed funds                                     | 2   | (1 )       | 1        |
| Total decrease in interest expense                            | (5 )  | (60 )      | (65 )    |
| Decrease in net interest and loan fee income <sup>(1)</sup>   | \$(349 )                                    | \$ (382 )  | \$(731 ) |

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

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## Summary of Changes in Interest Income and Expense

|   | For the Six Months Ended<br>June 30, 2017                  |            |           |
|---|--|------------|-----------|
|   | Compared with<br>For the Six Months Ended<br>June 30, 2016 |            |           |
|   | Volume   | Yield/Rate | Total     |
|   | (In thousands)   |            |           |
| Increase (decrease) in interest and loan fee income:          |  |            |           |
| Investment securities:  |  |            |           |
| Taxable   | \$3,117  | \$ 1,279   | \$4,396   |
| Tax-exempt <sup>(1)</sup>                                     | (217 )   | (694 )     | (911 )    |
| Total investments <sup>(1)</sup>                              | 2,900  | 585        | 3,485     |
| Loans:  |  |            |           |
| Taxable   | (3,102)  | (1,432 )   | (4,534)   |
| Tax-exempt <sup>(1)</sup>                                     | (150 )   | (86 )      | (236 )    |
| Total loans <sup>(1)</sup>                                    | (3,252)  | (1,518 )   | (4,770)   |
| Total decrease in interest and loan fee income <sup>(1)</sup> | (352 )   | (933 )     | (1,285)   |
| Increase (decrease) in interest expense:                      |  |            |           |
| Deposits:   |  |            |           |
| Savings and interest-bearing transaction                      | 31   | (57 )      | (26 )     |
| Time less than \$100,000                                      | (26 )  | (28 )      | (54 )     |
| Time \$100,000 or more  | (22 )  | (38 )      | (60 )     |
| Total interest-bearing deposits                               | (17 )  | (123 )     | (140 )    |
| Short-term borrowed funds                                     | 4  | (1 )       | 3         |
| Total decrease in interest expense                            | (13 )  | (124 )     | (137 )    |
| Decrease in net interest and loan fee income <sup>(1)</sup>   | \$(339 )   | \$( 809 )  | \$(1,148) |

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

### Provision for Loan Losses

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

The Company recorded a reversal of the provision for loan losses of \$1.9 million in the three and six months ended June 30, 2017. The Company provided no provision for loan losses in the three and six months ended June 30, 2016. During the first six months ended June 30, 2017, classified loans declined \$4.2 million to \$43.0 million (total

classified loans included nonperforming loans of \$6.7 million). The Company realized net recoveries of \$1.1 million in the second quarter 2017; these developments were reflected in Management's evaluation of credit quality, the level of the provision for loan losses, and the adequacy of the allowance for loan losses at June 30, 2017. Management's evaluation of credit quality includes originated and purchased loans. The Company recorded purchased loans at estimated fair value upon the acquisition dates. Such estimated fair values were recognized for individual loans, although small balance homogenous loans were pooled for valuation purposes. The valuation discounts recorded for purchased loans included Management's assessment of the risk of principal loss under economic and borrower conditions prevailing on the dates of purchase. The purchased County Bank loans secured by single-family residential real estate are "covered" through February 6, 2019 by loss-sharing agreements the Company entered with the FDIC which mitigates losses during the term of the agreements. Any deterioration in estimated value related to principal loss subsequent to the acquisition dates requires additional loss recognition through a provision for loan losses. No assurance can be given future provisions for loan losses related to purchased loans will not be necessary. For further information regarding credit risk, net credit losses and the allowance for loan losses, see the "Loan Portfolio Credit Risk" and "Allowance for Loan Losses" sections of this Report.



**Noninterest Income**

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

|                                     | For the Three<br>Months<br>Ended June 30, |          | For the Six Months |          |
|-------------------------------------|---|----------|--------------------|----------|
|                                     | 2017                                      | 2016     | 2017               | 2016     |
|                                     | (In thousands)                            |          |                    |          |
| Service charges on deposit accounts | \$4,945                                   | \$5,239  | \$9,868            | \$10,487 |
| Merchant processing services        | 2,052                                     | 1,638    | 3,927              | 3,167    |
| Debit card fees                     | 1,586                                     | 1,621    | 3,067              | 3,137    |
| Trust fees                          | 716                                       | 657      | 1,418              | 1,318    |
| Other service fees                  | 662                                       | 650      | 1,312              | 1,279    |
| ATM processing fees                 | 654                                       | 603      | 1,229              | 1,261    |
| Financial services commissions      | 142                                       | 137      | 337                | 293      |
| Other noninterest income            | 1,366                                     | 1,157    | 2,622              | 2,489    |
| Total                               | \$12,123                                  | \$11,702 | \$23,780           | \$23,431 |

