
Section 1: 10-K (10-K)

[Table of Contents](#)

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2018

OR

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

For the transition period from _____ to _____

Commission file number 0-30777

PACIFIC MERCANTILE BANCORP

(Exact name of Registrant as specified in its charter)

California

(State or other jurisdiction of
incorporation or organization)

949 South Coast Drive, Suite 300, Costa Mesa, California

(Address of principal executive offices)

33-0898238

(I.R.S. Employer
Identification No.)

92626

(Zip Code)

(714) 438-2500

(Registrant's telephone number, including area code)

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

Title of each class registered
Common Stock without par value

Name of each Exchange on which registered
Nasdaq Global Select Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities

Act. Yes No .

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

Table of Contents

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No .

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

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>
		Emerging growth company	<input type="checkbox"/>

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

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

The aggregate market value of voting and non-voting common equity held by non-affiliates of registrant as of June 30, 2018, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$150,595,390.

As of March 7, 2019, there were 22,019,198 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Except as otherwise stated therein, Part III of the Form 10-K is incorporated by reference from the Registrant’s Definitive Proxy Statement which is expected to be filed with the Commission on or before April 30, 2019 for its 2019 Annual Meeting of Shareholders.

Table of Contents

PACIFIC MERCANTILE BANCORP
ANNUAL REPORT ON FORM 10K
FOR THE YEAR ENDED DECEMBER 31, 2018

TABLE OF CONTENTS

	<u>Page No.</u>
<u>FORWARD LOOKING STATEMENTS</u>	
<u>PART I</u>	
<u>Item 1</u>	<u>Business</u> 2
<u>Item 1A</u>	<u>Risk Factors</u> 16
<u>Item 1B</u>	<u>Unresolved Staff Comments</u> 24
<u>Item 2</u>	<u>Properties</u> 24
<u>Item 3</u>	<u>Legal Proceedings</u> 24
<u>Item 4</u>	<u>Mine Safety Disclosures</u> 24
<u>PART II</u>	
<u>Item 5</u>	<u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> 26
<u>Item 6</u>	<u>Selected Financial Data</u> 28
<u>Item 7</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> 37
<u>Item 7A</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u> 52
<u>Item 8</u>	<u>Financial Statements and Supplementary Data</u> 54
<u>Item 9</u>	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosures</u> 98
<u>Item 9A</u>	<u>Controls and Procedures</u> 98
<u>Item 9B</u>	<u>Other Information</u> 99
<u>PART III</u>	
<u>Item 10</u>	<u>Directors, Executive Officers and Corporate Governance</u> 100
<u>Item 11</u>	<u>Executive Compensation</u> 100
<u>Item 12</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> 100
<u>Item 13</u>	<u>Certain Relationships and Related Transactions, and Director Independence</u> 100
<u>Item 14</u>	<u>Principal Accountant Fees and Services</u> 100
<u>PART IV</u>	
<u>Item 15</u>	<u>Exhibits, Financial Statement Schedules</u> 101
<u>Item 16</u>	<u>Form 10-K Summary</u> E-2
<u>Signatures</u>	S-1
<u>Exhibit Index</u>	E-0

FORWARD LOOKING STATEMENTS

Statements contained in this Annual Report on Form 10-K (this "Report") that are not historical facts or that discuss our expectations, beliefs or views regarding our future operations or future financial performance, or financial or other trends in our business or in the markets in which we operate, constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Often, they include words such as "believe," "expect," "anticipate," "intend," "plan," "estimate," "project," "forecast," or words of similar meaning, or future or conditional verbs such as "will," "would," "should," "could," or "may." The information contained in such forward-looking statements is based on current information available to us and on assumptions that we make about future economic and market conditions and other events over which we do not have control. In addition, our business and the markets in which we operate are subject to a number of risks and uncertainties. Such risks and uncertainties, and the occurrence of events in the future or changes in circumstances that had not been anticipated, could cause our financial condition or actual operating results in the future to differ materially from our expected financial condition or operating results that are set forth in the forward-looking statements contained in this Report and could, therefore, also affect the price performance of our shares.

In addition to the risk of incurring loan losses and provision for loan losses, which is an inherent risk of the banking business, these risks and uncertainties include, but are not limited to, the following: the risk that the credit quality of our borrowers declines; potential declines in the value of the collateral for secured loans; the risk that steps we have taken to strengthen our overall credit administration are not effective; the risk of a downturn in the United States or local economy, and domestic or international economic conditions, which could cause us to incur additional loan losses and adversely affect our results of operations in the future; the risk that our interest margins and, therefore, our net interest income will be adversely affected by changes in prevailing interest rates; the risk that we will not succeed in further reducing our remaining nonperforming assets, in which event we would face the prospect of further loan charge-offs and write-downs of assets; the risk that we will not be able to manage our interest rate risks effectively, in which event our operating results could be harmed; the prospect of changes in government regulation of banking and other financial services organizations, which could impact our costs of doing business and restrict our ability to take advantage of business and growth opportunities; the risk that our efforts to develop a robust commercial banking platform may not succeed; and the risk that we may be unable to realize our expected level of increasing deposit inflows. See Item 1A "Risk Factors" in this Report for additional information regarding these and other risks and uncertainties to which our business is subject.

Due to the risks and uncertainties we face, readers are cautioned not to place undue reliance on the forward-looking statements contained in this Report, which speak only as of the date of this Report, or to make predictions about future performance based solely on historical financial performance. We also disclaim any obligation to update forward-looking statements contained in this Report as a result of new information, future events or otherwise, except as may otherwise be required by law.

PART I

ITEM 1. BUSINESS

Background

Pacific Mercantile Bancorp is a California corporation that owns 100% of the stock of Pacific Mercantile Bank, a California state chartered commercial bank (which, for convenience, will sometimes be referred to in this Report as the “Bank”). The capital stock of the Bank is our principal asset and substantially all of our business operations are conducted and substantially all of our assets are owned by the Bank which, as a result, accounts for substantially all of our revenues, expenses and income. As the owner of a commercial bank, Pacific Mercantile Bancorp is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended (the “Bank Holding Company Act”), and, as such, our operations are regulated by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board” or the “FRB”) and the Federal Reserve Bank of San Francisco (“FRBSF”) under delegated authority from the FRB. See “Supervision and Regulation” below in this Item 1 of this Report. PM Asset Resolution, Inc. (“PMAR”) was a wholly owned subsidiary of Pacific Mercantile Bancorp, which existed for the purpose of purchasing certain non-performing loans and other real estate from the Bank and thereafter collecting on or disposing of those assets. During the year PMBC liquidated all assets at PMAR and during the third quarter of 2018, the entity was dissolved. For ease of reference, we will sometimes use the terms “Company,” “we,” “our,” or “us” in this Report to refer to Pacific Mercantile Bancorp on a consolidated basis and “PM Bancorp,” “Bancorp” or “PMBC” to refer to Pacific Mercantile Bancorp on a “stand-alone” or unconsolidated basis.

The Bank, which is headquartered in Orange County, California, approximately 40 miles south of Los Angeles, conducts a commercial banking business in Orange, Los Angeles, San Bernardino and San Diego counties in Southern California. The Bank is a member of the Federal Reserve System and its deposits are insured, to the maximum extent permitted by law, by the Federal Deposit Insurance Corporation (the “FDIC”).

The Bank commenced business in March 1999, with the opening of its first financial center, located in Newport Beach, California, and in April 1999 it launched its online banking site at www.pmbank.com.

The Bank's commercial lending solutions include working capital lines of credit and asset based lending, 7(a) and 504 Small Business Administration (“SBA”) loans, commercial real estate loans, growth capital loans, equipment financing, letters of credit and corporate credit cards. The Bank's depository and corporate banking services include cash and treasury management solutions, interest-bearing term deposit accounts, checking accounts, automated clearinghouse (“ACH”) payment and wire solutions, fraud protection, remote deposit capture, courier services, and online banking. Additionally, the Bank serves clients operating in the global marketplace through services including letters of credit and import/export financing.

The Bank attracts the majority of its loan and deposit business from the numerous small and middle market companies located in the Southern California region. The Bank reserves the right to change its business plan at any time, and no assurance can be given that, if the Bank's proposed business plan is followed, it will prove successful.

Our Business Strategy

We plan to expand our business by adhering to a business plan that is focused on building and growing a banking organization offering our customers the best attributes of a community bank, which are personalized and responsive service, while also offering the more sophisticated services of the big banks.

We will continue to focus our services and offer products primarily to small to mid-size businesses and professional firms in order to achieve internal growth of our banking franchise. We believe this focus will enable us to grow our loan portfolio and other earning assets and increase our core deposits (consisting of non-interest bearing demand, and lower-cost savings and money market deposits), with a goal to increase our net interest margin and improve our profitability. We also believe that, with our existing technology systems, we have the capability to increase the volume of our banking transactions without having to incur the cost or disruption of a major computer enhancement program.

Following our transition to a commercial banking model, it has become clear that our current client base is well served through our treasury management tools and rarely makes use of full-service branches. We reduced the size of several branches during 2016 and 2017. The resultant cost savings from the branch reorganization was redeployed to expand our business development team and more actively promote our online banking. We will continue to explore opportunities to create efficiencies in our office locations and redeploy those cost savings. As we add more relationship managers, we believe we can better penetrate our core markets and accelerate the growth of our commercial customer base.

Our Commercial Banking Operations

We seek to meet the banking needs of small and mid-size businesses and professional firms by providing our customers with:

- A broad range of loan and deposit products and banking and financial services, more typically offered by larger banks, in order to gain a competitive advantage over independent or community banks that do not provide the same range or breadth of services that we are able to provide to our customers; and
- A high level of personal service and responsiveness, more typical of independent and community banks, which we believe gives us a competitive advantage over large out-of-state and other large multi-regional banks that may be unable, or unwilling, due to the expense involved, to provide that same level of personal service to this segment of the banking market.

Deposit Products

Deposits are a bank’s principal source of funds for making loans and acquiring other interest earning assets. Additionally, the interest expense that a bank must incur to attract and maintain deposits has a significant impact on its operating results. A bank’s interest expense, in turn, will be determined in large measure by the types of deposits that it offers to, and is able to attract from, its customers. Generally, banks seek to attract “core deposits” which consist of demand deposits that bear no interest and low cost interest-bearing checking, savings and money market deposits. By comparison, time deposits (also sometimes referred to as “certificates of deposit”), including those in denominations of \$100,000 or more, usually bear much higher interest rates and are more interest-rate sensitive and volatile than core deposits. A bank that is not able to attract significant amounts of core deposits must rely on more expensive time deposits or alternative sources of cash, such as Federal Home Loan Bank (“FHLB”) borrowings, to fund interest-earning assets, which means that its cost of funds are likely to be higher and, as a result, its net interest margin is likely to be lower than a bank with a higher proportion of core deposits. See “MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS — Results of Operations-*Net Interest Income*” in Item 7 of this Report.

The following table sets forth information regarding the composition, by type of deposits, maintained by our customers during the year ended and as of December 31, 2018:

Type of Deposit	Average Balance During the Year Ended December 31, 2018		Balance at December 31, 2018	
	(Dollars in thousands)			
Noninterest-bearing checking accounts ⁽¹⁾	\$	348,923	\$	340,406
Interest-bearing checking accounts		69,841		64,144
Money market and savings deposits		412,366		460,355
Certificates of deposit ⁽²⁾		315,189		271,097
Totals	\$	1,146,319	\$	1,136,002

(1) Excludes noninterest bearing deposits maintained at the Bank by the Company with an annual average balance of \$15.4 million for the year ended December 31, 2018 and a balance of \$16.5 million at December 31, 2018.

(2) Comprised of time certificates of deposit in varying denominations under and over \$100,000. Excludes certificates of deposit maintained by the Company at the Bank with an average balance of \$248,000 for the year ended December 31, 2018 and a balance at December 31, 2018 of \$250,000. Excludes certificates of deposit maintained by PMAR at the Bank with an average balance of \$75,000 for the year ended December 31, 2018. There were no certificates of deposit maintained by PMAR at December 31, 2018.

Loan Products

We offer our customers a number of different loan products, including commercial loans and credit lines, accounts receivable and inventory financing, SBA guaranteed business loans, and owner-occupied commercial real estate loans. The following table sets forth the types and the amounts of our loans that were outstanding as of December 31, 2018:

Table of Contents

	At December 31, 2018	
	Amount	Percent of Total
	(Dollars in thousands)	
Commercial loans	\$ 444,441	40.6%
Commercial real estate loans – owner occupied	211,645	19.3%
Commercial real estate loans – all other	226,441	20.7%
Residential mortgage loans – multi-family	97,173	8.9%
Residential mortgage loans – single family ⁽¹⁾	21,176	1.9%
Land development loans	38,496	3.5%
Consumer loans	54,514	5.0%
Gross loans	<u>\$ 1,093,886</u>	<u>100.0%</u>

(1) These loans originated prior to March 2014 and our subsequent exit from the mortgage business and are retained in our loan portfolio as a loan diversification strategy.

Commercial Loans

The commercial loans we offer generally include short-term secured and unsecured business and commercial loans with maturities ranging from 12 to 24 months, accounts receivable financing for terms of up to 24 months, equipment loans which generally amortize over a period of up to 7 years, and SBA guaranteed business loans with terms of up to 10 years. The interest rates on these loans generally are adjustable and usually are indexed to *The Wall Street Journal's* prime rate and will vary based on market conditions and credit risk. In order to mitigate the risk of borrower default, we generally require collateral to support the credit or, in the case of loans made to businesses, we often require personal guarantees from their owners, or both. In addition, all such loans must have well-defined primary and secondary sources of repayment.

We also offer asset-based lending products made to businesses that are growing rapidly, but cannot internally fund their growth without borrowings. These loans are collateralized by a security interest in all business assets with specific advance rates made against the borrower's accounts receivable and inventory. We control our risk by monitoring borrower cash flow, financial performance and accounts receivable and inventory reports. In 2016, we centralized our loan monitoring function as a means to achieve improved portfolio risk monitoring of substantially all commercial loans, including asset-based loans.

Commercial loan growth is important to the growth and profitability of our banking franchise because commercial loan borrowers typically establish noninterest-bearing (demand) and interest-bearing transaction deposit accounts and banking services relationships with us. Those deposit accounts help us to reduce our overall cost of funds and those banking services relationships provide us with a source of non-interest income.

Commercial Real Estate Loans

The majority of our commercial real estate loans are secured by first trust deeds on nonresidential real property. Loans secured by nonresidential real estate often involve loan balances to single borrowers or groups of related borrowers. Payments on these loans depend to a large degree on the rental income stream from the properties and the global cash flows of the borrowers, which are generated from a wide variety of businesses and industries. As a result, repayment of these loans can be affected adversely by changes in the economy in general or by the real estate market more specifically. Accordingly, the nature of this type of loan makes it more difficult to monitor and evaluate. Consequently, we typically require personal guarantees from the owners of the businesses to which we make such loans.

Business Banking Services

We offer an array of banking and financial services designed to support the needs of our business banking clients. Those services include:

- Our online business banking portal allows our clients to conduct online transactions and access account information; features include the ability to:
 - View account balances and activity, including statements
 - Transfer funds between accounts
 - Access wires, ACH and bill pay capabilities
 - View check images
 - Setup account alerts
 - Prepare customizable reports and dashboard views

Table of Contents

- Download activity into Intuit QuickBooks and Quicken
- Our mobile banking platform allows our clients to conduct transactions and access account information from their mobile device; features include the ability to:
 - View available balances, transactions and transaction details
 - Create one time balance transfers
 - Create bill payments for existing payees
 - Schedule future dated bill payments
 - Cancel scheduled bill payments
 - View recent payments
 - Approve wires, ACH, and balance transfer transactions
 - Deposit checks
 - Find bank locations
- Collection services such as remote deposit capture services (PMB xPress Deposit), remittance payments (Lockbox), and incoming ACH and wire reporting and notification.
- Payable services such as checks, wire transfer and ACH origination, business bill pay service, and business credit cards. We also provide courier and onsite vault services for those clients with cash needs.
- Fraud prevention services such as Positive Pay, ACH Positive Pay, and transactional alerts.

Security Measures

Our ability to provide customers with secure and uninterrupted financial services is of paramount importance to our business. We believe our computer banking systems, services and software meet the highest standards of bank and electronic systems security. The following are among the security measures that we have implemented:

Bank-Wide Security Measures

- **Service Continuity.** In order to better ensure continuity of service, we have located our critical servers and telecommunications systems at an offsite hardened and secure data center. This center provides the physical environment necessary to keep servers up and running 24 hours a day, 7 days a week. This data center has raised floors, temperature control systems with separate cooling zones, seismically braced racks, and generators to keep the system operating during power outages and has been designed to withstand fires and major earthquakes. The center also has a wide range of physical security features, including smoke detection and fire suppression systems, motion sensors, and 24/7 secured access, as well as video camera surveillance and security breach alarms. The center is connected to the Internet by redundant high speed data circuits with advanced capacity monitoring.
- **Physical Security.** All servers and network computers reside in secure facilities. Only employees with proper identification may enter the primary server areas.
- **Monitoring.** Customer transactions on online servers and internal computer systems produce one or more entries into transactional logs. Our personnel routinely review these logs as a means of identifying and taking appropriate action with respect to any abnormal or unusual activity.

Internet Security Measures

We maintain electronic and procedural safeguards that comply with federal regulations to guard nonpublic personal information. We regularly assess and update our systems to improve our technology for protecting information. Our security measures include:

- Transport Layer Security;
- digital certificates;
- multi-factor authentication;
- data loss prevention systems;
- anti-virus, anti-malware, and patch management systems;
- intrusion detection/prevention systems;
- vulnerability management systems; and
- firewall protection.

Table of Contents

We believe the risk of fraud presented by online banking is not materially different from the risk of fraud inherent in any banking relationship. Potential security breaches can arise from any of the following circumstances:

- misappropriation of a customer's account number or password;
- compromise of the customer's computer system;
- penetration of our servers by an outside "hacker;"
- fraud committed by a new customer in completing his or her loan application or opening a deposit account with us; and
- fraud committed by employees or service providers.

Both traditional banks and internet banks are vulnerable to these types of fraud. By establishing the security measures described above, we believe we can minimize, to the extent practicable, our vulnerability to the first three types of fraud. To counteract fraud by new customers, employees and service providers, we have established internal procedures and policies designed to ensure that, as in any bank, proper control and supervision is exercised over new customers, employees and service providers. We also maintain insurance to protect us from losses due to fraud committed by employees or through breaches in our cyber security.

Additionally, the adequacy of our security measures is reviewed periodically by the FRBSF and the California Department of Business Oversight ("CDBO"), which are the federal and state government agencies, respectively, with primary supervisory authority over the Bank. We also retain the services of third party computer security firms to conduct periodic tests of our computer and online banking systems to identify potential threats to the security of our systems and to recommend additional actions that we can take to improve our security measures.

Competition

Competitive Conditions in the Traditional Banking Environment

The banking business in California generally, and in our service area in particular, is highly competitive and is dominated by a relatively small number of large multi-state and California-based banks that have numerous banking offices operating over wide geographic areas. We compete for deposits and loans with those banks, with community banks that are based or have branch offices in our market areas, and with savings banks (also sometimes referred to as "thrifts"), credit unions, money market and other mutual funds, stock brokerage firms, insurance companies, and other traditional and nontraditional financial service organizations. We also compete for customers' funds with governmental and private entities issuing debt or equity securities or other forms of investments which may offer different and potentially higher yields than those available through bank deposits.

Major financial institutions that operate throughout California and that have offices in our service areas include Bank of America, Wells Fargo Bank, JPMorgan Chase, Union Bank of California, Bank of the West, U. S. Bancorp, Comerica Bank and Citibank. Larger independent banks and other financial institutions with offices in our service areas include, among others, OneWest Bank, City National Bank, Citizens Business Bank, Manufacturers Bank, and California Bank and Trust.

These banks, as well as many other financial institutions in our service areas, have the financial capability to conduct extensive advertising campaigns and to shift their resources to regions or activities of greater potential profitability. Many of them also offer diversified financial services which we do not presently offer directly. The larger banks and financial institutions also have substantially more capital and higher lending limits than our Bank.

In order to compete with the banks and other financial institutions operating in our service areas, we rely on our ability to provide flexible, more convenient and more personalized service to customers, including online banking services and financial tools. At the same time, we:

- emphasize personal contacts with existing and potential new customers by our directors, officers and other employees;
- develop and participate in local promotional activities; and
- seek to develop specialized or streamlined services for customers.

To the extent customers desire loans in excess of our lending limits or services not offered by us, we attempt to assist them in obtaining such loans or other services through participations with other banks or assistance from our correspondent banks or third party vendors.

Table of Contents

Competitive Conditions in Online Banking

There are a number of banks that offer services exclusively over the internet, such as E*TRADE Bank, and other banks, such as Bank of America and Wells Fargo Bank, that market their internet banking services to their customers nationwide. We believe that only the larger of the commercial banks with which we compete offer the comprehensive set of online banking tools and services that we offer to our customers. However, most community banks do offer varying levels of internet banking services to their customers by relying on third party vendors to provide the functionality they need to provide such services. Additionally, many of the larger banks have greater market presence and greater financial resources to market their internet banking services than do we. Moreover, new competitors (including non-bank fintech start-ups) and other competitive factors have emerged over the past few years as part of the rapid development of internet commerce. We believe that these findings support our strategic decision, made at the outset of our business, to offer customers the benefits of both traditional and online banking services. However, utilization trends continue to show that our clients largely favor online banking services over traditional branch services. Thus, we have reduced and expect to continue to reduce the size of our branches and are redeploying the cost savings to expand our business development team and to more actively promote our online banking. We believe that this strategy has been an important factor in our recent growth in core deposits and will contribute to our growth in the future. See “BUSINESS — Our Business Strategy” earlier in this Item 1 of this Report.

Impact of Economic Conditions, Government Policies and Legislation on our Business

Government Monetary Policies. Our profitability, like that of most financial institutions, is affected to a significant extent by our net interest income, which is the difference between the interest income we generate on interest-earning assets, such as loans and investment securities, and the interest we pay on deposits and other interest-bearing liabilities, such as borrowings. Our interest income and interest expense, and hence our net interest income, depends to a great extent on prevailing market rates of interest, which are highly sensitive to many factors that are beyond our control, including inflation, recession and unemployment. Moreover, it is often difficult to predict with any assurance how changes in economic conditions of this nature will affect our future financial performance.

Our net interest income and operating results also are affected by monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the Federal Reserve Board. The Federal Reserve Board implements national monetary policies to curb inflation, or to stimulate borrowing and spending in response to economic downturns, through its open-market operations by adjusting the required level of reserves that banks and other depository institutions must maintain, and by varying the target federal funds and discount rates on borrowings by banks and other depository institutions. These actions affect the growth of bank loans, investments and deposits and the interest earned on interest-earning assets and paid on interest-bearing liabilities. The nature and impact of any future changes in monetary and fiscal policies on us cannot be predicted with any assurance.

Legislation Generally. From time to time, federal and state legislation is enacted which can affect our operations and our operating results by materially changing the costs of doing business, limiting or expanding the activities in which banks and other financial institutions may engage, or altering the competitive balance between banks and other financial services providers.

Economic Conditions and Recent Legislation and Other Government Actions.