Noninterest income for the second quarter 2017 increased by \$421 thousand from the same period in 2016. Merchant processing services fees increased \$414 thousand primarily due to increased transaction volumes. Offsetting the increase was service charges on deposits which decreased \$294 thousand due to declines in fees charged on overdrawn and insufficient funds accounts (down \$232 thousand) and lower fees on analyzed accounts (down \$56 thousand).

In the first half of 2017, noninterest income increased \$349 thousand compared with the first half of 2016 mostly due to a \$760 thousand increase in merchant processing services fees primarily due to the improved transaction volumes. Trust fees increased \$100 thousand due to marketing efforts. Offsetting the increase was service charges on deposits which decreased \$619 thousand due to declines in fees charged on overdrawn and insufficient funds accounts (down \$491 thousand) and lower fees on analyzed accounts (down \$152 thousand).

**Noninterest Expense**

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

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|  | For the Three<br>Months<br>Ended June 30, |          | For the Six Months |          |
|--|---|----------|--------------------|----------|
|  | 2017                                      | 2016     | 2017               | 2016     |
|  | (In thousands)                            |          |                    |          |
| Salaries and related benefits            | \$12,981                                  | \$12,887 | \$26,051           | \$26,004 |
| Occupancy                                | 3,509                                     | 3,400    | 7,142              | 6,798    |
| Outsourced data processing services      | 2,188                                     | 2,130    | 4,327              | 4,260    |
| Furniture and equipment                  | 1,267                                     | 1,187    | 2,521              | 2,400    |
| Amortization of identifiable intangibles | 762                                       | 870      | 1,562              | 1,775    |
| Courier service                          | 438                                       | 462      | 859                | 1,007    |
| Professional fees                        | 410                                       | 758      | 1,021              | 1,490    |
| Other real estate owned                  | (126 )                                    | (392 )   | (166 )             | (281 )   |
| Other noninterest expense                | 2,967                                     | 3,927    | 5,694              | 7,634    |
| Total                                    | \$24,396                                  | \$25,229 | \$49,011           | \$51,087 |

Noninterest expense decreased \$833 thousand in the second quarter 2017 compared with the same period in 2016. Other noninterest expense decreased \$960 thousand primarily due to decreases in correspondent bank service charges, insurance premiums and limited partnership operating losses. Professional fees decreased \$348 thousand due to lower legal fees associated with nonperforming assets. Amortization of intangibles decreased \$108 thousand as assets are amortized on a declining balance method. Offsetting the decrease were other real estate owned and occupancy expenses. Expenses of other real estate owned increased \$266 thousand due to lower gains on sale of foreclosed assets.

In the first half of 2017, noninterest expense decreased \$2.1 million compared with the first half of 2016. Other noninterest expense decreased \$1.9 million primarily due to decreases in correspondent bank service charges, insurance premiums and limited partnership operating losses. Professional fees decreased \$469 thousand due to lower legal fees associated with nonperforming assets. Amortization of intangibles decreased \$213 thousand as assets are amortized on a declining balance method. Occupancy expense increased \$344 thousand mostly due to branch closure expenses and higher maintenance costs. Expenses of other real estate owned increased \$115 thousand due to lower gains on sale of foreclosed assets.

### **Provision for Income Tax**

The Company recorded an income tax provision (FTE) of \$9.6 million for the second quarter 2017 and \$17.6 million for the first half of 2017. Effective January 1, 2017, the Company adopted ASU 2016-09 which has the potential to create volatility in the book tax provision at the time nonqualified stock options are exercised or expire. During the first half of 2017, 389 thousand shares were issued due to the exercise of nonqualified stock options resulting in a tax deduction exceeding related share based compensation by \$1.6 million. The first half of 2017 income tax provision was \$666 thousand lower than would have been under accounting standards prior to the adoption of ASU 2016-09. Second quarter and first half of 2017 income tax provision (FTE) compared with \$8.4 million and \$16.5 million for the second and first half of 2016, respectively. The effective tax rates (FTE) of 37.8% and 36.3% for the second quarter and first half of 2017, respectively, compared with 36.7% and 36.5% for the second quarter and first half of 2016, respectively. The second quarter and first half of 2017 effective tax rates (FTE) would have been 37.8% and 37.7%, respectively, under accounting rules applied in 2016.