The last economic recession, which is reported to have begun at the end of 2007 and ended in the middle of 2009, created wide ranging consequences and difficulties for the banking and financial services industry, in particular, and the economy in general. The recession led to significant write-downs of the assets and an erosion of the capital of a large number of banks and other lending and financial institutions which, in turn, significantly and adversely affected the operating results of banking and other financial institutions and led to steep declines in their stock prices. In addition, bank regulatory agencies have been very aggressive in responding to concerns and trends identified in their bank examinations, which has resulted in the increased issuance of enforcement orders requiring banks to take actions to address credit quality, liquidity and risk management and capital adequacy, as well as other safety and soundness concerns. All of these conditions, moreover, led the U.S. Congress, the U.S. Treasury Department and the federal banking regulators, including the FDIC, to take broad actions, to address systemic risks and volatility in the U.S. banking system. A description of some of the regulatory and other actions taken, and their impact on the Company, are described below under “Supervision and Regulation.”

Supervision and Regulation

Both federal and state laws extensively regulate bank holding companies and banks. Such regulation is intended primarily for the protection of depositors, the FDIC’s deposit insurance fund and customers, and is not for the benefit of shareholders. Set forth below is a summary description of the material laws and regulations that affect or bear on our operations. The description does not purport to be complete and is qualified in its entirety by reference to the laws and regulations that are summarized below.

Pacific Mercantile Bancorp

PM Bancorp is a registered bank holding company subject to regulation under the Bank Holding Company Act. Pursuant to the Bank Holding Company Act, PM Bancorp is subject to supervision and periodic examination by, and is required to file periodic reports with, the Federal Reserve Board. PM Bancorp is also a bank holding company within the meaning of the California Financial Code. As such, PM Bancorp and its subsidiaries are subject to supervision and periodic examination by, and may be required to file reports with, the CDBO.

As a bank holding company, PM Bancorp is allowed to engage, directly or indirectly, only in banking and other activities that the Federal Reserve Board deems to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Bank holding companies that meet certain eligibility requirements prescribed by the Bank Holding Company Act and elect and retain "financial holding company" status may engage in broader securities, insurance, merchant banking and other activities that are determined to be "financial in nature" or are incidental or complementary to activities that are financial in nature without prior FRB approval. PM Bancorp has not elected financial holding company status and neither PM Bancorp nor the Bank has engaged in any activities for which financial holding company status is required.

As a bank holding company, PM Bancorp is also required to obtain the prior approval of the Federal Reserve Board for the acquisition of more than 5% of the outstanding shares of any class of voting securities, or of substantially all of the assets, by merger with or purchase of (i) any bank or other bank holding company and (ii) any other entities engaged in banking-related businesses or that provide banking-related services.

The Dodd-Frank Act requires PM Bancorp to act as a source of financial strength to the Bank including committing resources to support the Bank even at times when PM Bancorp may not be in a financial position or believe that it is in the best interest of our shareholders to do so. It is the Federal Reserve Board's policy that, in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. For these reasons, among others, the Federal Reserve Board requires all bank holding companies to maintain capital at or above certain prescribed levels. A bank holding company's failure to meet these requirements will generally be considered by the Federal Reserve Board to be an unsafe and unsound banking practice or a violation of the Federal Reserve Board's regulations or both, which could lead to the imposition of restrictions on the offending bank holding company, including restrictions on its further growth. See the discussion below under the caption "Prompt Corrective Action." In addition, under the cross-guarantee provisions of the Federal Deposit Insurance Act ("FDIA"), the FDIC can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to such a commonly controlled institution.

Additionally, the Federal Reserve Board may require any bank holding company to terminate an activity or terminate control of, or liquidate or divest itself of, any subsidiary or affiliated company that the Federal Reserve Board determines constitutes a significant risk to the financial safety, soundness or stability of the bank holding company or any of its banking subsidiaries. The Federal Reserve Board also has the authority to regulate aspects of a bank holding company's debt. Subject to certain exceptions, bank holding companies also are required to file written notice and obtain approval from the Federal Reserve Board prior to purchasing or redeeming their common stock or other equity securities. A bank holding company and its non-banking subsidiaries also are prohibited from implementing so-called tying arrangements whereby customers may be required to use or purchase services or products from the bank holding company or any of its non-bank subsidiaries in order to obtain a loan or other services from any of the holding company's subsidiary banks.

Pacific Mercantile Bank

General. The Bank is subject to primary supervision, periodic examination and regulation by (i) the Federal Reserve Board, which is its primary federal banking regulator, because the Bank is a member of the Federal Reserve System and (ii) the CDBO, because the Bank is a California state chartered bank. The Bank also is subject to certain of the regulations promulgated by the FDIC, because its deposits are insured by the FDIC.

Various requirements and restrictions under the Federal and California banking laws affect the operations of the Bank. These laws and the implementing regulations cover most aspects of a bank's operations, including the reserves a bank must maintain against deposits and for possible loan losses and other contingencies; the types of deposits it obtains and the interest it is permitted to pay on certain deposit accounts; the loans and investments that a bank may make; the borrowings that a bank may incur; the number and location of banking offices that a bank may establish; the rate at which it may grow its assets; the acquisition and merger activities of a bank; the amount of dividends that a bank may pay; and the capital requirements that a bank must satisfy, which can determine the extent of supervisory control to which a bank will be subject by its federal and state bank regulators. A more detailed discussion regarding capital requirements that are applicable to us and the Bank is set forth below under the caption "*Prompt Corrective Action.*"

Table of Contents

Permissible Activities and Subsidiaries. California law permits state chartered commercial banks to engage in any activity permissible for national banks. Those permissible activities include conducting many so-called “closely related to banking” or “nonbanking” activities either directly or through their operating subsidiaries.

Federal Home Loan Bank System. The Bank is a member of the FHLB of San Francisco. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region and makes available loans or advances to its member banks. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. As an FHLB member, the Bank is required to own a certain amount of capital stock in the FHLB. At December 31, 2018, the Bank was in compliance with the FHLB’s stock ownership requirement. Historically, the FHLB has paid dividends on its capital stock to its members.

FRB Deposit Reserve Requirements. The Federal Reserve Board requires all federally-insured depository institutions to maintain noninterest bearing reserves at specified levels against their transaction accounts. At December 31, 2018, the Bank was in compliance with these requirements.

Single Borrower Loan Limitations. With certain limited exceptions, the maximum amount that a California state bank may lend to any borrower (including certain related entities) at any one time may not exceed 15% of the sum of the shareholders’ equity, allowance for loan and lease losses, capital notes and debentures of the bank if unsecured. The combined unsecured and secured obligations of any borrower may not exceed 25% of the sum of the shareholders’ equity, allowance for loan and lease losses, capital notes and debentures of the bank.

Restrictions on Transactions between the Bank and the Company and its other Affiliates. The Bank is subject to restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of, the Company or any of its other subsidiaries; the purchase of, or investments in, Company stock or other Company securities and the taking of such securities as collateral for loans; and the purchase of assets from the Company or any of its other subsidiaries. These restrictions prevent the Company and any of its subsidiaries from borrowing from the Bank unless the loans are secured by marketable obligations in designated amounts, and such secured loans and investments by the Bank in the Company or any of its subsidiaries are limited, individually, to 10% of the Bank’s capital and surplus (as defined by federal regulations) and, in the aggregate, for all loans made to and investments made in the Company and its other subsidiaries, to 20% of the Bank’s capital and surplus. California law also imposes restrictions with respect to transactions involving the Company and other persons deemed under that law to control the Bank. It is the policy of the federal banking agencies that tax sharing agreements between a bank holding company and subsidiary bank that file consolidated tax returns must provide that any refund received by the holding company be allocated between the holding company and the bank in proportion to their respective income, losses and other tax characteristics as if they had filed on a stand-alone basis and, until the bank’s share is paid to it (which should be done promptly upon receipt), its share must be held in trust or as agent for the benefit of the bank, and not merely owed by the holding company as a debt to the bank.

Enforcement. If, as a result of an examination of a bank, its primary federal bank regulatory agency were to determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of a bank’s operations had become unsatisfactory or that the bank or its management was in violation of any law or regulation, that agency has the authority to take a number of different remedial actions as it deems appropriate under the circumstances. These actions include the power to enjoin “unsafe or unsound” banking practices; to require that affirmative action be taken to correct any conditions resulting from any violation or practice; to issue an administrative order that can be judicially enforced; to require the bank to increase its capital; to restrict the bank’s growth; to assess civil monetary penalties against the bank or its officers or directors; to remove officers and directors of the bank; and, if the federal agency concludes that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate a bank’s deposit insurance, which in the case of a California chartered bank would result in revocation of its charter and require it to cease its banking operations. Additionally, under California law the CDBO has many of the same remedial powers with respect to the Bank, because it is a California state chartered bank.

Table of Contents

Dividends

Cash dividends from the Bank constitute the primary source of cash available to PM Bancorp for its operations and to fund any cash dividends that the board of directors might declare in the future. PM Bancorp is a legal entity separate and distinct from the Bank and the Bank is subject to various statutory and regulatory restrictions on its ability to pay cash dividends to PM Bancorp. Those restrictions would prohibit the Bank, subject to certain limited exceptions, from paying cash dividends in amounts that would cause the Bank to become undercapitalized. Additionally, the Federal Reserve Board and the CDBO have the authority to prohibit the Bank from paying dividends, if either of those authorities deems the payment of dividends by the Bank to be an unsafe or unsound practice. We have agreed that the Bank will not, without the FRB and the CDBO's prior written approval, pay any dividends to PM Bancorp. See "*Dividend Policy and Restrictions on the Payment of Dividends*" in Item 5 of this Report.

Additionally, it is FRB policy that bank holding companies should generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also an FRB policy that bank holding companies should not maintain dividend levels that undermine their ability to be a source of strength to their banking subsidiaries. Additionally, the FRB has indicated that bank holding companies should carefully review their dividend policies and has discouraged dividend payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong. We have committed to obtaining approval from the FRB and the CDBO prior to paying any dividends. There can be no assurance that our regulators will approve such payments or dividends in the future.

Safety and Soundness Standards

Banking institutions may be subject to potential enforcement actions by the federal regulators for unsafe or unsound practices or for violating any law, rule, regulation, or any condition imposed in writing by its primary federal banking regulatory agency or any written agreement with that agency. The federal banking agencies have adopted guidelines designed to identify and address potential safety and soundness concerns that could, if not corrected, lead to deterioration in the quality of a bank's assets, liquidity or capital. Those guidelines set forth operational and managerial standards relating to such matters as:

- internal controls, information systems and internal audit systems;
- loan documentation;
- credit underwriting;
- asset growth;
- earnings; and
- compensation, fees and benefits.

In addition, federal banking agencies have adopted safety and soundness guidelines with respect to asset quality. These guidelines provide standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. Under these standards, an FDIC-insured depository institution is expected to:

- conduct periodic asset quality reviews to identify problem assets, estimate the inherent losses in problem assets and establish reserves that are sufficient to absorb those estimated losses;
- compare problem asset totals to capital;
- take appropriate corrective action to resolve problem assets;
- consider the size and potential risks of material asset concentrations; and
- provide periodic asset quality reports with adequate information for the Bank's management and the board of directors to assess the level of asset risk.

These guidelines also establish standards for evaluating and monitoring earnings and for ensuring that earnings are sufficient for the maintenance of adequate capital and reserves.

Capital Requirements

The Company and the Bank are subject to the regulatory capital requirements administered by the federal banking agencies. The federal banking agencies' current risk-based capital guidelines are based upon the 1988 capital accord ("Basel I") of the Basel Committee on Banking Supervision (the "Basel Committee"). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies they apply. The requirements are intended to ensure that banking organizations

Table of Contents

have adequate capital given the risk levels of assets and off-balance sheet financial instruments. Under the requirements, banking organizations are required to maintain minimum ratios for Tier 1 capital and total capital to risk-weighted assets (including certain off-balance sheet items, such as letters of credit). For purposes of calculating the ratios, a banking organization's assets and some of its specified off-balance sheet commitments and obligations are assigned to various risk categories. A bank's or bank holding company's capital, in turn, is classified in one of two tiers, depending on type:

- *Core Capital (Tier 1)*. Tier 1 capital includes common equity, retained earnings, qualifying non-cumulative perpetual preferred stock, minority interests in equity accounts of consolidated subsidiaries (and, under existing standards, a limited amount of qualifying trust preferred securities and qualifying cumulative perpetual preferred stock at the holding company level), less goodwill, most intangible assets and certain other assets.
- *Supplementary Capital (Tier 2)*. Tier 2 capital includes, among other things, perpetual preferred stock and trust preferred securities not meeting the Tier 1 definition, qualifying mandatory convertible debt securities, qualifying subordinated debt, and allowances for loan and lease losses, subject to limitations.

These capital requirements were modified effective as of January 1, 2015 in connection with commencement of Basel III Capital Rules described below. Through 2014, we were required to maintain Tier 1 capital and "total capital" (the sum of Tier 1 and Tier 2 capital) equal to at least 4.0% and 8.0%, respectively, of our total risk-weighted assets (including various off-balance-sheet items, such as letters of credit). The Bank, like other depository institutions, was required to maintain similar capital levels under capital adequacy guidelines. In addition, for a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its Tier 1 and total capital ratios must have been at least 6.0% and 10.0% on a risk-adjusted basis, respectively.

Bank holding companies and banks are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization's Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). Through 2014, the requirements necessitated a minimum leverage ratio of 3.0% for bank holding companies and banks that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority's risk-adjusted measure for market risk. All other bank holding companies and banks are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. In addition, for a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%.

Basel III Capital Rules. As of January 1, 2015, the Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations took effect. The rules implement the Basel Committee's December 2010 framework known as "Basel III" for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and the Bank, compared to the current U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the existing risk-weighting approach, which was derived from the Basel I capital accords of the Basel Committee, with a more risk-sensitive approach based, in part, on the standardized approach in the Basel Committee's 2004 "Basel II" capital accords. The Basel III Capital Rules also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies' rules. The Basel III Capital Rules were effective for the Company and the Bank on January 1, 2015 subject to a phase-in period ending on January 1, 2019. Under a Federal Reserve Board policy amended in 2018, qualifying bank holding companies with consolidated assets of less than \$3.0 billion, such as the Company, are exempt from the requirements of the Basel III Capital Rules. The Bank, however, is subject to these rules.

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called "Common Equity Tier 1" ("CET1"), (ii) specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments as compared to existing regulations.

The Basel III capital Rules also include a capital conservation buffer designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a three-year period (increasing by 0.625% on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

As fully phased in as of January 1, 2019, the Basel III Capital Rules require the Bank to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus the 2.5% "capital conservation buffer" effectively resulting in a minimum ratio

Table of Contents

of CET1 to risk-weighted assets of at least 7%, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer effectively resulting in a minimum Tier 1 capital ratio of 8.5%, (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (resulting in a minimum total capital ratio of 10.5%), and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets .

The Basel III Capital Rules also provide for a “countercyclical capital buffer” that is applicable to only certain larger, covered institutions and is not expected to have any current applicability to the Company or the Bank.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1 for mortgage servicing rights, certain deferred tax assets, significant investments in non-consolidated financial entities and the effects of accumulated other comprehensive income. The Basel III Capital Rules also preclude certain hybrid securities, such as trust preferred securities, as Tier 1 capital of bank holding companies, subject to phase-out, but institutions with less than \$15 billion in assets are exempted from this new rule.

With respect to the Bank, the Basel III Capital Rules also revise the “prompt corrective action” regulations as discussed below under “*Prompt Corrective Action*.”

The Basel III Capital Rules prescribe a standardized approach for risk weightings that expand the risk-weighting categories from the four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories.

In addition, the Basel III Capital Rules provide more advantageous risk weights for derivatives and repurchase-style transactions cleared through a qualifying central counterparty and increase the scope of eligible guarantors and eligible collateral for purposes of credit risk mitigation.

As of December 31, 2018, the capital levels of the Bank exceed the minimums necessary to be categorized as well capitalized under the Basel III Capital Rules, including the applicable capital conservation buffers. See “See “Item 7. — MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS — Capital Resources — Regulatory Capital Requirements Applicable to Banking Institutions.”

Liquidity Requirements

Historically, the regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. In September 2013, the federal banking agencies adopted rules to impose quantitative liquidity requirements consistent with the liquidity coverage ratio standard established by the Basel Committee. These rules apply to larger (over \$250 billion in assets, with less stringent requirements for institutions over \$50 billion in assets) and internationally active institutions but, as adopted, do not apply to the Company or the Bank.

Prompt Corrective Action

The FDIA, requires among other things, the federal banking agencies to take “prompt corrective action” in respect of depository institutions that do not meet minimum capital requirements. The FDIA includes the following five capital tiers: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” and “critically undercapitalized.” A depository institution’s capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The relevant capital measures are the total capital ratio, the Tier 1 capital ratio and the leverage ratio. The Basel III Capital Rules affect the capital requirements for prompt corrective action purposes also.

A bank is (i) “well capitalized” if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, a CET1 ratio of 6.5% or greater and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure; (ii) “adequately capitalized” if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 4.0% or greater, a CET1 ratio of 4.5% or greater and a leverage ratio of 4.0% or greater and is not “well capitalized”; (iii) “undercapitalized” if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 4.0%, a CET1 ratio of less than 4.5% or a leverage ratio of less than 4.0%; (iv) “significantly undercapitalized” if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 3.0%, a CET1 ratio of less than 3.0% or a leverage ratio of less than 3.0%; and (v) “critically undercapitalized” if the institution’s tangible equity is equal to or less than 2.0% of average quarterly tangible assets. An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. A bank’s capital category is determined solely for the purpose

Table of Contents

of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank's overall financial condition or prospects for other purposes.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be "undercapitalized." "Undercapitalized" institutions are subject to growth limitations and are required to submit a capital restoration plan. The agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution's capital. In addition, for a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee that the institution will comply with such capital restoration plan. The bank holding company must also provide appropriate assurances of performance. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution's total assets at the time it became undercapitalized and (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is "significantly undercapitalized."

"Significantly undercapitalized" depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become "adequately capitalized," requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. "Critically undercapitalized" institutions are subject to the appointment of a receiver or conservator.

The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

At December 31, 2018, the Bank (on a stand-alone basis) continued to qualify as a well-capitalized institution, and the Company continued to exceed the minimum required capital ratios applicable to it, under the capital adequacy guidelines described above.

FDIC Deposit Insurance

The FDIC is an independent federal agency that insures customer deposits of federally insured banks and savings institutions in order to safeguard the safety and soundness of the banking and savings industries through the Deposit Insurance Fund (the "DIF") up to prescribed limits, currently \$250,000 per depositor. The DIF is funded primarily by FDIC assessments paid by each DIF member institution. The amount of each DIF member's assessment is based on its relative risk of default as measured by regulatory capital ratios and other supervisory factors. Pursuant to the Federal Deposit Insurance Reform Act of 2005, the FDIC is authorized to set the reserve ratio for the DIF annually at between 1.15% and 1.50% of estimated insured deposits. The FDIC may increase or decrease the assessment rate schedule on a semi-annual basis. The Dodd-Frank Act increased the minimum reserve ratio (the ratio of the net worth of the DIF to estimated insured deposits) from 1.15% of estimated deposits to 1.35% of estimated deposits (or a comparable percentage of the asset-based assessment base described above). The Dodd-Frank Act requires the FDIC to offset the effect of the increase in the minimum reserve ratio when setting assessments for insured depository institutions with less than \$10 billion in total consolidated assets, such as the Bank. The FDIC has until September 30, 2020 to achieve the new minimum reserve ratio of 1.35%.

Additionally, all FDIC-insured institutions are required to pay assessments to the FDIC to fund interest payments on bonds issued by the Financing Corporation ("FICO"), an agency of the Federal government established to recapitalize the predecessor to the DIF. The FICO assessment rates, which are determined quarterly, averaged approximately 0.00305% of insured deposits in fiscal 2018. These assessments will continue until the FICO bonds mature through 2019.

The FDIC may terminate a depository institution's deposit insurance upon a finding that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices that pose a risk to the DIF or that may prejudice the interest of the bank's depositors. Pursuant to California law, the termination of a California state chartered bank's FDIC deposit insurance would result in the revocation of the bank's charter, forcing it to cease conducting banking operations.

Community Reinvestment Act and Fair Lending Laws

The Bank is subject to fair lending requirements and the evaluation of its small business operations under the Community Reinvestment Act ("CRA"). The CRA generally requires the federal banking agencies to evaluate the record of a bank in meeting the credit needs of its local communities, including those of low- and moderate-income neighborhoods in its service area. A bank's compliance with its CRA obligations is based on a performance-based evaluation system which determines the bank's CRA ratings on the basis of its community lending and community development performance. When a bank holding company files an application for approval to acquire a bank or another bank holding company, the Federal Reserve Board will review the CRA assessment of

Table of Contents

each of the subsidiary banks of the applicant bank holding company, and a low CRA rating may be the basis for denying the application.

A bank may be subject to substantial penalties and corrective measures for a violation of fair lending laws. Federal banking agencies also may take compliance with fair lending laws into account when determining a bank's CRA rating and when regulating and supervising other activities of a bank or its bank holding company.

USA Patriot Act of 2001

In October 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism ("USA Patriot Act") of 2001 was enacted into law in response to the September 11, 2001 terrorist attacks. The USA Patriot Act was adopted to strengthen the ability of U.S. law enforcement and intelligence agencies to work cohesively to combat terrorism on a variety of fronts.

Of particular relevance to banks and other federally insured depository institutions are the USA Patriot Act's sweeping anti-money laundering and financial transparency provisions and various related implementing regulations that:

- establish due diligence requirements for financial institutions that administer, maintain, or manage private bank accounts and foreign correspondent accounts;
- prohibit U.S. institutions from providing correspondent accounts to foreign shell banks;
- establish standards for verifying customer identification at account opening; and
- set rules to promote cooperation among financial institutions, regulatory agencies and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Under implementing regulations issued by the U.S. Treasury Department, banking institutions are required to incorporate a customer identification program into their written money laundering plans that includes procedures for:

- verifying the identity of any person seeking to open an account, to the extent reasonable and practicable;
- maintaining records of the information used to verify the person's identity; and
- determining whether the person appears on any list of known or suspected terrorists or terrorist organizations.

Consumer Laws

The Company and the Bank are subject to a broad range of federal and state consumer protection laws and regulations prohibiting unfair or fraudulent business practices, untrue or misleading advertising and unfair competition. Those laws and regulations include:

- The Home Ownership and Equity Protection Act of 1994, which requires additional disclosures and consumer protections to borrowers designed to protect them against certain lending practices, such as practices deemed to constitute "predatory lending."
- Laws and regulations requiring banks to establish privacy policies which limit the disclosure of nonpublic information about consumers to nonaffiliated third parties.
- The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act, which requires banking institutions and financial services businesses to adopt practices and procedures designed to help deter identity theft, including developing appropriate fraud response programs, and provides consumers with greater control of their credit data.
- The Truth in Lending Act, which requires that credit terms be disclosed in a meaningful and consistent way so that consumers may compare credit terms more readily and knowledgeably.
- The Equal Credit Opportunity Act, which generally prohibits, in connection with any consumer or business credit transaction, discrimination on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), or the fact that a borrower is receiving income from public assistance programs.
- The Fair Housing Act, which regulates many lending practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status.

Table of Contents

- The Home Mortgage Disclosure Act, which includes a “fair lending” aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes.
- The Real Estate Settlement Procedures Act, which requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements and prohibits certain abusive practices, such as kickbacks.
- The National Flood Insurance Act, which requires homes in flood-prone areas with mortgages from a federally regulated lender to have flood insurance.
- The Secure and Fair Enforcement for Mortgage Licensing Act of 2008, which requires mortgage loan originator employees of federally insured institutions to register with the Nationwide Mortgage Licensing System and Registry, a database created by the states to support the licensing of mortgage loan originators, prior to originating residential mortgage loans.

Regulation W

The FRB has adopted Regulation W to comprehensively implement Sections 23A and 23B of the Federal Reserve Act.

Sections 23A and 23B and Regulation W limit transactions between a bank and its affiliates (which include its holding company) and limit a bank’s ability to transfer to its affiliates the benefits arising from the bank’s access to insured deposits, the payment system and the discount window and other benefits of the Federal Reserve system. The statute and regulation impose quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate (and a non-affiliate if an affiliate benefits from the transaction). However, certain transactions that generally do not expose a bank to undue risk or abuse the safety net are exempted from coverage under Regulation W.

Historically, a subsidiary of a bank was not considered an affiliate for purposes of Sections 23A and 23B, since their activities were limited to activities permissible for the bank itself. However, the Gramm-Leach-Bliley Act of 1999 authorized “financial subsidiaries” that may engage in activities not permissible for a bank. These financial subsidiaries are now considered affiliates. Certain transactions between a financial subsidiary and another affiliate of a bank are also covered by Sections 23A and 23B and under Regulation W.

Privacy

The Gramm-Leach-Bliley Act of 1999 and the California Financial Information Privacy Act require financial institutions to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to non-affiliated third parties. In general, the statutes require explanations to consumers on policies and procedures regarding the disclosure of such nonpublic personal information and, except as otherwise required by law, prohibit disclosing such information except as provided in the Bank’s policies and procedures. We have implemented privacy policies addressing these restrictions which are distributed regularly to all existing and new customers of the Bank.

Customer Information Security

The FRB and other bank regulatory agencies have adopted guidelines for safeguarding confidential, personal customer information. These guidelines require each financial institution, under the supervision and ongoing oversight of its board of directors or an appropriate committee thereof, to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazard to the security or integrity of such information and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. We have adopted a customer information security program to comply with such requirements.

Incentive Compensation

In June 2010, the FRB and the FDIC issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors. These three principles are incorporated into proposed joint compensation regulations under the Dodd-Frank Act that would prohibit incentive-based payment arrangements at specified regulated entities having at least \$1 billion in total

Table of Contents

assets that encourage inappropriate risks. The FRB will review, as part of its regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Company, that are not "large, complex banking organizations." These reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiency.

Legislative and Regulatory Initiatives

From time to time, various legislative and regulatory initiatives are introduced in the U.S. Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and our operating environment in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. We cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on our financial condition, results of operations or cash flows. A change in statutes, regulations or regulatory policies applicable to the Company or any of its subsidiaries could have a material effect on our business.

Employees

As of December 31, 2018, we employed 160 persons on a full-time equivalent basis and 0 persons on a part-time basis for a total of 160 persons. None of our employees are covered by a collective bargaining agreement. We believe relations with our employees are good.

Information Available on our Website

Our Internet address is www.pmbank.com. We make available on our website, free of charge, our filings made with the SEC electronically, including those on Form 10-K, Form 10-Q, and Form 8-K, and any amendments to those filings. Copies of these filings are available as soon as reasonably practicable after we have filed or furnished these documents to the SEC (at www.sec.gov).

ITEM 1A. RISK FACTORS

Our business is subject to a number of risks and uncertainties, including those described below, that could cause our financial condition or operating results in the future to differ significantly from our expected financial condition or operating results that are set forth in the forward looking statements contained in this Report. The risks discussed below are not the only ones facing our business but do represent those risks that we believe are material to us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also harm our business.

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

Our business, earnings and profitability are affected by the financial markets and economic conditions in the United States generally and, more specifically, in Southern California where a substantial portion of our business is generated, including factors such as the level and volatility of short-term and long-term interest rates, inflation, real estate values, unemployment and under-employment levels, bankruptcies, household income, consumer spending, fluctuations in both debt and equity capital markets, liquidity of the global financial markets, the availability and cost of capital and credit, investor sentiment and confidence in the financial markets and the sustainability of economic growth both in the United States and globally. The deterioration of any of these conditions could adversely affect the financial performance and/or condition of our borrowers, the demand for credit and other banking products, the ability of borrowers to pay interest on and repay principal on outstanding loans and the value of collateral securing those loans, which could lead to decreased loan utilization rates, increased delinquencies and defaults and changes to our customers' ability to meet certain credit obligations. If any of these events occur, we could experience one or more of the following adverse effects on our business:

- a decline in the demand for loans, which would cause a decline in interest income and our net interest margin;
- a decline in the value of our loans or other assets secured by residential or commercial real estate or by trading assets of our borrowers;
- a decrease in deposit balances due to overall reductions in the accounts of customers, which would adversely impact our liquidity position;
- an impairment of our investment securities and other real estate owned ("OREO"); and

- an increase in the volume of loans that become delinquent or the number of borrowers that file for protection under bankruptcy laws or default on their home loans or commercial loan obligations to us, either of which could result in a higher level of non-performing assets and cause us to increase our allowance for loan and lease losses (“ALLL”), thereby reducing our earnings.

In addition, because the substantial majority of our customers and the assets securing a large proportion of our loans are located in Southern California, any regional or local economic downturn that affects Southern California, including the financial condition of our existing or prospective borrowers or property values in Southern California, may affect us and our profitability more significantly and more adversely than our competitors whose operations are less geographically focused.

We could incur losses on the loans we make and underwriting practices may not protect us against losses in our loan portfolio.

Loan defaults and the incurrence of losses on the loans we make are an inherent risk of the banking business. We seek to mitigate the risks inherent in our loan portfolio by adhering to specific underwriting practices, including: analyzing a borrower's credit history, financial statements, tax returns and cash flow projections; valuing collateral based on reports of independent appraisers; and verifying liquid assets. Although we believe that our underwriting criteria are, and historically have been, appropriate for the various kinds of loans we make, we have incurred losses on loans that have met these criteria, and may continue to experience higher than expected losses depending on economic factors and consumer behavior. In addition, our ability to assess the creditworthiness of our customers may be impaired if the models and approaches we use to select, manage, and underwrite our customers become less predictive of future behaviors.

Lending risks have historically been exacerbated by cyclical slowdowns in the real estate markets in Los Angeles, Orange, Riverside, San Bernardino and San Diego counties of California where most of our customers are based. During the economic recession that began in 2007, for example, these markets experienced declining real estate prices, excess inventories of unsold homes, high vacancy rates at commercial properties and increases in unemployment and a resulting loss of confidence about the future among businesses and consumers that had combined to adversely affect business and consumer spending. These conditions led to increases in our non-performing assets in prior periods, which required us to record loan charge-offs and write-downs in the carrying values of real properties that we acquired by or in lieu of foreclosure and caused us to incur losses in those periods. While economic conditions in our markets have improved, as measured by increased real estate prices, lower vacancy rates at commercial properties and continued improvement in unemployment, future weakness in economic conditions could result in loan charge-offs and asset write-downs that would require us to increase the provisions we make for loan losses and losses on real estate owned that could have a material adverse effect on our future operating results, financial condition and capital.

A portion of our loan portfolio is secured by real estate, and events that negatively impact the real estate market could adversely affect asset quality and profitability for our loans secured by real property.

Many of the loans in our portfolio are secured by real estate. For instance, the majority of our commercial real estate loans, which represented approximately 40.0% of our total loans outstanding as of December 31, 2018, are secured by first trust deeds on nonresidential real property. Payments on these loans depend to a large degree on the rental income stream from the properties and the global cash flows of the borrowers. A downturn in the economy, generally, or in the real estate market where the collateral for a real estate loan is located, specifically, could negatively affect the borrower's ability to repay the loan and the value of the collateral securing the loan, which, in turn, could have an adverse effect on our profitability and asset quality. In addition, unexpected decreases in commercial real estate prices coupled with slow economic growth and elevated levels of unemployment could drive losses beyond that provided for in our ALLL, which could adversely affect our operating results and financial condition.

We may be required to increase our ALLL which would adversely affect our financial performance in the future.

On a quarterly basis we evaluate and conduct an analysis to determine the probable and estimable losses inherent in our loan portfolio. This evaluation requires us to make a number of estimates and judgments regarding the financial condition and creditworthiness of a significant number of our borrowers, the sufficiency of the collateral securing our loans, including the fair value of the properties collateralizing our outstanding loans, which may depreciate over time, be difficult to appraise and fluctuate in value, and economic trends that could affect the ability of borrowers to meet their payment obligations to us. Based on those estimates and judgments, we make determinations, which are necessarily subjective, with respect to (i) the adequacy of our ALLL to provide for write-downs in the carrying values and charge-offs of loans that may be required in the future and (ii) the need to increase the ALLL by means of a charge to income (commonly referred to as the provision for loan and lease losses). If those estimates or judgments prove to have been incorrect due to circumstances outside our control, the ineffectiveness of our credit administration or for other reasons or the Bank's regulators come to a different conclusion regarding the adequacy of the Bank's ALLL, we could have to increase the provisions we make for loan losses, which could reduce our income or could cause us to incur operating losses in the future. Moreover, additions to the allowance may be necessary based on changes in economic and

real estate market conditions, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control. These additions may require increased provision expense, which could negatively impact our results of operations.

In June 2016, the Financial Accounting Standards Board issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU 2016-13 requires banking organizations to determine the adequacy of their ALLL with an expected loss model, which is referred to as the current expected credit loss (“CECL”) model. Under the CECL model, banking organizations will be required to present certain financial assets carried at amortized cost, such as loans held-for-investment and held-to-maturity debt securities, at the net amount expected to be collected. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the “incurred loss” model required under current GAAP, which delays recognition until it is probable a loss has been incurred. ASU 2016-13 is expected to be effective for public business entities for fiscal years after December 15, 2019. CECL will change the manner in which we determine the adequacy of our ALLL. We are evaluating the impact the CECL model will have on our accounting, but we may recognize a one-time cumulative-effect adjustment to the ALLL as of the beginning of the first reporting period in which the new standard is effective. We cannot yet determine the magnitude of any such one-time cumulative adjustment or of the overall impact of the new standard on our financial condition or results of operations. The federal banking regulators, including the Federal Reserve Board, have adopted a rule that gives a banking organization the option to phase in over a three-year period the day-one adverse effects of CECL on its regulatory capital.

Our underwriting practices may not protect us against losses in our loan portfolio.

We maintain a comprehensive credit policy that includes specific underwriting guidelines as well as standards for loan origination and reporting and portfolio management. Our underwriting guidelines outline specific standards and risk management criteria for each lending product offered. We seek to mitigate the risks inherent in our loan portfolio by adhering to these specific underwriting guidelines. Although we believe that our underwriting criteria are, and historically have been, appropriate for the various kinds of loans we make, we have incurred losses on loans that have met these criteria, and may continue to experience higher than expected losses depending on economic factors and consumer behavior. Our ability to assess the creditworthiness of our customers may be impaired if the models and approaches we use to select, manage, and underwrite our customers become less predictive of future behaviors. Further, we may have higher credit risk, or experience higher credit losses, to the extent our loans are concentrated by loan type, industry segment, borrower type, or location of the borrower or collateral.

Current loan concentrations or strategic and tactical changes in loan types, geographic locations and loan concentrations may expose us to increased risks.

From 2008 to present, in light of the industry-wide real estate loan losses prevalent in our markets, and in order to transition from a transaction based approach to a long-term relationship based approach, the bank strategically exited the residential mortgage business and purposely increased non-real estate lending activity such as commercial and industrial and asset-based lending. Since 2008, our real estate loans as a percentage of the overall portfolio have generally declined. At the same time, the commercial and industrial and asset-based loans as a percentage of the entire loan portfolio have generally increased. Relative to other banks in our market, we may at any given time have loan concentrations in real estate, commercial and industrial or asset-based, that are higher or lower than other banks with which we compete. Since commercial and industrial and asset-based business loans generally have shorter term durations and variable rates, we believe this positions us well in a rising interest rate environment, reduces real estate risk exposures and better positions us for future profits. However, this current strategy and any subsequent periodic changes in strategic or tactical direction that affects our loan portfolio mix, loan types, geographic locations and concentrations could also have the effect of increasing our overall risk exposure. To manage these risks, we continuously monitor our loan concentration risk exposures relative to expenses, anticipated returns, forecast and actual losses and competitive outlook, and this proactive risk management could result in us temporarily or permanently changing/updating our strategy, tactics, loan types, geographic locations and concentrations, including possible changes implemented without or prior to public disclosure.

Our focus on lending to small to mid-sized businesses and professional firms may increase our credit risk.

Most of our commercial business and commercial real estate loans are made to small or midsize businesses and professional firms. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities and have a heightened vulnerability to economic conditions. If general economic conditions in the markets in which we operate negatively impact this important customer sector, our results of operations and financial condition and the value of our common stock may be adversely affected. Moreover, a portion of these loans have been made by us in recent years following our transition to a commercial banking model and the borrowers may not have experienced a complete business or economic cycle. Furthermore,

the deterioration of our borrowers' businesses may hinder their ability to repay their loans with us, which could have a material adverse effect on our business, financial condition, results of operations, and cash flows.

Liquidity risk could adversely affect our ability to fund operations and hurt our financial condition.

Liquidity is essential to our business, as we use cash to fund loans, investments, other interest-earning assets, and deposit withdrawals that occur in the ordinary course of our business. Our principal sources of liquidity include deposits, FHLB borrowings, sales of loans or investment securities held for sale, repayments to the Bank of loans it makes to borrowers and sales of equity securities by us. If our ability to obtain funds from these sources becomes limited or the costs to us of those funds increases, whether due to factors that affect us specifically, including our financial performance or the imposition of regulatory restrictions on us, or due to factors that affect the financial services industry generally, including weakening economic conditions or negative views and expectations about the prospects for the financial services industry as a whole, then, our ability to grow our banking business would be adversely affected and our financial condition and results of operations could be harmed.

We have a significant deferred tax asset that may or may not be fully realized.

We have a significant deferred tax asset. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between the carrying amounts and the tax basis of assets and liabilities computed using enacted tax rates. We periodically assess available positive and negative evidence to determine whether it is more likely than not that our net deferred tax asset will be realized. Realization of a deferred tax asset requires us to apply significant judgment and is inherently speculative because it requires estimates that cannot be made with certainty. We have determined that it is more likely than not that we will be able to utilize our deferred tax asset to offset or reduce future taxes, and, as a result, we have released the previously established full valuation allowance on our deferred tax asset. This determination required us to incur a benefit to operations in the period in which we released or decreased the valuation allowance. If, in the future, we conclude that it is more-likely-than-not that all or a portion of our deferred tax asset would not be realized, we would be required to establish a valuation allowance against that portion of our deferred tax asset. If, in the future, we are able to conclude that it is more likely, than not, that we will not be able to utilize our deferred tax asset, any future determination that a valuation allowance is again necessary will require us to incur a charge to operations that could have, a material impact on our financial condition, results of operations and regulatory capital condition. In addition, certain of our deferred tax assets, including our tax credit carryforwards and net operating loss carryforwards, are subject to expiration if we are unable to utilize them during their respective terms. We cannot assure you that we will be able to fully realize our deferred tax asset.

Changes in tax laws and regulations could affect our future taxable income.

A change in tax laws or regulations, or their interpretation, could materially affect us if we generate taxable income in a future period. For example, on December 22, 2017, the United States enacted H.R.1., known as the Tax Cuts and Jobs Act (the "2017 Tax Act"). The legislation significantly changes U.S. tax law by, among other things, reducing the U.S. federal corporate tax rate from 35% to 21%, implementing a territorial tax system and imposing a repatriation tax on deemed repatriated earnings of foreign subsidiaries. As a result of the 2017 Tax Act, we recorded a decrease related to our deferred tax assets and liabilities of \$5.8 million with a corresponding adjustment to our valuation allowance as of December 31, 2017. We currently do not expect the 2017 Tax Act to have a material impact on our financial statements. However, we are still in the process of evaluating the new law and do not know the full effect it will have on our business, including our financial statements. The 2017 Tax Act is unclear in many respects and could be subject to potential amendments and technical corrections, as well as interpretations and implementing regulations by the U.S. Treasury Department and IRS, any of which could lessen or increase the impact of the 2017 Tax Act on our business and financial statements. In addition, it is unclear how these U.S. federal income tax changes will affect state and local taxation, which often uses federal taxable income as a starting point for computing state and local tax liabilities.

We face intense competition from other banks, financial institutions and non-banking institutions that could hurt our business.

We conduct our business operations in Southern California, where the banking business is highly competitive and is dominated by large multi-state and in-state banks with operations and offices covering wide geographic areas. We also compete with other financial service businesses, mutual fund companies, and securities brokerage and investment banking firms that offer competitive banking and financial products and services, including online and mobile banking services, as well as products and services that we do not offer. The larger banks and many of those other financial institutions have greater financial and other resources than we do, which enables them to conduct extensive advertising campaigns and to allocate resources to regions or activities of greater potential profitability. They also have substantially more capital and higher lending limits than we do, which enable them to attract larger customers and offer financial products and services that we are unable to offer, putting us at a disadvantage in competing with them for loans and deposits. Increased competition may prevent us from (i) achieving increases,

or could even result in decreases, in our loan volume or deposit balances, or (ii) increasing interest rates on the loans we make or reducing the interest rates we pay to attract or retain deposits, either or both of which could cause a decline in our interest income or an increase in our interest expense and, therefore, lead to reductions in our net interest income and earnings. In addition, technology and other changes are allowing parties to complete financial transactions, which historically have involved banks, through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries could result in the loss of fee income, as well as the loss of customer deposits, which could have a material impact on our financial condition and results of operations.

A higher risk of severe weather and natural disasters in Southern California could disproportionately harm our business.

Historically, California, in which a substantial portion of our business is located, has been susceptible to natural disasters such as earthquakes, floods, droughts and wild fires. The nature and level of natural disasters cannot be predicted and may be exacerbated by global climate change. In the event of a major natural disaster, many of our borrowers may suffer uninsured property damage, experience interruption of their businesses or lose their jobs, which may negatively impact the ability of these borrowers to make deposits with us or repay their loans or negatively impact the values of collateral securing our loans, any of which could result in losses and increased provisions for credit losses. Additionally, the occurrence of natural disasters could harm our operations through interference with communications, including the interruption or loss of our computer systems, which could prevent or impede us from gathering deposits, originating loans and processing and controlling our business flow, as well as through the destruction of facilities and our operational, financial and management information systems. Although we have established disaster recovery plans and procedures, and we monitor the effects of any such events on our loans, properties and investments, the occurrence of any such event could have a material adverse effect on us or our financial condition and results of operations.

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

A substantial portion of our income is derived from the differential or “spread” between the interest we earn on loans, securities and other interest-earning assets, and the interest we pay on deposits, borrowings and other interest-bearing liabilities. Due to the differences in the maturities and repricing characteristics of our interest-earning assets and interest-bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. Accordingly, fluctuations in interest rates could adversely affect our interest rate spread and, in turn, our profitability. In addition, as a general rule, loan origination volumes are affected by market interest rates. Rising interest rates, generally, are associated with a lower volume of loan originations while lower interest rates are usually associated with higher loan originations. Conversely, in rising interest rate environments, loan repayment rates may decline and in falling interest rate environments, loan repayment rates may increase. Also, in a rising interest rate environment, we may accelerate the pace of rate increases on our deposit accounts as compared to the pace of increases in short-term market rates. Accordingly, changes in market interest rates could materially and adversely affect our net interest spread, asset quality and loan origination volume.

We have adopted an interest rate risk management strategy for the purpose of protecting us against interest rate changes. Developing an effective interest rate risk management strategy, however, is complex, and no risk management strategy can completely insulate us from risks associated with interest rate changes.

Government regulations may impair our operations, restrict our growth or increase our operating costs.

We are subject to extensive supervision, examination, and regulation by federal and state bank regulatory agencies, including the FRB and the FRBSF, and the CDBO. The primary objective of these agencies is to protect bank depositors and other customers and consumers, and not shareholders, whose respective interests often differ. Congress and these federal and state regulators continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations, or regulatory policies, including changes in interpretation or implementation of statutes, regulations, or policies, could affect the Company in substantial and unpredictable ways. If, as a result of an examination, the CDBO or the Federal Reserve should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of the Bank’s operations are unsatisfactory or that the Bank or its management is violating or has violated any law or regulation, the CDBO and the Federal Reserve, and separately the FDIC as insurer of the Bank’s deposits, have residual authority to, among other things, require affirmative action to correct any conditions resulting from any violation or practice and to impose restrictions that they believe are needed to protect depositors and customers of banking organizations. In addition, due to the complex and technical nature of many of the government regulations to which banking organizations are subject, inadvertent violations of those regulations may and sometimes do occur. In such an event, we would be required to correct or implement measures to prevent a recurrence of such violations. If more serious violations were to occur, the regulatory agencies could limit our activities or growth, impose fines on us, or ultimately require us to cease operations in the event we were to encounter severe liquidity problems or a

significant erosion of our capital below the minimum amounts required under applicable bank regulatory guidelines or if we engage in unsafe or unsound practices that could lead to termination of our deposit insurance or banking charter.

The Dodd-Frank Act poses uncertainties for our business and has increased, and is likely to continue to increase, our costs of doing business.

The 2010 Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States, established the Consumer Financial Protection Bureau (the “CFPB”) and requires the CFPB and other federal agencies to implement many new and significant rules and regulations. Certain provisions of the Dodd-Frank Act were made effective immediately. However, much of the Dodd-Frank Act is subject to further rulemaking and/or studies and the Trump Administration may ultimately roll back or modify certain of the regulations adopted under the Dodd-Frank Act. As a result, the enactment of the Dodd-Frank Act poses uncertainties for our business and has increased, and is likely to continue to increase, our costs of doing business. However, due to uncertainties concerning the timing and extent of future rulemaking, it is difficult to assess the extent to which the Dodd-Frank Act, or the resulting rules and regulations, will further impact our business and financial performance. Compliance with these new laws and regulations will result in additional costs, which could be significant, and may have a material and adverse effect on our results of operations. In addition, the Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level. We cannot predict whether California state agencies will adopt consumer protection laws and standards that are more stringent than those adopted at the federal level or, if any are adopted, what impact they may have on us, our business or our results of operations.

We face a risk of noncompliance and enforcement action with the Bank Secrecy Act, other anti- money laundering and anti- bribery statutes and regulations, and U.S. economic and trade sanctions.

The Bank Secrecy Act, the USA PATRIOT Act of 2001, and other laws and regulations require financial institutions to, among other things, institute and maintain an effective anti- money laundering program and file suspicious activity and currency transaction reports as appropriate. The federal Financial Crimes Enforcement Network is authorized to impose significant civil monetary penalties for violations of those requirements and has engaged in coordinated enforcement efforts with state and federal banking regulators, as well as the U.S. Department of Justice, Drug Enforcement Administration, and Internal Revenue Service. We also must comply with U.S. economic and trade sanctions administered by the U.S. Treasury Department’s Office of Foreign Assets Control and the Foreign Corrupt Practices Act, and we, like other financial institutions, are subject to increased scrutiny for compliance with these requirements. We maintain policies, procedures and systems designed to detect and deter prohibited financing activities. If these controls were deemed deficient, we could be subject to liability, including civil fines and regulatory actions, which may include restrictions on our ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our business plan. In addition, any failure to effectively maintain and implement adequate programs to combat money laundering and terrorist financing could have serious reputational consequences for us. Any of these results could materially and adversely affect our business, financial condition or results of operations.