### **Investment Portfolio**

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

Management has increased the investment securities portfolio in response to deposit growth and loan volume declines. The carrying value of the Company's investment securities portfolio was \$3.2 billion as of June 30, 2017 and December 31, 2016.

Management continually evaluates the Company's investment securities portfolio in response to established asset/liability management objectives, changing market conditions that could affect profitability, liquidity, and the level of interest rate risk to which the Company is exposed. These evaluations may cause Management to change the level of funds the Company deploys into investment securities and change the composition of the Company's investment securities portfolio. In 2016 Management reduced securities of U.S. Government sponsored entities to

reduce call optionality and increased agency residential MBS to develop more reliable cash flows.

As of June 30, 2017, substantially all of the Company's investment securities continue to be investment grade rated by one or more major rating agencies. In addition to monitoring credit rating agency evaluations, Management performs its own evaluations regarding the credit worthiness of the issuer or the securitized assets underlying asset-backed securities. The Company's procedures for evaluating investments in securities are in accordance with guidance issued by the Board of Governors of the Federal Reserve System, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Agencies" (SR 12-15) and other regulatory guidance. There have been no significant differences in our internal analyses compared with the ratings assigned by the third party credit rating agencies.

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

At June 30, 2017, the Company's investment securities portfolios included securities issued by 685 state and local government municipalities and agencies located within 44 states. None of the Company's investment securities were issued by Puerto Rican government entities. The largest exposure to any one municipality or agency was \$10.2 million (fair value) represented by nine general obligation bonds.

|  | At June 30, 2017 |            |
|--|------------------|------------|
|  | Amortized Cost   | Fair Value |
|  | (In thousands)   |            |
| Obligations of states and political subdivisions:      |                  |            |
| General obligation bonds:                              |                  |            |
| California   | \$101,999        | \$104,711  |
| Texas  | 68,641           | 69,016     |
| New Jersey   | 39,936           | 40,485     |
| Minnesota  | 30,630           | 31,013     |
| Pennsylvania   | 28,324           | 28,555     |
| Other (36 states)                                      | 276,892          | 280,397    |
| Total general obligation bonds                         | \$546,422        | \$554,177  |
| Revenue bonds:   |                  |            |
| California   | \$45,853         | \$47,016   |
| Kentucky   | 22,767           | 23,211     |
| Iowa   | 17,339           | 17,543     |
| Pennsylvania   | 16,062           | 16,169     |
| Colorado   | 15,533           | 15,861     |
| Washington   | 13,540           | 14,201     |
| Other (29 states)                                      | 141,327          | 143,954    |
| Total revenue bonds                                    | \$272,421        | \$277,955  |
| Total obligations of states and political subdivisions | \$818,843        | \$832,132  |

At December 31, 2016, the Company's investment securities portfolios included securities issued by 698 state and local government municipalities and agencies located within 44 states. None of the Company's investment securities were issued by Puerto Rican government entities. The largest exposure to any one municipality or agency was \$10.0 million (fair value) represented by nine general obligation bonds.

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|  | At December 31,<br>2016 |            |
|--|-------------------------|------------|
|  | Amortized Fair          |            |
|  | Cost                    | Value      |
|  | (In thousands)          |            |
| Obligations of states and political subdivisions:      |                         |            |
| General obligation bonds:                              |                         |            |
| California   | \$ 105,129              | \$ 106,391 |
| Texas  | 69,017                  | 68,671     |
| New Jersey   | 40,111                  | 40,102     |
| Pennsylvania   | 37,384                  | 37,543     |
| Minnesota  | 32,946                  | 32,847     |
| Other (36 states)                                      | 280,488                 | 279,571    |
| Total general obligation bonds                         | \$ 565,075              | \$ 565,125 |
| Revenue bonds:   |                         |            |
| California   | \$ 47,415               | \$ 48,429  |
| Kentucky   | 22,854                  | 22,902     |
| Pennsylvania   | 18,568                  | 18,683     |
| Iowa   | 18,086                  | 18,302     |
| Colorado   | 15,574                  | 15,674     |
| Other (30 states)                                      | 157,452                 | 159,054    |
| Total revenue bonds                                    | \$ 279,949              | \$ 283,044 |
| Total obligations of states and political subdivisions | \$ 845,024              | \$ 848,169 |

At June 30, 2017 and December 31, 2016, the revenue bonds in the Company's investment securities portfolios were issued by state and local government municipalities and agencies to fund public services such as water utility, sewer utility, recreational and school facilities, and general public and economic improvements. The revenue bonds were payable from 22 revenue sources at June 30, 2017 and 23 revenue sources December 31, 2016. The revenue sources that represent 5% or more individually of the total revenue bonds are summarized in the following tables.

|                                       | At June 30, 2017 |            |
|---------------------------------------|------------------|------------|
|                                       | Amortized Fair   |            |
|                                       | Cost             | Value      |
|                                       | (In thousands)   |            |
| Revenue bonds by revenue source:      |                  |            |
| Water                                 | \$ 53,923        | \$ 55,802  |
| Sewer                                 | 34,975           | 35,821     |
| Sales tax                             | 31,092           | 32,042     |
| Lease (renewal)                       | 21,026           | 21,459     |
| College & University                  | 17,755           | 17,772     |
| Other (17 sources)                    | 113,650          | 115,059    |
| Total revenue bonds by revenue source | \$ 272,421       | \$ 277,955 |

|                                       | At December 31,<br>2016 |           |
|---------------------------------------|-------------------------|-----------|
|                                       | Amortized Fair          |           |
|                                       | Cost                    | Value     |
|                                       | (In thousands)          |           |
| Revenue bonds by revenue source:      |                         |           |
| Water                                 | \$55,401                | \$56,826  |
| Sewer                                 | 37,996                  | 38,497    |
| Sales tax                             | 31,146                  | 31,835    |
| Lease (renewal)                       | 24,242                  | 24,235    |
| College & University                  | 17,856                  | 17,762    |
| Other (18 sources)                    | 113,308                 | 113,889   |
| Total revenue bonds by revenue source | \$279,949               | \$283,044 |

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



## Loan Portfolio Credit Risk

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

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

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

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

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

Classified loans with higher levels of credit risk are further designated as "nonaccrual loans." Management places classified loans on nonaccrual status when full collection of contractual interest and principal payments is in doubt.

Uncollected interest previously accrued on loans placed on nonaccrual status is reversed as a charge against interest income. The Company does not accrue interest income on loans following placement on nonaccrual status. Interest payments received on nonaccrual loans are applied to reduce the carrying amount of the loan unless the carrying amount is well secured by loan collateral. “Nonperforming assets” include nonaccrual loans, loans 90 or more days past due and still accruing, and repossessed loan collateral (commonly referred to as “Other Real Estate Owned”).

## Nonperforming Assets

|   | At June 30,    |          | At<br>December<br>31, |
|---|----------------|----------|-----------------------|
|   | 2017           | 2016     | 2016                  |
|   | (In thousands) |          |                       |
| Nonperforming nonaccrual loans          | \$2,215        | \$6,527  | \$ 3,956              |
| Performing nonaccrual loans             | 4,480          | 7,038    | 4,429                 |
| Total nonaccrual loans                  | 6,695          | 13,565   | 8,385                 |
| Accruing loans 90 or more days past due | 186            | 356      | 497                   |
| Total nonperforming loans               | 6,881          | 13,921   | 8,882                 |
| Other real estate owned                 | 1,645          | 4,162    | 3,095                 |
| Total nonperforming assets              | \$8,526        | \$18,083 | \$ 11,977             |

Nonperforming assets have declined during 2016 and the first half of 2017 due to payoffs and chargeoffs. At June 30, 2017, one loan secured by commercial real estate with a balance of \$4.3 million was on nonaccrual status. The remaining nine nonaccrual loans held at June 30, 2017 had an average carrying value of \$268 thousand and the largest carrying value was \$577 thousand.