Potential changes in U.S. accounting standards may adversely affect our financial statements.

We prepare our financial statements in accordance with generally accepted accounting principles in the United States (“GAAP”). From time to time we are required to adopt new or revised accounting standards issued by recognized authoritative bodies, including the Financial Accounting Standards Board. It is possible that future accounting standards that we are required to adopt could change the current accounting treatment that we apply to our consolidated financial statements and that such changes could have a materially adverse effect on our results of operations and financial condition. For example, as described above, we are evaluating the impact the new CECL model will have on our accounting, but our implementation of CECL could cause us to recognize a one-time cumulative-effect adjustment to the ALLL as of the beginning of the first reporting period in which the new standard is effective. For information regarding new accounting pronouncements and the expected impact, if any, on our financial position or results of operations, see Note 2 to the Notes to the consolidated financial statements in this Report.

Premiums for federal deposit insurance may increase in the future.

The Dodd-Frank Act broadens the base for FDIC insurance assessments. The FDIC insures deposits at FDIC-insured financial institutions, including the Bank. The FDIC charges insured financial institutions premiums to maintain the DIF at a specific level. In addition, the Dodd-Frank Act increased the minimum target DIF ratio from 1.15% of estimated insured deposits to 1.35% of estimated insured deposits and the FDIC must seek to achieve the 1.35% ratio by September 30, 2020. The FDIC has issued regulations to implement these provisions of the Dodd-Frank Act, and although it recently reduced deposit insurance premiums for the overwhelming majority of banks whose assets are less than \$10 billion, it has, in addition, established a higher reserve ratio of 2% as a long-term goal beyond what is required by statute, although there is no implementation deadline for the 2% ratio. The FDIC may increase the assessment rates or impose additional special assessments in the future to keep the DIF at the statutory target level. The Bank's FDIC insurance premiums increased substantially beginning in 2009, and have returned to more normal levels with the improved condition of the Bank. Any increase in our FDIC premiums could have a material adverse effect on the Bank's financial condition and results of operations.

The loss of key personnel could hurt our financial performance.

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the communities that we serve. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a great extent on the continued availability of our existing management and, in particular, on Thomas M. Vertin our President and Chief Executive Officer, Curt A. Christianssen our Chief Financial Officer, Thomas J. Inserra our Chief Risk Officer, and Robert Anderson our Chief Banking Officer. In addition to their skills and experience as bankers, our executive officers have extensive community ties upon which our competitive strategy is partially based. As a result, the loss of the services of any of these officers could harm our ability to implement our business strategy or our future operating results.

We rely on communications, information, operating and financial control systems technology from third-party service providers, and we may suffer an interruption in those systems.

We rely heavily on third-party service providers for much of our communications, information, operating, and financial control systems technology, including our online banking services and data processing systems. Any failure or interruption, or breaches in security, of these systems could result in failures or interruptions in our customer relationship management, general ledger, deposit, servicing and/or loan origination systems and, therefore, could harm our business, operating results and financial condition. Additionally, interruptions in service and security breaches could lead existing customers to terminate their banking relationships with us and could make it more difficult for us to attract new banking customers.

A breach in the security of our systems could disrupt our business, result in the disclosure of confidential information, damage our reputation and create significant financial and legal exposure to us.

We rely heavily on communications and information systems to conduct our business. Although we devote significant resources to maintain and regularly upgrade our systems and processes that are designed to protect the security of our computer systems, software, networks and other technology assets and the confidentiality, integrity and availability of information belonging to us and our customers, there is no assurance that all of our security measures will provide absolute security. Information security risks for financial institutions have generally increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, foreign governments, terrorists or other external parties. Those parties may also attempt to fraudulently induce employees, customers or other users of our systems to disclose sensitive information in order to gain access to our data or that of our customers. For example, other financial services institutions and companies engaged in data processing have reported breaches in the security of their websites or other systems, some of which have involved sophisticated and targeted attacks intended to obtain unauthorized access to confidential information, destroy data, disrupt or degrade service, sabotage systems or cause other damage, often through the introduction of computer viruses, malware, worms, cyberattacks, phishing attacks, and other means.

Despite our efforts to ensure the integrity of our systems, it is possible that we may not be able to anticipate or to implement effective preventive measures against all security breaches of these types, especially because the techniques used change frequently or are not recognized until launched. These risks may increase in the future as we continue to increase our internet-based product offerings and expand our internal usage of web-based products and applications. A successful penetration or circumvention of the security of our systems could cause serious negative consequences for us, including significant disruption of our operations, misappropriation of our confidential information or that of our customers, or damage to our computers or systems and those of our customers and counterparties, and could result in violations of applicable privacy and other laws, financial loss to us or our

customers, loss of confidence in our security measures, customer dissatisfaction, significant litigation exposure, and harm to our reputation, all of which could have a material adverse effect on us.

We are exposed to risk of environmental liabilities with respect to real properties which we may acquire.

If borrowers are unable to meet their loan repayment obligations, we will initiate foreclosure proceedings with respect to, and may take actions to acquire title to the personal and real property that collateralized their loans. As an owner of such properties, we could become subject to environmental liabilities and incur substantial costs for any property damage, personal injury, investigation and clean-up that may be required due to any environmental contamination that may be found to exist at any of those properties, even though we did not engage in the activities that led to such contamination. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties seeking damages for environmental contamination emanating from the site. If we were to become subject to significant environmental liabilities or costs, our business, financial condition, results of operations and prospects could be adversely affected.

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

Threats to our reputation can come from many sources, including adverse sentiment about financial institutions generally, unethical practices, employee misconduct, failure to deliver minimum standards of service or quality, compliance deficiencies and questionable or fraudulent activities of our customers. We have policies and procedures in place to promote ethical conduct and protect our reputation. However, these policies and procedures may not be fully effective. Negative publicity regarding our business, employees, or customers, with or without merit, may result in the loss of customers, investors and employees, costly litigation, a decline in revenues and increased governmental regulation.

We may be adversely affected by changes in the actual or perceived soundness or condition of other financial institutions.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial and financial soundness of other financial institutions. Financial institutions are closely related as a result of trading, investment, liquidity management, clearing, counterparty and other relationships. Loss of public confidence in any one institution, including through default, could lead to liquidity and credit problems, losses, or defaults for other institutions. Even the perceived lack of creditworthiness of, or questions about, a counterparty may lead to market-wide liquidity and credit problems, losses, or defaults by various institutions. This systemic risk may adversely affect financial intermediaries, such as clearing agencies, banks and exchanges we interact with on a daily basis or key funding providers, any of which could have a material adverse effect on our access to liquidity or otherwise have a material adverse effect on our business, financial condition, or results of operations.

The price of our common stock may be volatile or may decline, which may make it more difficult to realize a profit on your investment in our shares of common stock.

The trading prices of our common stock may fluctuate widely as a result of a number of factors, many of which are outside our control. Our stock price in the future could be adversely affected by other factors including:

- quarterly fluctuations in our operating results or financial condition;
- failure to meet analysts' revenue or earnings estimates;
- the restrictions on our ability to pay cash dividends on our common stock as described below;
- the imposition of additional regulatory restrictions on our business and operations or an inability to meet regulatory requirements;
- an inability to successfully implement our growth strategy;
- strategic actions by us or our competitors, such as acquisitions or restructurings;
- fluctuations in the stock prices and operating results of our competitors;
- general market conditions and, in particular, developments related to market conditions for financial services industry stocks;
- proposed or newly adopted legislative or regulatory changes or developments aimed at the financial services industry; and
- any future proceedings or litigation that may involve or affect us.

As a bank holding company that conducts substantially all of our operations through our subsidiaries, primarily the Bank, our ability to pay dividends, repurchase shares of our common stock or to repay our indebtedness depends upon liquid assets held by the holding company and the results of operations of our subsidiaries.

We are a separate and distinct legal entity from our subsidiaries and we receive substantially all of our revenue from dividends paid to us by the Bank. There are legal limitations on the Bank's ability to extend credit, pay dividends or otherwise supply funds to, or engage in transactions with, us. We have agreed that the Bank will not, without the FRB and the CDBO's prior written approval, pay any dividends to us. Our inability to receive dividends from the Bank could adversely affect our business, financial condition, results of operations and prospects.

Various statutory provisions restrict the amount of dividends the Bank can pay to us without regulatory approval. The Bank may not pay cash dividends if that payment could reduce the amount of its capital below that amount which is necessary to meet the "adequately capitalized" standard under regulatory capital requirements. It is also possible that, depending upon the financial condition of the Bank and other factors, regulatory authorities could conclude that payment of dividends or other payments, including payments to us, is an unsafe or unsound practice, and as a result, and could impose restrictions on or prohibit such payments. The FRB has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the FRB's view that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company's capital needs, asset quality and overall financial condition. We have committed to obtaining approval from the FRB and the CDBO prior to paying any dividends, or making any distributions representing interest, principal or other sums on subordinated debentures or trust preferred securities. There can be no assurance that our regulators will approve such payments or dividends in the future.

If we sell additional shares of our common stock in the future, our shareholders could suffer dilution in their share ownership and voting power.

Subject to market conditions and other factors, we may determine from time to time to issue additional shares of our common stock or pursue other equity financings to meet capital requirements or support the growth of our business. Further issuance of any shares of our common stock and/or preferred stock would dilute the ownership interests of any holders of our common stock at the time of such issuance. In addition, we have issued, and may continue to issue, stock options, warrants, or other stock grants under our equity incentive plan. It is probable that such options will be exercised during their respective terms if the stock price exceeds the exercise price of the particular option, in which case existing shareholders' share ownership and voting power will be diluted.

Certain banking laws and provisions of our articles of incorporation could discourage a third party from making a takeover offer that may be beneficial to our shareholders.

Provisions of federal banking laws, including regulatory approval requirements, could make it difficult for a third party to acquire us, even if doing so would be perceived to be beneficial to our shareholders. The acquisition of 10% or more of any class of voting stock of a bank holding company or depository institution, including shares of our common stock, generally creates a rebuttable presumption that the acquirer "controls" the bank holding company or depository institution. Also, a bank holding company must obtain the prior approval of the FRB before, among other things, acquiring direct or indirect ownership or control of more than 5% of the voting shares of any bank, including us.

Additionally, our Board of Directors has the power, under our articles of incorporation, to create and authorize the sale of one or more new series of preferred stock without having to obtain shareholder approval for such action. As a result, the Board could authorize the issuance of and issue shares of a new series of preferred stock to implement a shareholders rights plan (often referred to as a "poison pill") or could sell and issue preferred shares with special voting rights or conversion rights that could deter or delay attempts by our shareholders to remove or replace management, and attempts of third parties to engage in proxy contests and effectuate a change in control of us.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We lease office space in various locations throughout Southern California, including Costa Mesa, Newport Beach, Irvine, Century City, San Diego, La Habra and Ontario. We believe our leased facilities are adequate for us to conduct our business.

ITEM 3. LEGAL PROCEEDINGS

We are subject to legal actions that arise from time to time in the ordinary course of our business. Currently, neither we nor any of our subsidiaries is a party to, and none of our or our subsidiaries' property is the subject of, any material legal proceeding.

ITEM 4. MINE SAFETY DISCLOSURES

Table of Contents

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

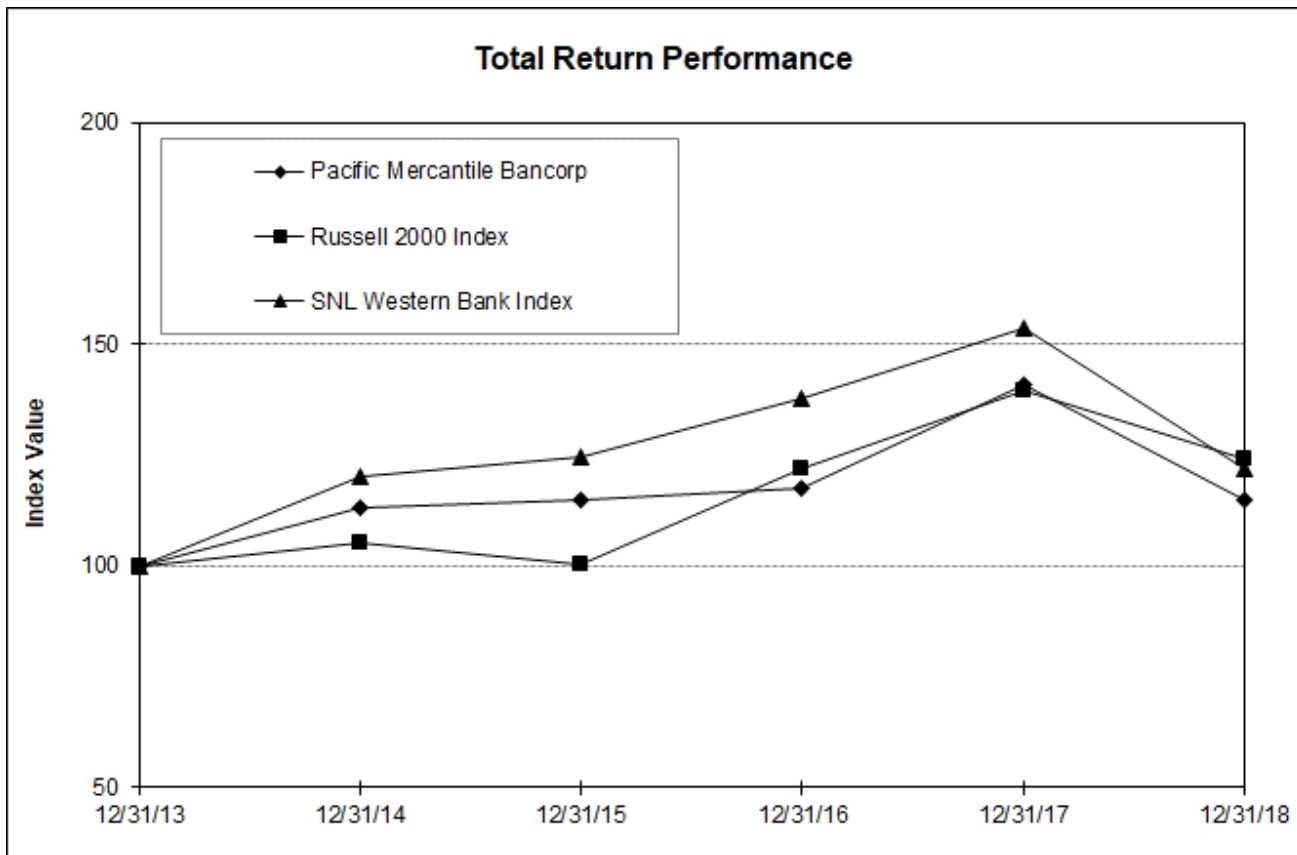
Trading Market for the Company’s Shares

Our common stock is traded on the Nasdaq Global Select Market under the symbol “PMBC.” As of March 7, 2019, there were approximately 60 holders of record of our common stock.

Stock Performance Graph

The following graph compares the percentage change in our cumulative total shareholder return on our common stock, in each of the years in the five year period ended December 31, 2018, with the cumulative total return of: (i) the Russell 2000 Index, which measures the performance of the smallest 2,000 members, by market capitalization, of the Russell 3,000 Index, and (ii) an index published by SNL Securities L.C. (“SNL”) and known as the SNL Western Bank Index, which is comprised of 51 banks and bank holding companies (including the Company), the shares of which are listed on Nasdaq or the New York Stock Exchange and most of which are based in California and the remainder of which are based in nine other western states.

The stock performance graph assumes that \$100 was invested at the close of market on the last trading day for the year ended December 31, 2013 in Company common stock and in the Russell 2000 Index and the SNL Western Bank Index and that any dividends paid in the indicated periods were reinvested. Shareholder returns shown in the stock performance graph are not necessarily indicative of future stock price performance.



(1) The source of the above graph and chart is SNL.

Index	Period Ending					
	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18
Pacific Mercantile Bancorp	100.00	113.18	114.63	117.36	140.68	114.95
Russell 2000 Index	100.00	104.89	100.26	121.63	139.44	124.09
SNL Western Bank Index	100.00	120.01	124.35	137.85	153.70	121.69

Table of Contents

The above performance graph shall not be deemed “filed” for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities under that section and shall not be deemed to be incorporated by reference into any of our filings under the Securities Act or the Exchange Act.

Dividend Policy and Restrictions on the Payment of Dividends

We have not declared or paid any cash dividends on our common stock since 2008.

Cash dividends from the Bank represent the principal source of funds available to Bancorp to pay cash dividends to shareholders. Therefore, government regulations, including the laws of the State of California, as they pertain to the payment of cash dividends by California state chartered banks, limit the amount of funds that the Bank would be permitted to dividend to Bancorp. As a result, those laws also affect our ability to pay cash dividends to our shareholders. In particular, under California law, cash dividends by a California state chartered bank may not exceed, in any calendar year, the lesser of (i) the sum of its net income for the year and its retained net income from the preceding two years (after deducting all dividends paid during the period), or (ii) the amount of its retained earnings. We have agreed that the Bank will not, without the FRB and CDBO's prior written approval, pay any dividends to Bancorp.

Additionally, because the payment of cash dividends has the effect of reducing capital, the capital requirements imposed on bank holding companies and commercial banks often operate, as a practical matter, to preclude the payment, or limit the amount of, cash dividends that might otherwise be permitted by California law; and the federal bank regulatory agencies, as part of their supervisory powers, generally require insured banks to adopt dividend policies which limit the payment of cash dividends much more strictly than do applicable state laws. Refer to “Supervision and Regulation” above in Item 1 and *Note 14, Shareholders' Equity* in the notes to our consolidated financial statements for more detail regarding the regulatory restrictions on our and the Bank's ability to pay dividends. We have committed to obtaining approval from the FRB and the CDBO prior to Bancorp paying any dividends, or making any distributions representing interest, principal or other sums on subordinated debentures or trust preferred securities. There can be no assurance that our regulators will approve such payments or dividends in the future.

Even if legal or regulatory restrictions do not prevent us from paying dividends to our shareholders, our Board of Directors follows a policy of retaining earnings to maintain capital, enhance the Bank's liquidity and support the growth of our banking franchise. Accordingly, we do not expect to pay cash dividends for the foreseeable future.

Restrictions on Inter-Company Transactions

Section 23(a) of the Federal Reserve Act limits the amounts that a bank may loan to its bank holding company to an aggregate of no more than 10% of the bank subsidiary's capital surplus and retained earnings and requires that such loans be secured by specified assets of the bank holding company—See “BUSINESS—Supervision and Regulation—*Restrictions on Transactions between the Bank and the Company and its other Affiliates*” in Item 1 of this Report. We do not have any present intention to obtain any borrowings from the Bank.

[Table of Contents](#)

ITEM 6. SELECTED FINANCIAL DATA

The selected statement of operations data for the fiscal years ended December 31, 2018, 2017 and 2016, the selected balance sheet data as of December 31, 2018 and 2017, and the selected financial ratios (other than book value per share), that follow below were derived from our audited consolidated financial statements included in Item 8 of this Report and should be read in conjunction with those audited consolidated financial statements, together with the notes thereto, and with “MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS ” set forth in Item 7 of this Report. The selected statement of operations data for the years ended December 31, 2015 and 2014, the selected balance sheet data as of December 31, 2016, 2015 and 2014, and the selected financial ratios (other than book value per share) for the periods prior to January 1, 2016 are derived from audited consolidated financial statements that are not included in this Report.

	Year Ended December 31,				
	2018	2017	2016	2015	2014
(Dollars in thousands except per share data)					
Selected Statement of Operations Data:					
Total interest income	\$ 62,542	\$ 51,573	\$ 41,000	\$ 38,797	\$ 38,290
Total interest expense	13,620	7,831	5,477	5,269	5,829
Net interest income	48,922	43,742	35,523	33,528	32,461
Provision for loan and lease losses	—	—	19,870	—	1,500
Net interest income after provision for loan and lease losses	48,922	43,742	15,653	33,528	30,961
Total noninterest income	4,635	4,374	2,937	2,686	4,370
Total noninterest expense	36,970	37,758	36,401	35,324	36,808
Income before income taxes	16,587	10,358	(17,811)	890	(1,477)
Income tax (benefit) provision	(10,752)	(91)	16,832	(11,551)	(608)
Net income (loss) from continuing operations	27,339	10,449	(34,643)	12,441	(869)
Net income from discontinued operations	—	—	—	—	1,226
Accumulated declared dividends on preferred stock	—	—	—	—	(547)
Accumulated undeclared dividends on preferred stock	—	—	—	—	(616)
Dividends on preferred stock	—	—	—	(927)	—
Inducements for exchange of the preferred stock	—	—	—	(512)	—
Net income (loss) allocable to common shareholders	\$ 27,339	\$ 10,449	\$ (34,643)	\$ 11,002	\$ (806)
Per share data-basic:					
Net income (loss) from continuing operations	\$ 1.17	\$ 0.45	\$ (1.51)	\$ 0.54	\$ (0.11)
Net income (loss) allocable to common shareholders	\$ 1.17	\$ 0.45	\$ (1.51)	\$ 0.54	\$ (0.04)
Per share data-diluted:					
Net income (loss) from continuing operations	\$ 1.16	\$ 0.45	\$ (1.51)	\$ 0.53	\$ (0.11)
Net income (loss) allocable to common shareholders	\$ 1.16	\$ 0.45	\$ (1.51)	\$ 0.53	\$ (0.04)
Weighted average shares outstanding					
Basic	22,788,164	23,071,671	22,802,439	20,516,575	19,230,913
Diluted	23,527,183	23,312,292	22,958,644	20,675,279	19,230,913
Dividends per common share	—	—	—	—	—
Dividends per Series A non-voting preferred share	—	—	—	—	—

	December 31,				
	2018	2017	2016	2015	2014
(Dollars in thousands except for per share information)					
Selected Balance Sheet Data:					
Cash and cash equivalents ⁽¹⁾	\$ 187,718	\$ 198,208	\$ 138,845	\$ 113,921	\$ 177,135
Total loans, net	1,083,240	1,053,201	931,525	849,733	824,197
Total assets	1,349,338	1,322,604	1,140,689	1,062,389	1,099,610
Total deposits	1,136,002	1,139,393	1,001,300	893,840	916,309
Junior subordinated debentures	17,527	17,527	17,527	17,527	17,527
Total shareholders’ equity	141,374	112,876	99,719	133,916	119,281
Book value per share	\$ 6.06	\$ 4.86	\$ 4.33	\$ 5.87	\$ 5.53

(1) Cash and cash equivalents include cash and due from banks and federal funds sold.

[Table of Contents](#)

	For the Year Ended December 31,				
	2018	2017	2016	2015	2014
	(unaudited)				
Selected Financial Ratios:					
Return on average assets	2.04%	0.88%	(3.13)%	1.17%	(0.08)%
Return on average equity	21.40%	9.78%	(27.56)%	10.23%	(0.74)%
Ratio of average equity to average assets	9.54%	9.03%	11.35 %	11.48%	11.30 %

Table of Contents

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The following discussion presents information about our consolidated results of operations, financial condition, liquidity and capital resources and should be read in conjunction with our consolidated financial statements and the notes thereto included in Item 8 of this Report.