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

### Allowance for Credit Losses

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

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

|  | For the Three Months |          | For the Six Months |          |
|--|----------------------|----------|--------------------|----------|
|  | Ended June 30,       |          | 2017               | 2016     |
|  | 2017                 | 2016     | 2017               | 2016     |
|  | (\$ in thousands)    |          |                    |          |
| Analysis of the Allowance for Loan Losses  |                      |          |                    |          |
| Balance, beginning of period               | \$24,919             | \$29,487 | \$25,954           | \$29,771 |
| Reversal of provision for loan losses      | (1,900 )             | -        | (1,900 )           | -        |
| Loans charged off                          |                      |          |                    |          |
| Commercial                                 | (726 )               | (764 )   | (829 )             | (1,935 ) |
| Real estate residential                    | -                    | -        | -                  | -        |
| Consumer installment and other             | (1,158 )             | (715 )   | (2,897 )           | (1,720 ) |
| Total chargeoffs                           | (1,884 )             | (1,479 ) | (3,726 )           | (3,655 ) |
| Recoveries of loans previously charged off |                      |          |                    |          |
| Commercial                                 | 338                  | 542      | 498                | 1,963    |
| Commercial real estate                     | 78                   | 15       | 88                 | 30       |
| Construction                               | 1,899                | -        | 1,899              | -        |
| Consumer installment and other             | 653                  | 345      | 1,290              | 801      |
| Total recoveries                           | 2,968                | 902      | 3,775              | 2,794    |
| Net loan recoveries (losses)               | 1,084                | (577 )   | 49                 | (861 )   |

|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Balance, end of period   | \$24,103 | \$28,910 | \$24,103 | \$28,910 |
| Net loan (recoveries) losses as a percentage of average total loans (annualized) | (0.33 %) | 0.16 %   | (0.01 %) | 0.12 %   |

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

The remainder of the allowance is considered to be unallocated. The unallocated allowance is established to provide for probable losses that have been incurred as of the reporting date but not reflected in the allocated allowance. The unallocated allowance addresses additional qualitative factors consistent with Management's analysis of the level of risks inherent in the loan portfolio, which are related to the risks of the Company's general lending activity. Included in the unallocated allowance is the risk of losses that are attributable to national or local economic or industry trends which have occurred but have not yet been recognized in loan chargeoff history (external factors). The primary external factor evaluated by the Company and the judgmental amount of unallocated reserve assigned by Management as of June 30, 2017 is economic and business conditions \$0.6 million. Also included in the unallocated allowance is the risk of losses attributable to general attributes of the Company's loan portfolio and credit administration (internal factors). The internal factors evaluated by the Company and the judgmental amount of unallocated reserve assigned by Management are: loan review system \$1.1 million, adequacy of lending Management and staff \$0.9 million and concentrations of credit \$1.3 million.

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

|                                 | Commercial<br>Commercial Real Estate | Commercial<br>Real Estate | Construction | Residential<br>Real Estate | Consumer<br>Installment<br>and Other | Unallocated | Total    |
|---------------------------------|--------------------------------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands)                  |                                      |                           |              |                            |                                      |             |          |
| Allowance for loan losses:      |                                      |                           |              |                            |                                      |             |          |
| Balance at beginning of period  | \$8,593                              | \$ 3,522                  | \$ 112       | \$ 1,214                   | \$ 6,984                             | \$ 4,494    | \$24,919 |
| Additions:                      |                                      |                           |              |                            |                                      |             |          |
| (Reversal) provision            | (38 )                                | (55 )                     | (1,851 )     | (109 )                     | 736                                  | (583 )      | (1,900 ) |
| Deductions:                     |                                      |                           |              |                            |                                      |             |          |
| Chargeoffs                      | (726 )                               | -                         | -            | -                          | (1,158 )                             | -           | (1,884 ) |
| Recoveries                      | 338                                  | 78                        | 1,899        | -                          | 653                                  | -           | 2,968    |
| Net loan (losses) recoveries    | (388 )                               | 78                        | 1,899        | -                          | (505 )                               | -           | 1,084    |
| Total allowance for loan losses | \$8,167                              | \$ 3,545                  | \$ 160       | \$ 1,105                   | \$ 7,215                             | \$ 3,911    | \$24,103 |

Allowance for Loan Losses  
For the Six Months Ended June 30, 2017

|                                 | Commercial<br>Commercial Real Estate | Commercial<br>Real Estate | Construction | Residential<br>Real Estate | Consumer<br>Installment<br>and Other | Unallocated | Total    |
|---------------------------------|--------------------------------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands)                  |                                      |                           |              |                            |                                      |             |          |
| Allowance for loan losses:      |                                      |                           |              |                            |                                      |             |          |
| Balance at beginning of period  | \$8,327                              | \$ 3,330                  | \$ 152       | \$ 1,330                   | \$ 7,980                             | \$ 4,835    | \$25,954 |
| Additions:                      |                                      |                           |              |                            |                                      |             |          |
| Provision (reversal)            | 171                                  | 127                       | (1,891 )     | (225 )                     | 842                                  | (924 )      | (1,900 ) |
| Deductions:                     |                                      |                           |              |                            |                                      |             |          |
| Chargeoffs                      | (829 )                               | -                         | -            | -                          | (2,897 )                             | -           | (3,726 ) |
| Recoveries                      | 498                                  | 88                        | 1,899        | -                          | 1,290                                | -           | 3,775    |
| Net loan (losses) recoveries    | (331 )                               | 88                        | 1,899        | -                          | (1,607 )                             | -           | 49       |
| Total allowance for loan losses | \$8,167                              | \$ 3,545                  | \$ 160       | \$ 1,105                   | \$ 7,215                             | \$ 3,911    | \$24,103 |

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Allowance for Loan Losses and Recorded Investment in Loans Evaluated for Impairment  
At June 30, 2017

|   | Commercial     | Commercial<br>Real Estate | Construction | Residential<br>Real<br>Estate | Consumer<br>Installment<br>and Other | Unallocated | Total       |
|---|----------------|---------------------------|--------------|-------------------------------|--------------------------------------|-------------|-------------|
|   | (In thousands) |                           |              |                               |                                      |             |             |
| Allowance for loan losses:                            |                |                           |              |                               |                                      |             |             |
| Individually evaluated for impairment                 | \$4,908        | \$ -                      | \$ -         | \$ -                          | \$ -                                 | \$ -        | \$4,908     |
| Collectively evaluated for impairment                 | 3,259          | 3,545                     | 160          | 1,105                         | 7,215                                | 3,911       | 19,195      |
| Purchased loans with evidence of credit deterioration | -              | -                         | -            | -                             | -                                    | -           | -           |
| Total   | \$8,167        | \$3,545                   | \$160        | \$1,105                       | \$7,215                              | \$3,911     | \$24,103    |
| Carrying value of loans:                              |                |                           |              |                               |                                      |             |             |
| Individually evaluated for impairment                 | \$10,829       | \$14,009                  | \$ -         | \$214                         | \$ -                                 | \$ -        | \$25,052    |
| Collectively evaluated for impairment                 | 333,846        | 549,820                   | 2,699        | 72,161                        | 333,877                              | -           | 1,292,403   |
| Purchased loans with evidence of credit deterioration | 27             | 543                       | -            | -                             | 316                                  | -           | 886         |
| Total   | \$344,702      | \$564,372                 | \$2,699      | \$72,375                      | \$334,193                            | \$ -        | \$1,318,341 |

The portion of the allowance for loan losses ascribed to loan segments declined from June 30, 2016 to June 30, 2017 due to declines in classified loans, delinquent loans, and the overall loan portfolio. The decline in the unallocated portion was due to improved economic conditions within the Company's geographic markets.

Management considers the \$24.1 million allowance for loan losses to be adequate as a reserve against loan losses inherent in the loan portfolio as of June 30, 2017.

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

## **Asset/Liability and Market Risk Management**

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

### **Interest Rate Risk**

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

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

Management expects a high level of uncertainty in regard to interest rate levels in the immediate term, and Management's most likely earnings forecast for the twelve months ending June 30, 2018 assumes market interest rates will gradually rise, with short-term rates rising more than long-term rates.

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

The Company's asset and liability position was "neutral" to slightly "asset sensitive" at June 30, 2017, depending on the interest rate assumptions applied to the simulation model employed by Management to measure interest rate risk. An "asset sensitive" position results in a slightly larger change in interest income than in interest expense resulting from application of assumed interest rate changes. Simulation estimates depend on, and will change with, the size and mix of the actual and projected balance sheet at the time of each simulation. Management continues to monitor the interest rate environment as well as economic conditions and other factors it deems relevant in managing the Company's exposure to interest rate risk.

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

### **Market Risk - Equity Markets**

Equity price risk can affect the Company. As an example, any preferred or common stock holdings, as permitted by banking regulations, can fluctuate in value. Management regularly assesses the extent and duration of any declines in market value, the causes of such declines, the likelihood of a recovery in market value, and its intent to hold securities until a recovery in value occurs. Declines in value of preferred or common stock holdings that are deemed "other than temporary" could result in loss recognition in the Company's income statement.

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



## **Market Risk - Other**

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

## **Liquidity and Funding**

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

In recent years, the Company's deposit base has provided the majority of the Company's funding requirements. This relatively stable and low-cost source of funds, along with shareholders' equity, provided 98 percent of funding for average total assets in the first half of 2017 and in 2016. The stability of the Company's funding from customer deposits is in part reliant on the confidence clients have in the Company. The Company places a very high priority in maintaining this confidence through conservative credit and capital management practices and by maintaining an appropriate level of liquidity reserves.