Our principal operating subsidiary is Pacific Mercantile Bank (the "Bank"), which is a California state chartered bank. The Bank accounts for substantially all of our consolidated revenues, expenses and income and our consolidated assets and liabilities. Accordingly, the following discussion focuses primarily on the Bank's results of operations and financial condition.

As of December 31, 2018, our total assets, net loans and total deposits were \$1.3 billion, \$1.1 billion and \$1.1 billion, respectively.

The Bank, which is headquartered in Orange County, California, approximately 40 miles south of Los Angeles, conducts a commercial banking business in Orange, Los Angeles, San Bernardino and San Diego counties in Southern California. The Bank is also a member of the Federal Reserve System and its deposits are insured, to the maximum extent permitted by law, by the Federal Deposit Insurance Corporation (the "FDIC"). For the years ended December 31, 2018, 2017 and 2016, we operated as one reportable segment, Commercial Banking.

Unless the context otherwise requires, the "Company," "we," "our," "ours," and "us" refer to Pacific Mercantile Bancorp and its consolidated subsidiaries.

Results of Operations

Operating Results for the Years Ended December 31, 2018, 2017, and 2016

Our operating results for the year ended December 31, 2018, compared to December 31, 2017, and for the year ended December 31, 2017, compared to December 31, 2016, were as follows:

	Year Ended December 31,			2018 vs. 2017 % Change	2017 vs. 2016 % Change
	2018	2017	2016		
	(Dollars in thousands)				
Interest income	\$ 62,542	\$ 51,573	\$ 41,000	21.3 %	25.8 %
Interest expense	13,620	7,831	5,477	73.9 %	43.0 %
Provision for loan and lease losses	—	—	19,870	— %	(100.0)%
Non-interest income	4,635	4,374	2,937	6.0 %	48.9 %
Non-interest expense	36,970	37,758	36,401	(2.1)%	3.7 %
Income tax provision (benefit)	(10,752)	(91)	16,832	11,715.4 %	(100.5)%
Net (loss) income allocable to common shareholders	\$ 27,339	\$ 10,449	\$ (34,643)	161.6 %	(130.2)%

Interest Income

2018 vs. 2017.

Total interest income increased 21.3% to \$62.5 million for the year ended December 31, 2018 from \$51.6 million for the year ended December 31, 2017. This increase is primarily due to an increase in interest income on loans during the year ended December 31, 2018 compared to the prior year due to an increase in average loan balances, as well as an increase in the average yield on loans. During the year ended December 31, 2018 and 2017, interest income on loans was \$57.6 million and \$49.0 million, respectively, yielding 5.38% and 4.91% on average loan balances of \$1.1 billion and \$996.7 million, respectively. The increase in the average loan balances is attributable to an increase in loan demand. The increase in the average yield on loans was primarily the result of the rising interest rate environment and the recovery of \$1.6 million in interest income on two loans that had been on nonaccrual status but were paid in full during the year ended December 31, 2018 as compared to \$1.1 million recovered on one loan relationship during the year ended December 31, 2017. The average yield on interest-earning assets was 4.78% for the year ended December 31, 2018 compared to 4.41% for the year ended December 31, 2017.

Table of Contents

During the years ended December 31, 2018 and 2017, interest income from our securities available-for-sale and stock, was \$1.2 million and \$1.2 million, yielding 2.92% and 2.49% on average balances of \$39.7 million and \$49.7 million, respectively. The average securities balances decreased as a result of sales and maturities of, and payments on, securities throughout the year ended December 31, 2018, which was partially offset by purchases during the second half of the year. The increase in the average yield is attributable to the rising interest rate environment and the result of a Federal Home Loan Bank (“FHLB”) special dividend of \$83 thousand received during December 2018. Interest income from our short-term investments, including our federal funds sold and interest-bearing deposits, was \$3.8 million and \$1.4 million for the year ended December 31, 2018 and 2017, respectively, yielding 1.92% and 1.11% on average balances of \$195.7 million and \$123.8 million, respectively. The increase in the average yield is a result of the rising interest rate environment. As a result, total interest income on investments increased for the year ended December 31, 2018.

2017 vs. 2016.

Total interest income increased 25.8% to \$51.6 million for the year ended December 31, 2017 from \$41.0 million for the year ended December 31, 2016. This increase is primarily due to an increase in interest income on loans during the year ended December 31, 2017 compared to the prior year due to an increase in average loan balances, as well as an increase in the average yield on loans and the recovery of \$1.1 million in interest income on a single loan relationship that had been on nonaccrual status but was paid in full during the third quarter of 2017. During the years ended December 31, 2017 and 2016, interest income on loans was \$49.0 million and \$38.6 million, respectively, yielding 4.91% and 4.50% on average loan balances of \$996.7 million and \$857.7 million, respectively. The increase in the average loan balances is attributable to an increase in loan demand. The increase in loan yield is primarily attributable to the actions of the Board of Governors of the Federal Reserve System (“Federal Reserve Board”) to raise short-term interest rates by 100 basis points since the fourth quarter of 2016. The average yield on interest-earning assets was 4.41% for the year ended December 31, 2017 compared to 3.81% for the year ended December 31, 2016.

During the years ended December 31, 2017 and 2016, interest income from our securities available-for-sale and stock, was \$1.2 million and \$1.6 million, respectively, yielding 2.49% and 2.76% on average balances of \$49.7 million and \$57.1 million, respectively. The average securities balances decreased as a result of maturities of, and payments on, securities which we did not fully replace due to liquidity needs. Interest income from our short-term investments, including our federal funds sold and interest-bearing deposits, was \$1.4 million and \$842 thousand for the years ended December 31, 2017 and 2016, respectively, yielding 1.11% and 0.52% on average balances of \$123.8 million and \$162.6 million, respectively. The increase in the average yield is attributable to the Federal Reserve Board raising interest rates by 100 basis points since the fourth quarter of 2016. As a result, total interest income on investments increased for the year ended December 31, 2017.

Interest Expense

2018 vs. 2017.

Total interest expense increased 73.9% to \$13.6 million for the year ended December 31, 2018 from \$7.8 million for the year ended December 31, 2017. The increase was primarily due to an increase in the volume of and average cost of funds of our interest-bearing liabilities to 1.60% at December 31, 2018 from 1.05% at December 31, 2017, which consisted of deposits, borrowings and junior subordinated debentures, which was primarily the result of new client acquisition, our decision to increase the rate of interest paid on our certificates of deposit resulting from the rising interest rate environment, and an increase in our FHLB borrowings. Interest expense on our certificates of deposit for the years ended December 31, 2018 and 2017 was \$5.3 million and \$3.8 million, respectively, with a cost of funds of 1.70% and 1.26% on average balances of \$315.2 million and \$298.5 million, respectively.

2017 vs. 2016.

Total interest expense increased 43.0% to \$7.8 million for the year ended December 31, 2017 from \$5.5 million for the year ended December 31, 2016. The increase was primarily due to an increase in the volume of and average cost of funds of our interest-bearing liabilities to 1.05% at December 31, 2017 from 0.81% at December 31, 2016, which consisted of deposits, borrowings and junior subordinated debentures, which was primarily the result of new client acquisition, our decision to increase the rate of interest paid on our certificates of deposit resulting from the rising interest rate environment, and an increase in our FHLB borrowings. Interest expense on our certificates of deposit for the years ended December 31, 2017 and 2016 was \$3.8 million and \$2.6 million, respectively, with a cost of funds of 1.26% and 0.99%, on average balances of \$298.5 million and \$263.6 million, respectively.

Net Interest Margin

One of the principal determinants of a bank’s income is its net interest income, which is the difference between (i) the interest that a bank earns on loans, investment securities and other interest earning assets, on the one hand, and (ii) its interest expense, which consists primarily of the interest it must pay to attract and retain deposits and the interest that it pays on borrowings and other interest-bearing liabilities, on the other hand. As a general rule, all other things being equal, the greater the difference

Table of Contents

or “spread” between the amount of our interest income and the amount of our interest expense, the greater will be our net income; whereas, a decline in that difference or “spread” will generally result in a decline in our net income.

A bank’s interest income and interest expense are affected by a number of factors, some of which are outside of its control, including national and local economic conditions and the monetary policies of the Federal Reserve Board which affect interest rates, competition in the market place for loans and deposits, the demand for loans and the ability of borrowers to meet their loan payment obligations. Net interest income, when expressed as a percentage of total average interest earning assets, is a banking organization’s “net interest margin.”

As a result of the Federal Reserve Board raising interest rates by 175 basis points since 2016, we experienced expansion in our net interest margin. The favorable impact of higher prevailing interest rates on our asset-sensitive balance sheet was evidenced in the year ended December 31, 2018 as compared to the year ended December 31, 2016. While we are unable to ascertain whether the Federal Reserve Board will continue to increase short-term interest rates in the future, we expect the favorable impact on our net interest margin to remain in the event that interest rates continue to rise. However, we believe that the competition for deposits is increasing and could lead to increases in the cost of interest-bearing deposit liabilities that may partially offset the contractual increase in the yield on earning assets.

The following tables set forth information regarding our average balance sheet, yields on interest earning assets, interest expense on interest-bearing liabilities, the interest rate spread and the interest rate margin for the years ended December 31, 2018, 2017 and 2016. Average balances are calculated based on average daily balances.

	Year Ended December 31,								
	2018			2017			2016		
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
(Dollars in thousands)									
Interest earning assets									
Short-term investments ⁽¹⁾	\$ 195,736	\$ 3,756	1.92%	\$ 123,761	\$ 1,379	1.11%	\$ 162,585	\$ 842	0.52%
Securities available for sale and stock ⁽²⁾	39,744	1,160	2.92%	49,745	1,237	2.49%	57,135	1,578	2.76%
Loans ⁽³⁾	1,071,874	57,626	5.38%	996,696	48,957	4.91%	857,666	38,580	4.50%
Total interest-earning assets	1,307,354	62,542	4.78%	1,170,202	51,573	4.41%	1,077,386	41,000	3.81%
Noninterest-earning assets									
Cash and due from banks	16,785			14,482			15,533		
All other assets ⁽³⁾	14,577			(1,116)			14,550		
Total assets	<u>\$ 1,338,716</u>			<u>\$1,183,568</u>			<u>\$ 1,107,469</u>		
Interest-bearing liabilities:									
Interest-bearing checking accounts	\$ 69,841	\$ 363	0.52%	\$ 87,771	\$ 347	0.40%	\$ 60,024	162	0.27%
Money market and savings accounts	412,366	6,358	1.54%	334,703	2,859	0.85%	327,401	2,048	0.63%
Certificates of deposit	315,189	5,349	1.70%	298,531	3,752	1.26%	263,569	2,610	0.99%
Other borrowings	36,209	705	1.95%	4,538	203	4.47%	7,407	75	1.01%
Junior subordinated debentures	17,527	845	4.82%	17,527	670	3.82%	17,527	582	3.32%
Total interest bearing liabilities	851,132	13,620	1.60%	743,070	7,831	1.05%	675,928	5,477	0.81%
Noninterest-bearing liabilities									
Demand deposits	348,923			326,105			299,447		
Accrued expenses and other liabilities	10,931			7,566			6,380		
Shareholders' equity	127,730			106,827			125,714		
Total liabilities and shareholders' equity	<u>\$ 1,338,716</u>			<u>\$1,183,568</u>			<u>\$ 1,107,469</u>		
Net interest income		<u>\$ 48,922</u>			<u>\$ 43,742</u>			<u>\$ 35,523</u>	
Net interest income/spread			<u>3.18%</u>			<u>3.36%</u>			<u>3.00%</u>
Net interest margin			3.74%			3.74%			3.30%

Table of Contents

- (1) Short-term investments consist of federal funds sold and interest bearing deposits that we maintain at other financial institutions.
- (2) Stock consists of FHLB stock and Federal Reserve Bank stock.
- (3) Loans include the average balance of nonaccrual loans and loan fees. The allowance for loan and lease losses is included within the "All other assets" line item.

The following table sets forth changes in interest income, including loan fees, and interest paid in each of the years ended December 31, 2018, 2017 and 2016 and the extent to which those changes were attributable to changes in (i) the volumes of or in the rates of interest earned on interest-earning assets and (ii) the volumes of or the rates of interest paid on our interest-bearing liabilities.

	2018 Compared to 2017			2017 Compared to 2016		
	Increase (Decrease) due to Changes in		Total Increase (Decrease)	Increase (Decrease) due to Changes in		Total Increase (Decrease)
Volume	Rates	Volume		Rates		
(Dollars in thousands)						
Interest income						
Short-term investments ⁽¹⁾	\$ 1,060	\$ 1,317	\$ 2,377	\$ (241)	\$ 778	\$ 537
Securities available for sale and stock ⁽²⁾	(272)	195	(77)	(193)	(148)	(341)
Loans	3,848	4,821	8,669	6,621	3,756	10,377
Total earning assets	4,636	6,333	10,969	6,187	4,386	10,573
Interest expense						
Interest-bearing checking accounts	(80)	96	16	92	93	185
Money market and savings accounts	783	2,716	3,499	47	764	811
Certificates of deposit	219	1,378	1,597	377	765	1,142
Borrowings	677	(175)	502	(38)	166	128
Junior subordinated debentures	—	175	175	—	88	88
Total interest-bearing liabilities	1,599	4,190	5,789	478	1,876	2,354
Net interest income	\$ 3,037	\$ 2,143	\$ 5,180	\$ 5,709	\$ 2,510	\$ 8,219

(1) Short-term investments consist of federal funds sold and interest bearing deposits that we maintain at financial institutions.

(2) Stock consists of FHLB stock and Federal Reserve Bank stock.

Provision for Loan and Lease Losses

We maintain reserves to provide for loan losses that occur in the ordinary course of the banking business. When it is determined that the payment in full of a loan has become unlikely, the carrying value of the loan is reduced ("written down") to what management believes is its realizable value or, if it is determined that a loan no longer has any realizable value, the carrying value of the loan is written off in its entirety (a loan "charge-off"). Loan charge-offs and write-downs are charged against our allowance for loan and lease losses ("ALLL"). The amount of the ALLL is increased periodically to replenish the ALLL after it has been reduced due to loan write-downs or charge-offs. The ALLL also is increased or decreased periodically to reflect increases or decreases in the volume of outstanding loans and to take account of changes in the risk of probable loan losses due to financial performance of borrowers, the value of collateral securing non-performing loans or changing economic conditions. Increases in the ALLL are made through a "provision for loan and lease losses" that is recorded as an expense in the statement of operations. Increases in the ALLL are also recognized through the recovery of charged-off loans which are added back to the ALLL. As such, recoveries are a direct offset for a provision for loan and lease losses that would otherwise be needed to replenish or increase the ALLL.

We employ economic models and data that conform to bank regulatory guidelines and reflect sound industry practices as well as our own historical loan loss experience to determine the sufficiency of the ALLL and any provisions needed to increase or replenish the ALLL. Those determinations involve judgments and assumptions about current economic conditions and external events that can impact the ability of borrowers to meet their loan obligations. However, the duration and impact of these factors cannot be determined with any certainty. As such, unanticipated changes in economic or market conditions, bank regulatory guidelines or the sound practices that are used to determine the sufficiency of the ALLL, could require us to record additional, and possibly significant, provisions to increase the ALLL. This would have the effect of reducing reportable income or, in the most extreme circumstance, creating a reportable loss. In addition, the Federal Reserve Bank and the California Department of Business Oversight ("CDBO"), as an integral part of their regulatory oversight, periodically review the adequacy of our ALLL. These agencies may require us to make additional provisions for perceived potential loan losses, over and above the provisions that we have already made, the effect of which would be to reduce our income or increase any losses we might incur.

Table of Contents

We recorded no provision for loan and lease losses during either the year ended December 31, 2018 or December 31, 2017 primarily as a result of reserves for new loan growth being offset by a decline in the level of classified assets. We recorded a \$19.9 million provision for loan and lease losses for the year ended December 31, 2016 primarily as a result of new loan growth and downgrades and charge offs on loans that exceeded recoveries. Approximately 60%, or \$12.0 million, of the \$19.9 million provision for loan and lease losses was attributable to the full charge-off of one large shared national credit.

See "*Financial Condition—Nonperforming Loans and the Allowance for Loan and Lease Losses*" below in this Item 7 for additional information regarding the ALLL.

Noninterest Income

The following table identifies the components of and the percentage changes in noninterest income in the years ended December 31, 2018, 2017 and 2016:

	Year Ended December 31,				
	Amount	Amount	Amount	Percentage Change	Percentage Change
	2018	2017	2016	2018 vs. 2017	2017 vs. 2016
	(Dollars in thousands)				
Service fees on deposits and other banking services	\$ 1,549	\$ 1,347	\$ 1,093	15.0 %	23.2 %
Net gain (loss) on sale of securities available for sale	48	(4)	—	(1,300.0)%	(100.0)%
Net loss on sale of other assets	(4)	(37)	(527)	(89.2)%	(93.0)%
Net gain on sale of small business administration loans	—	—	40	— %	(100.0)%
Other noninterest income	3,042	3,068	2,331	(0.8)%	31.6 %
Total noninterest income	<u>\$ 4,635</u>	<u>\$ 4,374</u>	<u>\$ 2,937</u>	6.0 %	48.9 %

2018 vs. 2017.

Noninterest income increased \$261 thousand, or 6.0%, for the year ended December 31, 2018 as compared to the year ended December 31, 2017, primarily as a result of:

- An increase in loan servicing and referral fees during the year ended December 31, 2018 as compared to the same period in 2017; and
- An increase of \$52 thousand in gain on the sale of securities available-for-sale during the year ended December 31, 2018 as compared to the same period in 2017; partially offset by
- A decrease in other noninterest income attributable to recoveries of fees on previously charged off loans during the second quarter of 2017 for which a similar level of recoveries did not occur during the year ended December 31, 2018.

2017 vs. 2016.

During the year ended December 31, 2017, noninterest income increased by \$1.4 million, or 48.9%, to \$4.4 million from \$2.9 million for the year ended December 31, 2016, primarily as a result of:

- An increase in loan servicing and referral fees during the year ended December 31, 2017 as compared to the same period in 2016; and
- A loss of \$37 thousand on the sale of other assets during the year ended December 31, 2017 as compared to a loss of \$527 thousand during the same period in 2016; partially offset by
- A decrease of \$40 thousand in net on sale of small business administration ("SBA") loans for the year ended December 31, 2017 as compared to the same period in 2017.

Noninterest Expense

The following table sets forth the principal components and the amounts of, and the percentage changes in, noninterest expense in the years ended December 31, 2018, 2017 and 2016.

[Table of Contents](#)

	Year Ended December 31,				
	2018	2017	2016	2018 vs. 2017	2017 vs. 2016
	Amount	Amount	Amount	Percent Change	Percent Change
(Dollars in thousands)					
Salaries and employee benefits	\$ 23,749	\$ 22,977	\$ 21,817	3.4 %	5.3 %
Occupancy	2,388	2,605	3,061	(8.3)%	(14.9)%
Equipment and depreciation	1,802	1,687	1,802	6.8 %	(6.4)%
Data processing	1,681	1,479	1,271	13.7 %	16.4 %
FDIC expense	927	1,073	950	(13.6)%	12.9 %
Other real estate owned expense, net	123	—	(70)	100.0 %	(100.0)%
Professional fees	2,468	4,215	4,046	(41.4)%	4.2 %
Business development	946	729	795	29.8 %	(8.3)%
Loan related expense	769	456	375	68.6 %	21.6 %
Insurance	248	221	291	12.2 %	(24.1)%
Other operating expenses ⁽¹⁾	1,869	2,316	2,063	(19.3)%	12.3 %
Total noninterest expense	<u>\$ 36,970</u>	<u>\$ 37,758</u>	<u>\$ 36,401</u>	(2.1)%	3.7 %

(1) Other operating expenses primarily consist of telephone, investor relations, promotional, regulatory expenses, and correspondent bank fees.

2018 vs. 2017.

Noninterest expense decreased \$788 thousand, or 2.1%, for the year ended December 31, 2018 as compared to the year ended December 31, 2017, primarily as a result of:

- A decrease of \$1.7 million in our professional fees primarily related to lower legal fees in the first quarter of 2018, the recovery of legal fees attributable to the payoff of a loan relationship in the second quarter of 2018 that was previously on nonaccrual status and the recovery of legal fees in the third quarter of 2018 related to a loan relationship that was fully charged off in previous years; partially offset by
- An increase of \$772 thousand in salaries and employee benefits primarily related to an increase in employee compensation expense;
- An increase of \$123 thousand in other real estate owned expense during the year ended December 31, 2018 as compared to the same period in 2017; and
- An increase in various expense accounts related to the normal course of operating, including expenses related to loan production and business development during the year ended December 31, 2018 as compared to the year ended December 31, 2017.

2017 vs. 2016.

During the year ended December 31, 2017, noninterest expense increased by \$1.4 million, or 3.7%, to \$37.8 million from \$36.4 million for the year ended December 31, 2016, primarily as a result of:

- An increase of \$1.2 million in salaries and employee benefits primarily related to our incentive compensation accrual for the year ended December 31, 2017 and the reversal of our incentive compensation accrual during the fourth quarter of 2016 due to the losses experienced in 2016; and
- An increase of \$169 thousand in our professional fees attributable to an increase in accounting and legal fees during the year ended December 31, 2017.

Provision for (Benefit from) Income Tax

During the year ended December 31, 2018, we had an income tax benefit of \$10.8 million. The income tax benefit during the year ended December 31, 2018 is as a result of our net income during the year and the release of our full valuation allowance of \$11.1 million on our net deferred tax asset during the second quarter of 2018, discussed further below. Accounting rules specify that management must evaluate the deferred tax asset on a recurring basis to determine whether enough positive evidence exists to determine whether it is more-likely-than-not that the deferred tax asset will be available to offset or reduce future taxes. The tax code allows net operating losses incurred prior to December 31, 2017 to be carried forward for 20 years from the date of the loss, and based on its evaluation, management believes that the Company will be able to realize the deferred tax asset within the period that our net operating losses may be carried forward. Due to the hierarchy of evidence that the accounting rules specify, management determined that there continued to be enough positive evidence to support no valuation allowance on our deferred tax asset at December 31, 2018. Significant positive evidence included our three-year cumulative income position, continued improvement in asset quality, and the expectation that we will continue to have positive earnings based on nine trailing quarters

Table of Contents

of positive income and our forecast. Negative evidence included our accumulated deficit. Due to the hierarchy of evidence that the accounting rules specify, management determined that there continued to be enough positive evidence to support no valuation allowance on our deferred tax asset at December 31, 2018.

During the year ended December 31, 2017, we had an income tax benefit of \$91 thousand. The income tax benefit for the year ended December 31, 2017 represents the reclassification of the alternative minimum tax credit carryforward from a deferred tax asset to an income tax receivable as required by the Tax Cuts and Jobs Act signed into law on December 22, 2017. This was partially offset by the payment to the State of California for the cost of doing business within the state. No additional income tax expense was recorded as a result of our full valuation allowance, discussed further below. The year ended December 31, 2017 results reflect the estimated impact of the enactment of the new tax law, which resulted in a minimal increase in net income due to the elimination of the corporate alternative minimum tax. Additionally, as part of the newly enacted tax law, the decrease in our deferred tax asset and corresponding valuation allowance as of December 31, 2017 is primarily attributable to the Federal corporate tax rate decreasing from 35% to 21%, which caused us to decrease our gross deferred tax asset and the related valuation allowance to \$15.9 million from \$21.7 million as of September 30, 2017. Accounting rules specify that management must evaluate the deferred tax asset on a recurring basis to determine whether enough positive evidence exists to determine whether it is more-likely-than-not that the deferred tax asset will be available to offset or reduce future taxes. The tax code allows net operating losses to be carried forward for 20 years from the date of the loss, and while management believes that the Company will be able to realize the deferred tax asset within the period that our net operating losses may be carried forward, we are unable to assert the timing as to when that realization will occur. Due to the hierarchy of evidence that the accounting rules specify, management determined that a full valuation allowance that was previously established on the balance of our deferred tax asset was still required at December 31, 2017.