Liquidity is further provided by assets such as balances held at the Federal Reserve Bank, investment securities, and amortizing loans. The Company's investment securities portfolio provides a substantial secondary liquidity reserve. The Company held \$3.2 billion in total investment securities at June 30, 2017. Under certain deposit, borrowing and other arrangements, the Company must hold and pledge investment securities as collateral. At June 30, 2017, such collateral requirements totaled approximately \$795 million.

Liquidity risk can result from the mismatching of asset and liability cash flows, or from disruptions in the financial markets. The Company performs liquidity stress tests on a periodic basis to evaluate the sustainability of its liquidity. Under the stress testing, the Company assumes outflows of funds increase beyond expected levels. Measurement of such heightened outflows considers the composition of the Company's deposit base, including any concentration of deposits, non-deposit funding such as short-term borrowings, and unfunded lending commitments. The Company evaluates its stock of highly liquid assets to meet the assumed higher levels of outflows. Highly liquid assets include cash and amounts due from other banks from daily transaction settlements, reduced by branch cash needs and Federal Reserve Bank reserve requirements, and investment securities based on regulatory risk-weighting guidelines. Based

on the results of the most recent liquidity stress test, Management is satisfied with the liquidity condition of the Bank and the Company. However, no assurance can be given the Bank or Company will not experience a period of reduced liquidity.

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

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

The Bank's dividends paid to the Parent Company, proceeds from the exercise of stock options, and Parent Company cash balances provided adequate cash for the Parent Company to pay shareholder dividends of \$20 million in the first half of 2017 and \$40 million in 2016, and retire common stock in the amount of \$314 thousand in the first half of 2017 and \$6 million in 2016. Payment of dividends to the Parent Company by the Bank is limited under California and Federal laws. The Company believes these regulatory dividend restrictions will not have an impact on the Parent Company's ability to meet its ongoing cash obligations.

## **Capital Resources**

The Company has historically generated high levels of earnings, which provide a means of accumulating capital. The Company's net income as a percentage of average shareholders' equity ("return on equity" or "ROE") has been 10.6% in the first half of 2017 and 10.9% in 2016. The Company also raises capital as employees exercise stock options. Capital raised through the exercise of stock options was \$18 million in the first half of 2017 and \$24 million in 2016.

The Company paid common dividends totaling \$20 million in the first half of 2017 and \$40 million in 2016, which represent dividends per common share of \$0.78 and \$1.56, respectively. The Company's earnings have historically exceeded dividends paid to shareholders. The amount of earnings in excess of dividends provides the Company resources to finance growth and maintain appropriate levels of shareholders' equity. In the absence of profitable growth opportunities, the Company has repurchased and retired its common stock as another means to return earnings to shareholders. The Company repurchased and retired 6 thousand shares valued at \$314 thousand in the first half of 2017 and 137 thousand shares valued at \$6 million in 2016.

The Company's primary capital resource is shareholders' equity, which was \$596 million at June 30, 2017 compared with \$561 million at December 31, 2016. The Company's ratio of equity to total assets was 11.04% at June 30, 2017 and 10.46% at December 31, 2016.

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

## **Capital to Risk-Adjusted Assets**

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

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

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

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

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

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

|                              | At June 30, 2017 |         | Required for<br>Capital Adequacy<br>Purposes |                                 | To Be<br>Well-capitalized<br>Under Prompt<br>Corrective<br>Action<br>Regulations<br>(Bank) |   |
|------------------------------|------------------|---------|--|---------------------------------|--|---|
|                              | Company          | Bank    | Effective<br>January<br>1, 2017              | Effective<br>January 1,<br>2019 |  |   |
| Common Equity Tier I Capital | 15.72 %          | 12.23 % | 5.75 % <sup>(1)</sup>                        | 7.00 % <sup>(2)</sup>           | 6.50   | % |
| Tier I Capital               | 15.72 %          | 12.23 % | 7.25 % <sup>(1)</sup>                        | 8.50 % <sup>(2)</sup>           | 8.00   | % |
| Total Capital                | 16.69 %          | 13.41 % | 9.25 % <sup>(1)</sup>                        | 10.50 % <sup>(2)</sup>          | 10.00  | % |
| Leverage Ratio               | 9.00 %           | 6.96 %  | 4.00 %                                       | 4.00 %                          | 5.00   | % |

<sup>(1)</sup> Includes 1.25% capital conservation buffer.