During the year ended December 31, 2016, we had income tax expense of \$16.8 million as a result of the establishment of a full valuation allowance during 2016 on the balance of our deferred tax asset, which includes current and historical losses that may be used to offset taxes on future profits. Accounting rules specify that management must evaluate the deferred tax asset on a recurring basis to determine whether enough positive evidence exists to determine whether it is more-likely-than-not that the deferred tax asset will be available to offset or reduce future taxes. Negative evidence included the significant losses incurred during the second and third quarters of 2016, an increase in our nonperforming assets from December 31, 2015, and our accumulated deficit. Positive evidence included our forecast of our taxable income, the time period in which we have to utilize our deferred tax asset and the current economic conditions. The tax code allows net operating losses to be carried forward for 20 years from the date of the loss, and while management believed that the Company would be able to realize the deferred tax asset within that period, we were unable to assert the timing as to when that realization would occur. As a result of this conclusion and due to the hierarchy of evidence that the accounting rules specify, a valuation allowance had been recorded as of December 31, 2016 to offset the deferred tax asset.

See “–Critical Accounting Policies - Utilization and Valuation of Deferred Income Tax Benefits” below for additional information regarding our deferred tax asset.

Financial Condition

Assets

Our total consolidated assets increased by \$27 million at December 31, 2018 from \$1.3 billion at December 31, 2017. The following table sets forth the composition of our interest earning assets at:

	<u>December 31, 2018</u>	<u>December 31, 2017</u>
	(Dollars in thousands)	
Interest-bearing deposits with financial institutions ⁽¹⁾	\$ 174,468	\$ 186,010
Interest-bearing time deposits with financial institutions	2,420	2,920
Federal Reserve Bank of San Francisco and Federal Home Loan Bank Stock, at cost	8,822	8,107
Securities available for sale, at fair value	31,231	39,738
Loans (net of allowances of \$13,506 and \$14,196, respectively)	1,083,240	1,053,201

(1) Includes interest-earning balances maintained at the Federal Reserve Bank of San Francisco (“FRBSF”).

Securities Available for Sale

Securities Available for Sale. Securities that we intend to hold for an indefinite period of time, but which may be sold in response to changes in liquidity needs, interest rates, or prepayment risks or other similar factors, are classified as “securities

Table of Contents

available for sale". Such securities are recorded on our balance sheet at their respective fair values and increases or decreases in those values are recorded as unrealized gains or losses, respectively, and are reported as Other Comprehensive Income (Loss) on our accompanying consolidated balance sheet, rather than included in or deducted from our earnings.

The following is a summary of the major components of securities available for sale and a comparison of the amortized cost, estimated fair values and the gross unrealized gains and losses attributable to those securities, as of December 31, 2018, 2017 and 2016:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
Securities available for sale at December 31, 2018:				
U.S. Treasury securities	\$ 2,999	\$ —	\$ (19)	\$ 2,980
Residential mortgage backed securities issued by U.S. Agencies	24,739	1	(1,023)	23,717
Commercial mortgage backed securities issued by U.S. Agencies	4,495	40	(1)	4,534
Total securities available for sale	<u>\$ 32,233</u>	<u>\$ 41</u>	<u>\$ (1,043)</u>	<u>\$ 31,231</u>
Securities available for sale at December 31, 2017:				
U.S. Treasury securities	\$ 2,996	\$ —	\$ (25)	\$ 2,971
Residential mortgage backed securities issued by U.S. Agencies	30,894	5	(777)	30,122
Asset backed security	1,992	—	(251)	1,741
Mutual funds	5,000	11	(107)	4,904
Total securities available for sale	<u>\$ 40,882</u>	<u>\$ 16</u>	<u>\$ (1,160)</u>	<u>\$ 39,738</u>
Securities available for sale at December 31, 2016:				
Residential mortgage backed securities issued by U.S. Agencies	\$ 37,813	\$ 6	\$ (1,144)	\$ 36,675
Residential collateralized mortgage obligations issued by non agencies	484	—	(16)	468
Asset backed security	2,025	—	(592)	1,433
Mutual funds	5,000	11	(107)	4,904
Total securities available for sale	<u>\$ 45,322</u>	<u>\$ 17</u>	<u>\$ (1,859)</u>	<u>\$ 43,480</u>

At December 31, 2018, 2017 and 2016, U.S. agency mortgage backed securities and collateralized mortgage obligations with an aggregate fair market value of \$18.2 million, \$22.7 million and \$21.1 million, respectively, were pledged to secure FHLB borrowings, repurchase agreements, local agency deposits and treasury, tax and loan accounts.

The amortized cost of securities available for sale at December 31, 2018 is shown in the table below by contractual maturities taking into consideration historical prepayments based on the prior twelve months of principal payments. Expected maturities will differ from contractual maturities and historical prepayments, particularly with respect to collateralized mortgage obligations, primarily because prepayment rates are affected by changes in conditions in the interest rate market and, therefore, future prepayment rates may differ from historical prepayment rates.

[Table of Contents](#)

(Dollars in thousands)	December 31, 2018 Maturing in									
	One year or less		Over one year through five years		Over five years through ten years		Over ten years		Total	
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield
Securities available for sale:										
U.S. Treasury securities	\$ 2,999	1.30%	\$ —	—%	\$ —	—%	\$ —	—%	\$ 2,999	1.30%
Residential mortgage backed securities issued by U.S. Agencies	4,746	1.51%	12,932	1.56%	6,808	1.67%	253	2.93%	24,739	1.60%
Commercial mortgage backed securities issued by U.S. Agencies	129	3.16%	534	3.13%	3,163	3.39%	669	3.20%	4,495	3.32%
Total Securities Available for sale	\$ 7,874	1.46%	\$ 13,466	1.62%	\$ 9,971	2.22%	\$ 922	3.13%	\$ 32,233	1.81%

The table below indicates, as of December 31, 2018, the gross unrealized losses and fair values of our investments, aggregated by investment category, and length of time that the individual securities have been in a continuous unrealized loss position.

(Dollars in thousands)	Securities with Unrealized Loss at December 31, 2018					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury securities	\$ —	\$ —	\$ 2,980	\$ (19)	\$ 2,980	\$ (19)
Residential mortgage backed securities issued by U.S. Agencies	361	(3)	23,299	(1,020)	23,660	(1,023)
Commercial mortgage backed securities issued by U.S. Agencies	999	(1)	—	—	999	(1)
Total	\$ 1,360	\$ (4)	\$ 26,279	\$ (1,039)	\$ 27,639	\$ (1,043)

We regularly monitor investments for significant declines in fair value. We have determined that declines in the fair values of these investments below their respective amortized costs, as set forth in the tables above, are temporary because (i) those declines were due to interest rate changes and not to a deterioration in the creditworthiness of the issuers of those investment securities, and (ii) we have the ability to hold those securities until there is a recovery in their values or until their maturity.

Table of Contents

Loans

The following table sets forth the composition, by loan category, of our loan portfolio at December 31, 2018, 2017, 2016, 2015 and 2014:

	At December 31,									
	2018		2017		2016		2015		2014	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)									
Commercial loans	\$ 444,441	40.6%	\$ 394,493	37.1%	\$ 333,376	35.2%	\$ 347,300	40.3%	\$ 301,746	36.0%
Commercial real estate loans – owner occupied	211,645	19.3%	214,365	20.1%	214,420	22.7%	195,554	22.7%	212,515	25.4%
Commercial real estate loans – all other	226,441	20.7%	228,090	21.4%	173,223	18.3%	146,641	17.0%	146,676	17.5%
Residential mortgage loans – multi-family	97,173	8.9%	114,302	10.7%	130,930	13.8%	81,487	9.5%	95,276	11.4%
Residential mortgage loans – single family	21,176	1.9%	24,848	2.3%	34,527	3.6%	52,072	6.0%	64,326	7.7%
Construction and land development loans	38,496	3.5%	34,614	3.3%	18,485	2.0%	10,001	1.2%	7,745	0.9%
Consumer loans	54,514	5.0%	53,918	5.1%	41,563	4.4%	28,663	3.3%	9,687	1.2%
Total loans	<u>1,093,886</u>	<u>100.0%</u>	<u>1,064,630</u>	<u>100.0%</u>	<u>946,524</u>	<u>100.0%</u>	<u>861,718</u>	<u>100.0%</u>	<u>837,971</u>	<u>100.0%</u>
Deferred fee (income) costs, net	2,860		2,767		1,802		731		59	
Allowance for loan and lease losses	(13,506)		(14,196)		(16,801)		(12,716)		(13,833)	
Loans, net	<u>\$ 1,083,240</u>		<u>\$ 1,053,201</u>		<u>\$ 931,525</u>		<u>\$ 849,733</u>		<u>\$ 824,197</u>	

Commercial loans are loans to businesses to finance capital purchases or improvements, or to provide cash flow for operations. Real estate and residential mortgage loans are loans secured by trust deeds on real properties, including commercial properties and single family and multi-family residences. Construction loans are interim loans to finance specific construction projects. Land development loans are loans secured by non-able bare land. Consumer loans include installment loans to consumers.

The following table sets forth the maturity distribution of our loan portfolio (excluding single and multi-family residential mortgage loans and consumer loans) at December 31, 2018:

	December 31, 2018			
	One Year or Less	Over One Year Through Five Years	Over Five Years	Total
	(Dollars in thousands)			
Real estate loans ⁽¹⁾				
Floating rate	\$ 68,210	\$ 26,877	\$ 123,678	\$ 218,765
Fixed rate	3,406	70,542	183,869	257,817
Commercial loans				
Floating rate	128,513	184,719	34,042	347,274
Fixed rate	21,933	38,702	36,532	97,167
Total	<u>\$ 222,062</u>	<u>\$ 320,840</u>	<u>\$ 378,121</u>	<u>\$ 921,023</u>

(1) Does not include mortgage loans on single or multi-family residences or consumer loans, which totaled \$118.3 million and \$54.5 million, respectively, at December 31, 2018.

Table of Contents

Nonperforming Assets and Allowance for Loan and Lease Losses

Nonperforming Assets. Non-performing loans consist of (i) loans on non-accrual status which are loans on which the accrual of interest has been discontinued and include restructured loans when there has not been a history of past performance on debt service in accordance with the contractual terms of the restructured loans, and (ii) loans 90 days or more past due and still accruing interest. Non-performing assets are comprised of non-performing loans and OREO, which consists of real properties which we have acquired by or in lieu of foreclosure and which we intend to offer for sale.

Loans are placed on non-accrual status when, in our opinion, the full timely collection of principal or interest is in doubt. Generally, the accrual of interest is discontinued when principal or interest payments become more than 90 days past due, unless we believe the loan is adequately collateralized and the loan is in the process of collection. However, in certain instances, we may place a particular loan on non-accrual status earlier, depending upon the individual circumstances involved in that loan's delinquency. When a loan is placed on non-accrual status, previously accrued but unpaid interest is reversed against current income. Subsequent collections of unpaid amounts on such a loan are applied to reduce principal when received, except when the ultimate collectability of principal is probable, in which case such payments are applied to interest and are credited to income. Non-accrual loans may be restored to accrual status if and when principal and interest become current and full repayment is expected. Interest income is recognized on the accrual basis for impaired loans which, based on our non-accrual policy, do not require non-accrual treatment.

The following table sets forth information regarding our nonperforming assets, as well as information regarding restructured loans, at December 31, 2018, 2017, 2016, 2015 and 2014:

	At December 31, 2018	At December 31, 2017	At December 31, 2016	At December 31, 2015	At December 31, 2014
(Dollars in thousands)					
Nonaccrual loans:					
Commercial loans	\$ 3,352	\$ 3,222	\$ 20,330	\$ 12,284	\$ 16,182
Commercial real estate	831	2,461	4,346	10,083	4,288
Residential real estate	—	171	221	1,148	1,472
Construction and land development	—	—	—	1,618	2,111
Consumer	43	56	—	—	—
Total nonaccrual loans	\$ 4,226	\$ 5,910	\$ 24,897	\$ 25,133	\$ 24,053
Loans past due 90 days and still accruing interest:					
Commercial loans	\$ 1,278	\$ —	\$ —	\$ —	\$ —
Total loans past due 90 days and still accruing interest ⁽¹⁾	\$ 1,278	\$ —	\$ —	\$ —	\$ —
Other real estate owned (OREO):					
Commercial loans	\$ 1,173	\$ —	\$ —	\$ —	\$ —
Residential real estate	\$ —	\$ —	\$ —	650	962
Construction and land development	—	—	—	—	630
Total other real estate owned	\$ 1,173	\$ —	\$ —	\$ 650	\$ 1,592
Other nonperforming assets:					
Other foreclosed assets	91	36	—	—	—
Total nonperforming assets ⁽²⁾	\$ 5,490	\$ 5,946	\$ 24,897	\$ 25,783	\$ 25,645
Restructured loans:					
Accruing loans	\$ —	\$ 450	\$ —	\$ 724	\$ 11,084
Nonaccruing loans (included in nonaccrual loans above)	—	809	8,931	20,070	5,935
Total restructured loans	\$ —	\$ 1,259	\$ 8,931	\$ 20,794	\$ 17,019

(1) This amount represents one loan relationship. Subsequent to December 31, 2018, this balance was paid off.

(2) Excludes loans past due 90 days and still accruing interest.

As the above table indicates, total nonperforming assets decreased by approximately \$456 thousand, or 7.7%, to \$5.5 million as of December 31, 2018 from \$5.9 million as of December 31, 2017. The increase in our non-performing loans resulted primarily from \$3.1 million of payoffs or paydowns on our nonaccrual loans, the transfer to OREO of \$1.3 million, the transfer to other assets of \$91 thousand, \$814 thousand of loans that returned to accrual status and charge-offs of \$1.6 million during the year ended December 31, 2018, partially offset by additions totaling \$5.3 million during the same period. The increase in our OREO owned balance from December 31, 2017 related to the foreclosure of two residential properties securing a commercial loan during the year ended December 31, 2018, partially offset by the sale of one of the two properties during the year ended December 31, 2018 for a gain on sale of \$29 thousand. The increase in our other foreclosed assets balance from December 31,

Table of Contents

2017 related to the addition of three automobiles for \$91 thousand, partially offset by the sale of an automobile for \$36 thousand during the year ended December 31, 2018.

Information Regarding Impaired Loans. At December 31, 2018, loans deemed impaired totaled \$4.2 million as compared to \$6.4 million at December 31, 2017. We had an average investment in impaired loans of \$5.7 million for the year ended December 31, 2018 as compared to \$16.4 million for the year ended December 31, 2017. The interest that would have been earned during the year ended December 31, 2018 had the nonaccruing impaired loans remained current in accordance with their original terms was approximately \$362 thousand.

The following table sets forth the amount of impaired loans to which a portion of the ALLL has been specifically allocated, and the aggregate amount so allocated, in accordance with ASC 310-10, and the amount of the ALLL and the amount of impaired loans for which no such allocations were made, in each case at December 31, 2018 and December 31, 2017:

	December 31, 2018			December 31, 2017		
	Loans	Reserves for Loan Losses	% of Reserves to Loans	Loans	Reserves for Loan Losses	% of Reserves to Loans
(Dollars in thousands)						
Impaired loans with specific reserves	\$ —	\$ —	—%	\$ 450	\$ 7	1.6%
Impaired loans without specific reserves	4,226	—	—	5,910	—	—
Total impaired loans	\$ 4,226	\$ —	—%	\$ 6,360	\$ 7	0.1%

The \$2.1 million decrease in impaired loans to \$4.2 million at December 31, 2018 from \$6.4 million at December 31, 2017 was primarily attributable to \$3.2 million in principal payments, \$678 thousand transferred to performing loans, \$1.4 million transferred to OREO, \$76 thousand transferred to other assets and \$2.8 million charged-off during the year ended December 31, 2018 partially offset by additions of \$6.0 million to impaired loans during the same period. Based on an internal analysis, using the current estimated fair values of the collateral or the discounted present values of the future estimated cash flows of the impaired loans, we concluded that, at December 31, 2018, no specific reserves were required on our impaired loans and that all impaired loans were well secured and adequately collateralized with no specific reserves required.

Allowance for Loan and Lease Losses. The ALLL totaled \$13.5 million, representing 1.23% of loans outstanding, at December 31, 2018, as compared to \$14.2 million, or 1.33% of loans outstanding, at December 31, 2017.

The adequacy of the ALLL is determined through periodic evaluations of the loan portfolio and other factors that can reasonably be expected to affect the ability of borrowers to meet their loan obligations. Those factors are inherently subjective as the process for determining the adequacy of the ALLL involves some significant estimates and assumptions about such matters such as (i) economic conditions and trends and the amounts and timing of expected future cash flows of borrowers which can affect their ability to meet their loan obligations to us, (ii) the fair value of the collateral securing non-performing loans, (iii) estimates of losses that we may incur on non-performing loans, which are determined on the basis of historical loss experience and industry loss factors and bank regulatory guidelines, which are subject to change, and (iv) various qualitative factors. Since those factors are subject to changes in economic and other conditions and changes in regulatory guidelines or other circumstances over which we have no control, the amount of the ALLL may prove to be insufficient to cover all of the loan losses we might incur in the future. In such an event, it may become necessary for us to increase the ALLL from time to time to maintain its adequacy. Such increases are effectuated by means of a charge to income, referred to as the “provision for loan and lease losses”, in our statements of our operations. See “—Results of Operations— Provision for Loan and Lease Losses, above in this Item 7.

The amount of the ALLL is first determined by assigning reserve ratios for all loans. All non-accrual loans and other loans classified as “Special Mention,” “Substandard” or “Doubtful” (“classified loans” or “classification categories”) and not fully collateralized are then assigned specific reserves within the ALLL, with greater reserve allocations made to loans deemed to be of a higher risk. These ratios are determined based on prior loss history and industry guidelines and loss factors, by type of loan, adjusted for current economic factors and current economic trends. Refer to Note 5, Loans and Allowance for Loan and Lease Losses for definitions related to our credit quality indicators stated above.

On a quarterly basis, we utilize a classification based loan loss migration model as well as review individual loans in determining the adequacy of the ALLL. Our loss migration analysis tracks a certain number of quarters of loan loss history and industry loss factors to determine historical losses by classification category for each loan type, except certain consumer loans (automobile, mortgage and credit cards), which are analyzed as homogeneous loan pools. These calculated loss factors are then applied to outstanding loan balances. We analyze impaired loans individually.

Table of Contents

In determining whether and the extent to which we will make adjustments to our loan loss migration model for purposes of determining the ALLL, we also consider a number of qualitative factors that can affect the performance and the collectability of the loans in our loan portfolio. Such qualitative factors include:

- The effects of changes that we may make in our loan policies or underwriting standards on the quality of the loans and the risks in our loan portfolios;
- Trends and changes in local, regional and national economic conditions, as well as changes in industry specific conditions, and any other reasonably foreseeable events that could affect the performance or the collectability of the loans in our loan portfolios;
- Material changes that may occur in the mix or in the volume of the loans in our loan portfolios that could alter, whether positively or negatively, the risk profile of those portfolios;
- Changes in management or loan personnel or other circumstances that could, either positively or negatively, impact the application of our loan underwriting standards, the monitoring of nonperforming loans or our loan collection efforts; and
- External factors that, in addition to economic conditions, can affect the ability of borrowers to meet their loan obligations, such as fires, earthquakes and terrorist attacks.

Determining the effects that these qualitative factors may have on the performance of each category of loans in our loan portfolio requires numerous judgments, assumptions and estimates about conditions, trends and events which may subsequently prove to have been incorrect due to circumstances outside of our control. Moreover, the effects of qualitative factors such as these on the performance of our loan portfolios are often difficult to quantify. As a result, we may sustain loan losses in any particular period that are sizable in relation to the ALLL or that may even exceed the ALLL.

Set forth below is information regarding loan balances and the related ALLL, by portfolio type, for the years ended December 31, 2018, 2017, 2016, 2015 and 2014.

Table of Contents

(Dollars in thousands)	Commercial	Real Estate	Construction and Land Development	Consumer and Single Family Mortgages	Unallocated	Total
ALLL for the year ended December 31, 2018:						
Balance at beginning of year	\$ 9,155	\$ 2,906	\$ 650	\$ 1,043	\$ 442	\$ 14,196
Charge offs	(2,757)	—	—	(8)	—	(2,765)
Recoveries	1,959	69	—	47	—	2,075
Provision	(286)	668	(224)	208	(366)	—
Balance at end of year	\$ 8,071	\$ 3,643	\$ 426	\$ 1,290	\$ 76	\$ 13,506
Allowance for loan and lease losses as a percentage of average total loans						1.26 %
Allowance for loan and lease losses as a percentage of total outstanding loans						1.23 %
Ratio of net charge-offs to average loans outstanding during the period						0.06 %
ALLL for the year ended December 31, 2017:						
Balance at beginning of year	\$ 11,276	\$ 4,226	\$ 343	\$ 642	\$ 314	\$ 16,801
Charge offs	(4,124)	(432)	—	(179)	—	(4,735)
Recoveries	1,852	72	27	179	—	2,130
Provision	151	(960)	280	401	128	—
Balance at end of year	\$ 9,155	\$ 2,906	\$ 650	\$ 1,043	\$ 442	\$ 14,196
Allowance for loan and lease losses as a percentage of average total loans						1.42 %
Allowance for loan and lease losses as a percentage of total outstanding loans						1.33 %
Ratio of net charge-offs to average loans outstanding during the period						0.26 %
ALLL for the year ended December 31, 2016:						
Balance at beginning of year	\$ 6,639	\$ 5,109	\$ 282	\$ 686	\$ —	\$ 12,716
Charge offs	(15,390)	(1,119)	—	(540)	—	(17,049)
Recoveries	1,189	1	57	17	—	1,264
Provision	18,838	235	4	479	314	19,870
Balance at end of year	\$ 11,276	\$ 4,226	\$ 343	\$ 642	\$ 314	\$ 16,801
Allowance for loan and lease losses as a percentage of average total loans						1.96 %
Allowance for loan and lease losses as a percentage of total outstanding loans						1.78 %
Ratio of net charge-offs to average loans outstanding during the period						1.84 %
ALLL for the year ended December 31, 2015:						
Balance at beginning of year	\$ 7,670	\$ 5,133	\$ 296	\$ 734	\$ —	\$ 13,833
Charge offs	(2,643)	—	(85)	(199)	—	(2,927)
Recoveries	1,798	4	—	8	—	1,810
Provision	(186)	(28)	71	143	—	—
Balance at end of year	\$ 6,639	\$ 5,109	\$ 282	\$ 686	\$ —	\$ 12,716
Allowance for loan and lease losses as a percentage of average total loans						1.54 %
Allowance for loan and lease losses as a percentage of total outstanding loans						1.48 %
Ratio of net charge-offs to average loans outstanding during the period						0.13 %
ALLL for the year ended December 31, 2014:						
Balance at beginning of year	\$ 5,812	\$ 4,517	\$ 165	\$ 864	\$ —	\$ 11,358
Charge offs	(551)	—	—	(102)	—	(653)
Recoveries	1,467	76	—	85	—	1,628
Provision	942	540	131	(113)	—	1,500
Balance at end of year	\$ 7,670	\$ 5,133	\$ 296	\$ 734	\$ —	\$ 13,833

Allowance for loan and lease losses as a percentage of average total loans	1.73 %
Allowance for loan and lease losses as a percentage of total outstanding loans	1.65 %
Ratio of net charge-offs to average loans outstanding during the period	(0.12)%

Table of Contents

The ALLL decreased \$690 thousand from December 31, 2017 to December 31, 2018 primarily as a result of a decrease in our classified loan portfolio during the year ended December 31, 2018, which was partially offset by charge-offs exceeding recoveries and new loan growth during that same period. The reserve for loan losses may include an unallocated amount based upon our judgment as to possible credit losses inherent in the loan portfolio that may not have been captured by historical loss experience, qualitative factors, or specific evaluations of impaired loans. Unallocated reserves may be adjusted for factors including, but not limited to, unexpected or unusual events, volatile market and economic conditions, effects of changes or seasoning in methodologies, regulatory guidance and recommendations, or other factors that may impact borrower operating conditions and loss expectations. Management's judgment as to unallocated reserves is determined in the context of, but separate from, the historical loss trends and qualitative factors described above. The unallocated reserve for loan losses of \$76 thousand at December 31, 2018 has decreased \$366 thousand from the balance at December 31, 2017, primarily due to charge-offs during the year ended December 31, 2018. Management believes that the amount of unallocated reserve for loan losses is appropriate and will continue to evaluate it on an ongoing basis.

We classify our loan portfolios using asset quality ratings. The credit quality table in Note 5, Loans and Allowance for Loan and Lease Losses below in Item 8, provides a summary of loans by portfolio type and asset quality ratings as of December 31, 2018 and December 31, 2017. Loans totaled approximately \$1.1 billion at December 31, 2018, an increase of \$29.3 million from \$1.1 billion at December 31, 2017. The disaggregation of the loan portfolio by risk rating in the credit quality table located in Note 5 reflects the following changes that occurred between December 31, 2017 and December 31, 2018:

- Loans rated "Pass" totaled \$1.1 billion, an increase of \$35.8 million from \$1.0 billion at December 31, 2017. The increase was primarily attributable to new loan growth and upgrades of \$1.3 million and \$3.2 million from "Special Mention" and "Substandard", respectively, partially offset by the sale of \$15.1 million of loans during the second quarter of 2018, downgrades to "Special Mention" and "Substandard" of \$12.8 million and \$1.7 million, respectively, and paydowns of principal payments.
- Loans rated "Special Mention" totaled \$15.3 million, a decrease of \$2.1 million from \$17.4 million at December 31, 2017. The decrease was primarily the result of \$10.5 million downgraded to "Substandard", \$3.0 million of payoffs and principal payments, \$1.3 million upgraded to "Pass", and \$71 thousand of loans charged-off, partially offset by \$12.8 million downgraded from "Pass."
- Loans rated "Substandard" totaled \$6.7 million, a decrease of \$4.1 million from \$10.8 million at December 31, 2017. This decrease was primarily the result of \$10.3 million in principal payments, upgrades of \$3.2 million to "Pass", \$1.2 million transferred to OREO and \$1.8 million of loans charged-off; partially offset by \$1.7 million and \$6.0 million downgraded from "Pass" and "Special Mention", respectively.
- Loans rated "Doubtful" totaled \$0, a decrease of \$366 thousand from \$366 thousand at December 31, 2017. This decrease was the result of a commercial loan of \$366 thousand transferred to OREO.

Our loss migration analysis currently utilizes a series of nineteen staggered 16-quarter migration periods, which was increased during the second quarter of 2015 from four staggered 16-quarter migration periods in order to broaden the loss experience incorporated into the analysis. As a result, for purposes of determining applicable loss factors at December 31, 2018, our migration analysis covered the period from December 31, 2013 to December 31, 2017. We believe this was consistent with and reasonably reflects current economic conditions, portfolio trends and the risks that were inherent in our loan portfolio at December 31, 2018.

The table below sets forth loan delinquencies, by quarter, from December 31, 2018 to December 31, 2017.

	<u>December 31, 2018</u>	<u>September 30, 2018</u>	<u>June 30, 2018</u>	<u>March 31, 2018</u>	<u>December 31, 2017</u>
Loans Delinquent:	(Dollars in thousands)				
90 days or more:					
Commercial loans	\$ 4,273	\$ 2,669	\$ 2,669	\$ 1,385	\$ 2,125
Commercial real estate	—	—	—	—	—
Residential mortgages	—	—	—	—	—
Land development loans	—	—	—	—	—
	<u>4,273</u>	<u>2,669</u>	<u>2,669</u>	<u>1,385</u>	<u>2,125</u>
30-89 days:					
Commercial loans	3,705	6,357	6,798	100	1,387
Commercial real estate	831	4,720	3,870	1,746	936
Residential mortgages	—	—	—	—	—
Consumer loans	13	—	—	18	—
	<u>4,549</u>	<u>11,077</u>	<u>10,668</u>	<u>1,864</u>	<u>2,323</u>
Total Past Due⁽¹⁾⁽²⁾:	<u>\$ 8,822</u>	<u>\$ 13,746</u>	<u>\$ 13,337</u>	<u>\$ 3,249</u>	<u>\$ 4,448</u>

Table of Contents

- (1) Past due balances include nonaccrual loans.
(2) Subsequent to December 31, 2018, we received principal payments of \$7.6 million from two loan relationships.

As the above table indicates, total past due loans increased by \$4.4 million, or 98.3%, to \$8.8 million at December 31, 2018 from \$4.4 million at December 31, 2017. Loans past due 90 days or more increased by \$2.1 million, or 101.1%, to \$4.3 million at December 31, 2018, from \$2.1 million at December 31, 2017 primarily resulting from \$4.3 million of additions of delinquent loans, partially offset by \$1.2 million transferred to OREO, \$809 thousand of payoffs and \$140 thousand charged off.

Loans 30-89 days past due increased by \$2.2 million, or 95.8%, to \$4.5 million at December 31, 2018 from \$2.3 million at December 31, 2017 primarily attributable to additions of delinquent loans of \$4.6 million, partially offset by \$1.9 million of payoffs, \$150 thousand brought current and \$240 thousand that moved to 90 days or more past due.

Deposits

Average Balances of and Average Interest Rates Paid on Deposits

Set forth below are the average amounts of, and the average rates paid on, deposits for the years ended December 31, 2018, 2017 and 2016:

	Year Ended December 31,					
	2018		2017		2016	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
	(Dollars in thousands)					
Noninterest bearing demand deposits	\$ 348,923	—	\$ 326,105	—	\$ 299,447	—
Interest-bearing checking accounts	69,841	0.52%	87,771	0.40%	60,024	0.27%
Money market and savings deposits	412,366	1.54%	334,703	0.85%	327,401	0.63%
Time deposits ⁽¹⁾	315,189	1.70%	298,531	1.26%	263,569	0.99%
Total deposits	<u>\$ 1,146,319</u>	<u>1.05%</u>	<u>\$ 1,047,110</u>	<u>0.66%</u>	<u>\$ 950,441</u>	<u>0.51%</u>

- (1) Comprised of time certificates of deposit in denominations of less than and more than \$100,000.

Deposit Totals

Deposits totaled \$1.1 billion at December 31, 2018 as compared to \$1.1 billion at December 31, 2017. The following table provides information regarding the mix of our deposits at December 31, 2018 and December 31, 2017:

	At December 31, 2018		At December 31, 2017	
	Amounts	% of Total Deposits	Amounts	% of Total Deposits
	(Dollars in thousands)			
Core deposits				
Noninterest bearing demand deposits	\$ 340,406	30.0%	\$ 338,273	29.7%
Savings and other interest-bearing transaction deposits	524,499	46.2%	439,784	38.6%
Time deposits	271,097	23.9%	361,336	31.7%
Total deposits	<u>\$ 1,136,002</u>	<u>100.0%</u>	<u>\$ 1,139,393</u>	<u>100.0%</u>

Certificates of deposit in denominations of \$100,000 or more, on which we pay higher rates of interest than on other deposits, aggregated \$244.2 million, or 21.5%, of total deposits at December 31, 2018, as compared to \$330.5 million, and 29.0%, of total deposits at December 31, 2017.

Set forth below is a maturity schedule of domestic time certificates of deposit outstanding at December 31, 2018 and December 31, 2017:

Table of Contents

Maturities	December 31, 2018		December 31, 2017	
	Certificates of Deposit Under \$ 100,000	Certificates of Deposit \$100,000 or more	Certificates of Deposit Under \$100,000	Certificates of Deposit \$100,000 or more
	(Dollars in thousands)			
Three months or less	\$ 7,074	\$ 60,802	\$ 8,674	\$ 77,981
Over three and through six months	5,162	64,020	5,532	47,652
Over six and through twelve months	9,936	80,212	10,391	90,470
Over twelve months	4,710	39,181	6,214	114,422
Total	\$ 26,882	\$ 244,215	\$ 30,811	\$ 330,525

Liquidity

We actively manage our liquidity needs to ensure that sufficient funds are available to meet our needs for cash, including to fund new loans to and deposit withdrawals by our customers. We project the future sources and uses of funds and maintain liquid funds for unanticipated events. Our primary sources of cash include cash we have on deposit at other financial institutions, payments from borrowers on their loans, proceeds from sales or maturities of securities held for sale, increases in deposits and increases in borrowings principally from the FHLB. The primary uses of cash include funding new loans and making advances on existing lines of credit, purchasing investments, including securities available for sale, funding deposit withdrawals and paying operating expenses. We maintain funds in overnight federal funds and other short-term investments to provide for short-term liquidity needs. We also have obtained credit lines from the FHLB and other financial institutions to meet any additional liquidity requirements we might have. See "*Contractual Obligations—Borrowings*" below for additional information related to our borrowings from the FHLB.

Our liquid assets, which included cash and due from banks, federal funds sold, interest earning deposits that we maintain with financial institutions and unpledged securities available for sale (excluding Federal Reserve Bank and FHLB stock) totaled \$202.2 million, which represented 15% of total assets, at December 31, 2018. We believe that our cash and cash equivalent resources, together with available borrowings under our credit facilities, will be sufficient to meet normal operating requirements for at least the next twelve months, including to enable us to meet any increase in deposit withdrawals that might occur in the foreseeable future.

Cash Flow Provided by Operating Activities. In 2018, operating activities provided net cash of \$17.3 million primarily attributable to our net income of \$27.3 million, partially offset by a non-cash recognition of \$11.1 million in our deferred tax asset, which resulted from the full release of our valuation allowance. In 2017, operating activities provided net cash of \$10.6 million primarily attributable to net income of \$10.4 million.

Cash Flow Used in Investing Activities. In 2018, investing activities used net cash of \$24.0 million, primarily attributable to \$32.3 million used to fund an increase in loans and \$5.2 million used to purchase securities available for sale and other stock, partially offset by \$6.9 million of cash provided from the sale of debt securities available for sale and equity securities and \$6.0 million of cash from maturities of and principal payments on securities available for sale. In 2017, investing activities used net cash of \$115.5 million, primarily attributable to \$120.2 million used to fund an increase in loans and \$3.4 million used to purchase securities available for sale and other stock, partially offset by \$6.8 million of cash from maturities of and principal payments on securities available for sale.

Cash Flow Provided by Financing Activities. In 2018, financing activities used net cash of \$3.7 million, consisting primarily of a \$5.5 million net decrease in interest bearing deposits, which resulted from a decision to decrease our reliance on certificates of deposit, and a \$727 thousand net decrease in borrowings, partially offset by a \$2.1 million net increase in noninterest bearing deposits. In 2017, financing activities provided net cash of \$164.3 million, consisting primarily of a \$5.7 million net increase in noninterest bearing deposits and a \$132.4 million net increase in interest bearing deposits, which resulted from a decision to increase our liquidity, and a \$25.0 million net increase in borrowings.

Ratio of Loans to Deposits. The relationship between gross loans and total deposits can provide a useful measure of a bank's liquidity. Since repayment of loans tends to be less predictable than the maturity of investments and other liquid resources, the higher the loan-to-deposit ratio the less liquid are our assets. On the other hand, since we realize greater yields on loans than we do on investments, a lower loan-to-deposit ratio can adversely affect interest income and earnings. As a result, our goal is to achieve a loan-to-deposit ratio that appropriately balances the requirements of liquidity and the need to generate a fair return on our assets. At December 31, 2018 and 2017, the loan-to-deposit ratio was 96% and 93%, respectively.

Capital Resources

Table of Contents

Regulatory Capital Requirements Applicable to Banking Institutions

Under federal banking regulations that apply to all United States-based bank holding companies over \$3 billion in total assets and all federally insured banks, the Bank (on a stand-alone basis) must meet specific capital adequacy requirements that, for the most part, involve quantitative measures, primarily in terms of the ratios of their capital to their assets, liabilities, and certain off-balance sheet items, calculated under regulatory accounting practices. The Company (on a consolidated basis) is below the reporting threshold of \$3 billion in total assets and therefore exempt from these capital adequacy requirements. These regulations place a banking institution into one of five capital categories based on its regulatory capital ratios:

- well-capitalized
- adequately capitalized
- undercapitalized
- significantly undercapitalized; or
- critically undercapitalized

Certain qualitative assessments also are made by a banking institution's primary federal regulatory agency that could lead the agency to determine that the banking institution should be assigned to a lower capital category than the one indicated by the quantitative measures used to assess the institution's capital adequacy. At each successive lower capital category, a banking institution is subject to greater operating restrictions and increased regulatory supervision by its federal bank regulatory agency.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total capital, common equity Tier 1 capital and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). We believe that, as of December 31, 2018, the Bank met all capital adequacy requirements to which it was subject and has not been notified by any regulatory agency that would require the Bank to maintain additional capital.

The actual capital amounts and ratios of the Bank at December 31, 2018 are presented in the following table:

At December 31, 2018	Actual Capital		Applicable Federal Regulatory Requirement			
			For Capital Adequacy Purposes		To be Categorized As Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
Total Capital to Risk Weighted Assets:						
Bank	160,372	13.0%	106,072	At least 8.625	\$ 122,982	At least 10.0
Common Equity Tier 1 Capital to Risk Weighted Assets:						
Bank	146,516	11.9%	63,028	At least 5.125	79,938	At least 6.5
Tier 1 Capital to Risk Weighted Assets:						
Bank	146,516	11.9%	81,475	At least 6.625	\$ 98,385	At least 8.0
Tier 1 Capital to Average Assets:						
Bank	146,516	10.8%	54,403	At least 4.0	\$ 68,004	At least 5.0

As the above table indicates, at December 31, 2018, the Bank (on a stand-alone basis) had capital ratios exceeding the minimums required to be qualified as a "well-capitalized" institution under federally mandated capital standards and federally established prompt corrective action regulations.

In early July 2013, the Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier 1 capital ratio, increase the minimum Tier 1 capital ratio requirement, and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The final rules took effect for community banks on January 1, 2015, subject to a transition period for certain parts of the rules. At December 31, 2018, the Bank (on a stand-alone basis) continued to qualify as a well-capitalized institution under the capital adequacy guidelines described above.

Table of Contents

Dividend Policy and Share Repurchase Programs.

It is, and since the beginning of 2009 it has been, the policy of the Boards of Directors of the Company and the Bank to preserve cash to enhance our capital positions and the Bank's liquidity. In addition, we have agreed that the Bank will not, without the FRB and the CDBO's prior written approval, pay any dividends to Bancorp. Accordingly, we do not expect to pay dividends or make share repurchases for the foreseeable future.

The principal source of cash available to a bank holding company consists of cash dividends from its bank subsidiaries. There are currently several restrictions on the Bank's ability to pay us cash dividends. Government regulations, including the laws of the State of California, as they pertain to the payment of cash dividends by California state chartered banks, limits the amount of funds that the Bank is permitted to dividend to us. Further, Section 23(a) of the Federal Reserve Act limits the amounts that a bank may loan to its bank holding company to an aggregate of no more than 10% of the bank subsidiary's capital surplus and retained earnings and requires that such loans be secured by specified assets of the bank holding company. We have committed to obtaining approval from the FRB and the CDBO prior to Bancorp paying any dividends, or making any distributions representing interest, principal or other sums on subordinated debentures or trust preferred securities. There can be no assurance that our regulators will approve such payments or dividends in the future. Refer to "Supervision and Regulation" above in Item 1 and *Note 14, Shareholders' Equity* in the notes to our consolidated financial statements for more detail regarding the regulatory restrictions on our and the Bank's ability to pay dividends.

Table of Contents

Off Balance Sheet Arrangements

Loan Commitments and Standby Letters of Credit. To meet the financing needs of our customers in the normal course of business, we are a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At December 31, 2018 and 2017, we were committed to fund certain loans including letters of credit amounting to approximately \$302 million and \$295 million, respectively.

Commitments to extend credit and standby letters of credit generally have fixed expiration dates or other termination clauses and the customer may be required to pay a fee and meet other conditions in order to draw on those commitments or standby letters of credit. We expect, based on historical experience, that many of the commitments will expire without being drawn upon and, therefore, the total commitment amounts do not necessarily represent future cash requirements.

To varying degrees, commitments to extend credit involve elements of credit and interest rate risk for us that are in excess of the amounts recognized in our balance sheets. Our maximum exposure to credit loss in the event of nonperformance by the customers to whom such commitments are made could potentially be equal to the amount of those commitments. As a result, before making such a commitment to a customer, we evaluate the customer's creditworthiness using the same underwriting standards that we would apply if we were approving loans to the customer. In addition, we often require the customer to secure its payment obligations for amounts drawn on such commitments with collateral such as accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, residential properties and properties under construction. As a consequence, our exposure to credit and interest rate risk on such commitments is not different in character or amount than risks inherent in the outstanding loans in our loan portfolio.

Standby letters of credit are conditional commitments issued by the Bank to guarantee a payment obligation of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

Contractual Obligations

The following table summarizes the contractual obligations as of December 31, 2018:

	Maturity/Obligation by Period				
	Total	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
	<i>(Dollars in thousands)</i>				
Deposits	\$ 1,136,002	\$ 1,092,111	\$ 31,711	\$ 12,180	\$ —
FHLB Borrowings	40,000	40,000	—	—	—
Junior Subordinated Debentures	17,527	—	—	—	17,527
Operating Leases	4,657	2,398	1,589	670	—
Total	\$ 1,198,186	\$ 1,134,509	\$ 33,300	\$ 12,850	\$ 17,527

The table above excludes unrecognized tax benefits because we are unable to reasonably estimate the period during which these obligations may be incurred, if at all.

FHLB Borrowings. As of December 31, 2018, we had \$40.0 million of outstanding borrowings obtained from the FHLB. The table below sets forth the amounts of, the interest rates we pay on, and the maturity dates of these FHLB borrowings. These borrowings had a weighted-average annualized interest rate of 2.54% for the year ended December 31, 2018.

Principal Amounts	Interest Rate	Maturity Dates
	<i>(Dollars in thousands)</i>	
10,000	2.31%	January 15, 2019
10,000	2.55%	March 4, 2019
10,000	2.66%	May 28, 2019
10,000	2.65%	June 26, 2019

At December 31, 2018, \$807 million of loans were pledged to secure our FHLB borrowings and to support our unfunded borrowing capacity. At December 31, 2018, we had unused borrowing capacity of \$365 million with the FHLB.

Table of Contents

The highest amount of borrowings outstanding at any month-end during the year ended December 31, 2018 was \$40.9 million, which consisted primarily of borrowings from the FHLB. By comparison, the highest amount of borrowings outstanding at any month end in 2017 consisted primarily of \$40.9 million of borrowings from the FHLB.

Junior Subordinated Debentures. Pursuant to rulings of the FRB, bank holding companies were permitted to issue long term subordinated debt instruments that, subject to certain conditions, would qualify as and, therefore, augment capital for regulatory purposes. At December 31, 2018, we had outstanding approximately \$17.5 million principal amount of the Debentures.

Set forth below is certain information regarding the Debentures:

<u>Original Issue Dates</u>	<u>Principal Amount</u>	<u>Interest Rates</u>	<u>Maturity Dates</u>
September 2002	\$ 7,217	LIBOR plus 3.40%	September 2032
October 2004	10,310	LIBOR plus 2.00%	October 2034
Total	\$ 17,527		

(1) Subject to the receipt of prior regulatory approval, we may redeem the Debentures, in whole or in part, without premium or penalty, at any time prior to maturity.

These Debentures require quarterly interest payments, which are used to make quarterly distributions required to be paid on the corresponding trust preferred securities. Subject to certain conditions, we have the right, at our discretion, to defer those interest payments, and the corresponding distributions on the trust preferred securities, for up to five years. Exercise of this deferral right does not constitute a default of our obligations to pay the interest on the Debentures or the corresponding distributions that are payable on the trust preferred securities. As of December 31, 2018, we were current on all interest payments. We have committed to obtaining approval from the FRB and the CDBO prior to making any distributions representing interest, principal or other sums on subordinated debentures or trust preferred securities. There can be no assurance that our regulators will approve such payments in the future.

Operating Lease Obligations. We lease certain facilities and equipment under various non-cancelable operating leases, which include escalation clauses ranging between 2% and 6% per annum. Future minimum non-cancelable lease commitments, were as follows:

	<u>At December 31, 2018</u>
	<u>(Dollars in thousands)</u>
2019	\$ 2,398
2020	1,242
2021	347
2022	218
2023 and beyond	452
Total	\$ 4,657

Maturing Time Certificates of Deposits. Set forth below is a maturity schedule, as of December 31, 2018, of time certificates of deposit of \$100,000 or more:

	<u>At December 31, 2018</u>
	<u>(In thousands)</u>
2019	\$ 205,034
2020	26,333
2021	1,647
2022	9,545
2023 and beyond	1,656
Total	\$ 244,215

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) and general practices in the banking industry. Certain of those accounting policies are considered critical accounting policies, because they require us to make assumptions and judgments regarding circumstances or trends that could

Table of Contents

affect the carrying value of our material assets, such as, for example, assumptions regarding economic conditions or trends that could impact our ability to fully collect our loans or ultimately realize the carrying value of certain of our other assets, such as securities available for sale and our deferred tax asset. Those assumptions and judgments are based on current information available to us regarding those economic conditions or trends or other circumstances. If adverse changes were to occur in the conditions, trends or other events on which our assumptions or judgments had been based, then under GAAP it could become necessary for us to reduce the carrying values of any affected assets on our balance sheet. In addition, because reductions in the carrying value of assets are sometimes effectuated by or require charges to income, such reductions also may have the effect of reducing our income.

Our critical accounting policies consist of the accounting policies and practices we follow in determining (i) the sufficiency of the allowance we establish for loan and lease losses, (ii) the fair values of our investment securities available for sale and financial instruments, and (iii) the amount of our deferred tax asset, consisting primarily of tax loss carryforwards and tax credits that we believe will be able to offset income taxes in future periods.