<sup>(2)</sup> Includes 2.5% capital conservation buffer.

|                              | At December 31,<br>2016 |         | Required for<br>Capital Adequacy<br>Purposes |                                 | To Be<br>Well-capitalized<br>Under Prompt<br>Corrective<br>Action<br>Regulations<br>(Bank) |   |
|------------------------------|-------------------------|---------|--|---------------------------------|--|---|
|                              | Company                 | Bank    | Effective<br>January 1,<br>2016              | Effective<br>January 1,<br>2019 |  |   |
| Common Equity Tier I Capital | 14.85 %                 | 11.70 % | 5.125 % <sup>(3)</sup>                       | 7.00 % <sup>(4)</sup>           | 6.50   | % |
| Tier I Capital               | 14.85 %                 | 11.70 % | 6.625 % <sup>(3)</sup>                       | 8.50 % <sup>(4)</sup>           | 8.00   | % |
| Total Capital                | 15.95 %                 | 13.02 % | 8.625 % <sup>(3)</sup>                       | 10.50 % <sup>(4)</sup>          | 10.00  | % |
| Leverage Ratio               | 8.46 %                  | 6.63 %  | 4.000 %                                      | 4.00 %                          | 5.00   | % |

<sup>(3)</sup> Includes 0.625% capital conservation buffer.

<sup>(4)</sup> Includes 2.5% capital conservation buffer.

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

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

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

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

#### **Item 4. Controls and Procedures**

The Company's principal executive officer and principal financial officer have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended, as of June 30, 2017.

Based upon their evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that material information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported as and when required and that such information is communicated to the Company's management, including the principal executive officer and the principal financial officer, to allow for timely decisions regarding required disclosures. The evaluation did not identify any change in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2017 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II. OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

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

#### **Item 1A. Risk Factors**

The Company's Form 10-K as of December 31, 2016 includes detailed disclosure about the risks faced by the Company's business; such risks have not materially changed since the Form 10-K was filed.

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

(a) Previously reported on Form 8-K.

(b) None

(c) Issuer Purchases of Equity Securities

The table below sets forth the information with respect to purchases made by or on behalf of Westamerica Bancorporation or any “affiliated purchaser” (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of common stock during the quarter ended June 30, 2017 (in thousands, except per share data).

| Period                   | 2017  |  | (d)   |  |
|--------------------------|---|--|---|--|
|                          | (a)<br>Total<br>Number<br>of<br>shares<br>Purchased | (b)<br>Average<br>Price<br>Paid per<br>Share | (c) Number<br>of Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that<br>May Yet<br>Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|                          | (In thousands, except price paid)                   |  |   |  |
| April 1 through April 30 | 6   | \$ 56.51                                     | 6   | 1,744  |
| May 1 through May 31     | -   | -  | -   | 1,744  |
| June 1 through June 30   | -   | -  | -   | 1,744  |
| Total                    | 6   | \$ 56.51                                     | 6   | 1,744  |

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



Shares were repurchased during the second quarter 2017 pursuant to a program approved by the Board of Directors on July 28, 2016 authorized the purchase of up to 1,750 thousand shares of the Company's common stock from time to time prior to September 1, 2017.

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

**(a) Submission of Matters to a Vote of Security Holders**

The information required by this item is incorporated by reference to Item 5.07 to the Registrant's Form 8-K, filed with the Securities and Exchange Commission on May 1, 2017.

**Item 6. Exhibits**

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

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**SIGNATURES**

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

WESTAMERICA BANCORPORATION

(Registrant)

/s/ JOHN "ROBERT" THORSON

John "Robert" Thorson

Senior Vice President and Chief Financial Officer

(Chief Financial and Accounting Officer)

Date: August 4, 2017

**EXHIBIT INDEX**

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

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

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

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

Exhibit 101: Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2017, is formatted in XBRL interactive data files: (i) Consolidated Statements of Income for the three and six months ended June 30, 2017 and 2016; (ii) Consolidated Balance Sheets at June 30, 2017, and December 31, 2016; (iii) Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2017 and 2016, (iv) Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2017 and 2016; (v) Consolidated Statements of Cash Flows for the six months ended June 30, 2017 and 2016; and (vi) Notes to the Unaudited Consolidated Financial Statements.