Allowance for Loan and Lease Losses. We maintain reserves to provide for loan and lease losses that occur in the ordinary course of the banking business. When it is determined that the payment in full of a loan has become unlikely, the carrying value of the loan is reduced ("written down") to what management believes is its realizable value or, if it is determined that a loan no longer has any realizable value, the carrying value of the loan is written off in its entirety (a loan "charge-off"). Loan charge-offs and write-downs are charged against our ALLL. The amount of the ALLL is increased periodically to replenish the ALLL after it has been reduced due to loan write-downs or charge-offs. The ALLL also is increased or decreased periodically to reflect increases or decreases in the volume of outstanding loans and to take account of changes in the risk of potential loan losses due to a deterioration or improvement in the condition of borrowers or in the value of properties securing non-performing loans or adverse changes or improvements in economic conditions. Increases in the ALLL are made through a charge, recorded as an expense in the statement of operations, referred to as the "provision for loan and lease losses." Recoveries of loans previously charged-off are added back to and, therefore, to that extent increase the ALLL and reduce the amount of the provision for loan losses that might otherwise have had to be made to replenish or increase the ALLL. See "—Financial Condition—Nonperforming Loans and the Allowance for Loan and Lease Losses" above in this Item 7 for additional information regarding the ALLL.

Fair Value of Securities Available for Sale. Under applicable accounting principles, we are required to recognize any unrealized loss or gain on the securities we hold for sale. An unrealized gain occurs when the fair value of a security available for sale increases above its amortized cost as recorded on our balance sheet. An unrealized loss occurs when the fair value of a security available for sale declines below its amortized cost as recorded on our balance sheet. As a result, we make determinations, on a quarterly basis, of the fair values of the securities available for sale in order to determine if there are any unrealized losses in those securities. When there is an active market for such a security, the determination of its fair value is based on market prices. If there is no active trading market, but such securities do trade from time to time, we rely primarily on quotes we obtain from third party vendors and securities brokers to determine the fair values of those securities. However, quotes are not always available for some securities and, in those instances, we make those fair value determinations on the basis of a variety of industry standard pricing methodologies, such as discounted cash flow analyses, matrix pricing, and option adjusted spread models, as well as fundamental analysis of the creditworthiness of the obligors under those securities. These methodologies require us to make various assumptions relating to such matters as future prepayment speeds, yield, duration, Federal Reserve Board monetary policies and the supply and demand for the individual securities. Consequently, if changes were to occur in market or other conditions or the circumstances on which our earlier assumptions or judgments were based, it could become necessary for us to reduce the fair values of such securities, which would result in charges to accumulated other comprehensive income (loss) on our balance sheet. Moreover, if we conclude that reductions in the fair values of any securities are other than temporary, it would be necessary for us to recognize an impairment loss to noninterest income in our statement of operations.

Fair Value of Financial Instruments. ASC 820-10-35 defines fair value, establishes a framework for measuring fair value and outlines a fair value hierarchy based on the inputs to valuation techniques used to measure fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (also referred to as an exit price). Fair value measurements are categorized into a three-level hierarchy based on the extent to which the measurement relies on observable market inputs in measuring fair value. Level 1, which is the highest priority in the fair value hierarchy, is based on unadjusted quoted prices in active markets for identical assets or liabilities. Level 2 is based upon quoted prices in active markets for identical assets or liabilities. Level 3, which is the lowest priority in the fair value hierarchy, is based on unobservable inputs. Assets and liabilities are classified within this hierarchy in their entirety based on the lowest level of any input that is significant to the fair value measurement.

The use of fair value to measure our financial instruments is fundamental to our financial statements and is a critical accounting estimate because a substantial portion of our mortgage banking assets and liabilities (included in discontinued operations) are recorded at estimated fair value. Financial instruments classified as Level 3 are generally based on unobservable inputs, and the process to determine fair value is generally more subjective and involves a high degree of management judgment

Table of Contents

and assumptions. These assumptions may have a significant effect on our estimates of fair value, and the use of different assumptions, as well as changes in market conditions and interest rates, could have a material effect on our results of operations or financial condition.

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As an accelerated filer subject to the smaller reporting company disclosure requirements we are not required to provide the information required by this item.

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of
Pacific Mercantile Bancorp

Opinion on the Internal Control Over Financial Reporting

We have audited Pacific Mercantile Bancorp and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated statements of financial condition of the Company as of December 31, 2018 and 2017, the related consolidated statements of operations, comprehensive income (loss), shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes to the consolidated financial statements, and our report dated March 11, 2019, expressed an unqualified opinion.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ RSM US LLP

Irvine, CA
March 11, 2019

Table of Contents

ITEM 8. FINANCIAL STATEMENTS

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	<u>Page No.</u>
<u>Report of Independent Registered Public Accounting Firm</u>	<u>55</u>
<u>Consolidated Statements of Financial Condition as of December 31, 2018 and 2017</u>	<u>56</u>
<u>Consolidated Statements of Operations for the years ended December 31, 2018, 2017 and 2016</u>	<u>57</u>
<u>Consolidated Statements of Comprehensive Income (Loss) for the years ended December 31, 2018, 2017 and 2016</u>	<u>58</u>
<u>Consolidated Statement of Shareholders' Equity for the years ended December 31, 2018, 2017 and 2016</u>	<u>59</u>
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2018, 2017 and 2016</u>	<u>60</u>
<u>Notes to Consolidated Financial Statements</u>	<u>62</u>

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of
Pacific Mercantile Bancorp

Opinion on the Financial Statements

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

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 11, 2019, expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

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

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ RSM US LLP

We have served as the Company's auditor since 2014.

Irvine, CA
March 11, 2019

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Dollars in thousands, except for per share data)

	December 31,	
	2018	2017
ASSETS		
Cash and due from banks	\$ 13,250	\$ 12,198
Interest bearing deposits with financial institutions	174,468	186,010
Cash and cash equivalents	187,718	198,208
Interest-bearing time deposits with financial institutions	2,420	2,920
Federal Reserve Bank of San Francisco and Federal Home Loan Bank Stock, at cost	8,822	8,107
Securities available for sale, at fair value	31,231	39,738
Loans (net of allowances of \$13,506 and \$14,196, respectively)	1,083,240	1,053,201
Other real estate owned	1,173	—
Accrued interest receivable	4,003	3,872
Premises and equipment, net	1,039	1,094
Net deferred tax assets	10,935	—
Other assets	18,757	15,464
Total assets	\$ 1,349,338	\$ 1,322,604
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	\$ 340,406	\$ 338,273
Interest-bearing	795,596	801,120
Total deposits	1,136,002	1,139,393
Borrowings	40,000	40,866
Accrued interest payable	361	397
Other liabilities	14,074	11,545
Junior subordinated debentures	17,527	17,527
Total liabilities	1,207,964	1,209,728
Commitments and contingencies (Note 15)		
Shareholders' equity:		
Preferred stock, no par value, 1,467,155 shares authorized:		
Series A Non-Voting Preferred Stock, no par value, 1,467,155 shares authorized at December 31, 2018 and 0 shares authorized at December 31, 2017; 1,467,155 shares issued and outstanding at December 31, 2018 and 0 shares issued and outstanding at December 31, 2017	8,480	—
Common stock, no par value, 85,000,000 shares authorized; 21,916,195 and 23,232,515 shares issued and outstanding at December 31, 2018 and December 31, 2017, respectively	143,466	150,689
Accumulated deficit	(9,428)	(36,670)
Accumulated other comprehensive loss	(1,144)	(1,143)
Total shareholders' equity	141,374	112,876
Total liabilities and shareholders' equity	\$ 1,349,338	\$ 1,322,604

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

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except for per share data)

	Year Ended December 31,		
	2018	2017	2016
Interest income:			
Loans, including fees	\$ 57,626	\$ 48,957	\$ 38,580
Securities available for sale and stock	1,160	1,237	1,578
Interest-bearing deposits with financial institutions	3,756	1,379	842
Total interest income	62,542	51,573	41,000
Interest expense:			
Deposits	12,070	6,958	4,820
Borrowings	1,550	873	657
Total interest expense	13,620	7,831	5,477
Net interest income	48,922	43,742	35,523
Provision for loan and lease losses	—	—	19,870
Net interest income after provision for loan and lease losses	48,922	43,742	15,653
Noninterest income			
Service fees on deposits and other banking services	1,549	1,347	1,093
Net gain (loss) on sale of securities available for sale	48	(4)	—
Net gain on sale of small business administration loans	—	—	40
Net loss on sale of other assets	(4)	(37)	(527)
Other noninterest income	3,042	3,068	2,331
Total noninterest income	4,635	4,374	2,937
Noninterest expense			
Salaries and employee benefits	23,749	22,977	21,817
Occupancy	2,388	2,605	3,061
Equipment and depreciation	1,802	1,687	1,802
Data processing	1,681	1,479	1,271
FDIC expense	927	1,073	950
Other real estate owned expense, net	123	—	(70)
Professional fees	2,468	4,215	4,046
Business development	946	729	795
Loan related expense	769	456	375
Insurance	248	221	291
Other operating expense	1,869	2,316	2,063
Total noninterest expense	36,970	37,758	36,401
Income before income taxes	16,587	10,358	(17,811)
Income tax (benefit) provision	(10,752)	(91)	16,832
Net income (loss) allocable to common shareholders	\$ 27,339	\$ 10,449	\$ (34,643)
Basic income (loss) per common share:			
Net income (loss) allocable to common shareholders	\$ 1.17	\$ 0.45	\$ (1.51)
Diluted income (loss) per common share:			
Net income (loss) allocable to common shareholders	\$ 1.16	\$ 0.45	\$ (1.51)
Weighted average number of common shares outstanding:			
Basic	22,788,164	23,071,671	22,802,439
Diluted	23,527,183	23,312,292	22,958,644

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

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)
(Dollars in thousands)

	<u>Year Ended December 31,</u>		
	<u>2018</u>	<u>2017</u>	<u>2016</u>
Net income (loss)	\$ 27,339	\$ 10,449	\$ (34,643)
Other comprehensive (loss) income, net of tax:			
Change in unrealized holding (loss) gain on securities available for sale	(50)	695	(1,032)
Less: Reclassification adjustment for change in accounting principle	(97)	—	—
Less: Reclassification adjustment for net gains (losses) included in net income	48	(4)	—
Net unrealized holding (loss) gain on securities available for sale	(1)	699	(1,032)
Total comprehensive income (loss)	<u>\$ 27,338</u>	<u>\$ 11,148</u>	<u>\$ (35,675)</u>

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

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Shares and dollars in thousands)

For the Three Years Ended December 31, 2018

	Series A Non-Voting Preferred stock		Common stock		Retained earnings (accumulated deficit)	Accumulated other comprehensive income (loss)	Total
	Number of shares	Amount	Number of shares	Amount			
Balance at December 31, 2015	—	\$ —	22,820	\$ 147,202	\$ (12,476)	\$ (810)	\$ 133,916
Issuance of restricted stock, net			90				—
Tax effect from vesting of restricted stock			(2)	(16)			(16)
Common stock based compensation expense	—	—	—	1,039	—	—	1,039
Common stock options exercised	—	—	97	455	—	—	455
Net loss	—	—	—	—	(34,643)	—	(34,643)
Other comprehensive loss	—	—	—	—	—	(1,032)	(1,032)
Balance at December 31, 2016	—	\$ —	23,005	\$ 148,680	\$ (47,119)	\$ (1,842)	\$ 99,719
Issuance of restricted stock, net	—	—	22	—	—	—	—
Common Stock based compensation expense	—	—	—	796	—	—	796
Common stock options exercised	—	—	206	1,213	—	—	1,213
Net income	—	—	—	—	10,449	—	10,449
Other comprehensive income	—	—	—	—	—	699	699
Balance at December 31, 2017	—	\$ —	23,233	\$ 150,689	\$ (36,670)	\$ (1,143)	\$ 112,876
Exchange of common stock for Series A Non-Voting Preferred Stock	1,467	8,480	(1,467)	(8,480)	—	—	—
Implementation of ASU 2016-01	—	—	—	—	(97)	—	(97)
Issuance of restricted stock, net	—	—	75	—	—	—	—
Common stock based compensation expense	—	—	—	885	—	—	885
Common stock options exercised	—	—	75	372	—	—	372
Net income	—	—	—	—	27,339	—	27,339
Other comprehensive loss	—	—	—	—	—	(1)	(1)
Balance at December 31, 2018	1,467	\$ 8,480	21,916	\$ 143,466	\$ (9,428)	\$ (1,144)	\$ 141,374

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

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOW
(Dollars in thousands)

	Year Ended December 31,		
	2018	2017	2016
Cash Flows From Operating Activities:			
Net income (loss)	\$ 27,339	\$ 10,449	\$ (34,643)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	405	428	485
Provision for loan and lease losses	—	—	19,870
Amortization of premium on securities	179	221	283
Net (gain) loss on sale of securities available for sale	(48)	4	—
Other	59	—	—
Net amortization of deferred fees and unearned income on loans	50	(388)	(349)
Net gain on sales of other real estate owned	(29)	—	(107)
Net gain on sale of premises and equipment	—	(2)	—
Net loss on sale of other assets	4	37	527
Net gain on sale of small business administration loans	—	—	(40)
Small business administration loan originations	—	—	(806)
Proceeds from sale of small business administration loans	—	—	840
Write down of other real estate owned	102	—	—
Stock-based compensation expense	885	796	1,039
Tax effect of restricted stock vesting	—	—	(16)
Changes in operating assets and liabilities:			
Net increase in accrued interest receivable	(131)	(1,170)	(436)
Net (increase) decrease in other assets	(3,193)	(4,376)	144
Net (increase) decrease in deferred taxes	(11,077)	—	16,837
Net decrease (increase) in income taxes receivable	226	(215)	681
Net (decrease) increase in accrued interest payable	(36)	196	(54)
Net increase in other liabilities	2,529	4,603	91
Net cash provided by operating activities	17,264	10,583	4,346
Cash Flows From Investing Activities:			
Net decrease in interest-bearing time deposits with financial institutions	500	749	996
Maturities of and principal payments received on securities available for sale and other stock	5,978	7,247	8,193
Purchase of securities available for sale and other stock	(5,215)	(3,350)	—
Proceeds from sale of securities available for sale and other stock	6,883	382	—
Principal payments received on other investments	17	—	—
Purchase of other investments	(364)	(227)	(385)
Proceeds from sale of other real estate owned	827	—	757
Net increase in loans	(32,316)	(120,205)	(101,331)
Proceeds from sale of other assets	32	141	33
Purchases of premises and equipment	(350)	(265)	(600)
Proceeds from sale of premises and equipment	—	2	—
Net cash used in investing activities	(24,008)	(115,526)	(92,337)
Cash Flows From Financing Activities:			
Net (decrease) increase in deposits	(3,391)	138,093	107,460
Proceeds from borrowings	71,000	70,000	15,000
Payments of borrowings	(71,727)	(45,000)	(10,000)
Proceeds from exercise of common stock options	372	1,213	455
Net cash (used in) provided by financing activities	(3,746)	164,306	112,915
Net (decrease) increase in cash and cash equivalents	(10,490)	59,363	24,924
Cash and Cash Equivalents, beginning of period	198,208	138,845	113,921

Cash and Cash Equivalents, end of period	\$ 187,718	\$ 198,208	\$ 138,845
Supplementary Cash Flow Information:			
Cash paid for interest on deposits and other borrowings	\$ 13,656	\$ 7,635	\$ 5,531
Cash paid for income taxes	\$ 99	\$ 123	\$ 12

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

Table of Contents

(Dollars in thousands)

	Year Ended December 31,		
	2018	2017	2016
Non-Cash Investing Activities:			
Transfer of loans into other real estate owned	\$ 1,346	\$ —	\$ —
Transfer of loans into other assets	\$ 15	\$ 217	\$ —
Participation sold accounted for as other borrowings	\$ —	\$ 866	\$ —
Impact of change in accounting principle	\$ 97	\$ —	\$ —
Assumption of debt upon foreclosure of property	\$ 727	\$ —	\$ —
Non-Cash Financing Activities:			
Exchange of common stock for preferred stock	\$ 8,480	\$ —	\$ —

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

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. Nature of Business

Organization

Pacific Mercantile Bancorp (“PMBC”) is a bank holding company which, through its wholly owned subsidiary, Pacific Mercantile Bank (the “Bank”), is engaged in the commercial banking business in Southern California. PMBC is registered as a one bank holding company under the United States Bank Holding Company Act of 1956, as amended, and, as such, is regulated by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) and the Federal Reserve Bank of San Francisco (“FRBSF”) under delegated authority from the Federal Reserve Board. Substantially all of our operations are conducted and substantially all of our assets are owned by the Bank, which accounts for substantially all of our consolidated revenues, expenses, and income. The Bank provides a full range of banking services to small and medium-size businesses and professionals primarily in Orange, Los Angeles, San Bernardino and San Diego counties in Southern California and is subject to competition from, among other things, other banks and financial institutions and from financial services organizations conducting operations in those same markets. The Bank is chartered by the California Department of Business Oversight under the Division of Financial Institutions and is a member of the FRBSF. In addition, the deposit accounts of the Bank’s customers are insured by the Federal Deposit Insurance Corporation (“FDIC”) up to the maximum amount allowed by law.

During the third quarter of 2018, PMBC dissolved its wholly-owned subsidiary, PM Asset Resolution, Inc. (“PMAR”), which was established for the purpose of purchasing certain non-performing loans and other real estate from the Bank and thereafter collecting or disposing of those assets. Prior to PMAR being dissolved, all assets were liquidated and returned to PMBC.

PMBC, the Bank and PMAR are sometimes referred to, together, on a consolidated basis, as the “Company” or as “we”, “us” or “our”.

2. Significant Accounting Policies

The accompanying consolidated financial statements have been prepared in accordance with the instructions of the U.S. Securities and Exchange Commission (the “SEC”) to Form 10-K and in accordance with generally accepted accounting principles in effect in the United States (“GAAP”), on a basis consistent with prior periods.

Use of Estimates

The preparation of the financial statements in conformity with GAAP requires us to make certain estimates and assumptions that could affect the reported amounts of certain of our assets, liabilities, and contingencies at the date of the financial statements and the reported amounts of our revenues and expenses during the reporting periods. Material estimates that are particularly susceptible to changes in the near term relate primarily to our determinations of the allowance for loan and lease losses (“ALLL”), the fair values of securities available for sale, and the determination of a valuation allowance pertaining to deferred tax assets. If circumstances or financial trends on which those estimates were based were to change in the future or there were to occur any currently unanticipated events affecting the amounts of those estimates, our future financial position or results of operations could differ, possibly materially, from those expected at the current time.

Principles of Consolidation

Our consolidated financial statements for the years ended December 31, 2018, 2017 and 2016 include the accounts of PMBC, the Bank and PMAR. All significant intercompany balances and transactions were eliminated in consolidation.

Cash and Cash Equivalents

For purposes of the statements of cash flow, cash and cash equivalents consist of cash and due from banks, interest bearing demand deposits with the FRBSF, federal funds sold and interest-bearing deposits, with original maturities of 90 days or less, with financial institutions. Generally, federal funds are sold for one-day periods. As of December 31, 2018 and 2017, the Bank maintained required reserves with FRBSF of approximately \$727,000 and \$1,175,000, respectively, which are included in cash and due from banks in the accompanying consolidated statements of financial condition.

Federal Home Loan Bank Stock and Federal Reserve Bank Stock

The Bank, as a member of the Federal Home Loan Bank System, is required to maintain an investment in capital stock of the Federal Home Loan Bank of San Francisco (“FHLB”) in varying amounts based on asset size and on amounts borrowed from the FHLB. Because no ready market exists and there is no quoted market value for this stock, the Bank’s investment in this stock is carried at cost.

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The Bank also maintains an investment in capital stock of the FRBSF, which is carried at cost because no ready market exists and there is no quoted market value for this stock.

Securities Available for Sale, at Fair Value

Securities available for sale are those which we intend to hold for an indefinite period of time, but which may be sold in response to changes in liquidity needs, changes in interest rates, changes in prepayment risks and other similar factors. These securities are recorded at fair value, with unrealized gains and losses excluded from earnings and reported as other comprehensive income or loss, net of taxes. Purchased premiums and discounts are recognized as interest income using the interest method over the term of these securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Declines in the fair value of these securities below their cost which are other-than-temporary are reflected in earnings as realized losses. In determining other-than-temporary losses, we consider a number of factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether we have the intent to sell the security or it is more likely than not that we will be required to sell the security before its anticipated recovery. A high degree of subjectivity and judgment is involved in assessing whether an other-than-temporary decline exists and such assessments are based on information available to us at the time we make such assessments. We recognize other-than-temporary impairments ("OTTI") to our available-for-sale debt securities in accordance with FASB ASC 320-10. When there are credit losses associated with, but we have no intention to sell, an impaired debt security, and it is more likely than not that we will not have to sell the security before recovery of its cost basis, we will separate the amount of impairment, or OTTI, between the amount that is credit-related and the amount that is related to non-credit factors. Credit-related impairments are recognized in our consolidated statements of operations. Any non-credit-related impairments are recognized and reflected in other comprehensive income in our consolidated statements of financial condition.

Loans and Allowance for Loan and Lease Losses

Loans that we intend and have the ability to hold for the foreseeable future or until maturity or pay-off are stated at their respective principal amounts outstanding, net of unearned income. Interest is accrued daily as earned, except where reasonable doubt exists as to collectability of the loan. A loan with principal or interest that is 90 days or more past due, based on its contractual payment due dates, is placed on nonaccrual status, in which case accrual of interest is discontinued, except that we may elect to continue the accrual of interest when the estimated net realizable value of collateral securing the loan is expected to be sufficient to enable us to recover both principal and accrued interest and those loans are in the process of collection. Generally, interest payments received on nonaccrual loans are applied to principal. Once all principal has been received by us, any additional interest payments are recognized as interest income on a cash basis.

An ALLL is established by means of a provision for loan and lease losses that is charged against income. If we conclude that the collection, in full, of the carrying amount of a loan has become unlikely, the loan, or the portion thereof that is believed to be uncollectible, is charged against the ALLL. We carefully monitor changing economic conditions, the loan portfolio by category, the financial condition of borrowers and the history of the performance of the loan portfolio in determining the adequacy of the ALLL. Additionally, as the volume of loans increases, additional provisions for loan losses may be required to maintain the allowance at levels deemed adequate. Moreover, if economic conditions were to deteriorate, causing the risk of loan losses to increase, it would become necessary to increase the allowance to an even greater extent, which would necessitate additional provisions that would be charged to income. We also evaluate the unfunded portion of loan commitments and establish a loss reserve, included in other liabilities, for such unfunded commitments through a charge against noninterest expense. The loss reserve for unfunded loan commitments was \$350,000 at December 31, 2018 and 2017.

The ALLL is based on estimates, and ultimate loan losses may vary from current estimates. These estimates are reviewed periodically and, as adjustments become necessary, they are recorded in earnings in the periods in which they become known.

Impaired Loans

A loan is generally classified as impaired when, in management's opinion, the principal or interest will not be collectible in accordance with its contractual terms. We measure and reserve for impairment on a loan-by-loan basis using either the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the loan is collateral dependent. We exclude smaller, homogeneous loans, such as consumer installment loans and lines of credit, from these impairment calculations. Also, loans that experience insignificant payment delays or shortfalls are generally not considered impaired.

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Restructured Loans

We sometimes modify or restructure loans when the borrower is experiencing financial difficulties by making a concession to the borrower in the form of changes in the amortization terms, reductions in the interest rates, the acceptance of interest only payments and, in limited cases, concessions to the outstanding loan balances. These loans are classified as troubled debt restructurings (“TDRs”) and considered impaired loans. TDRs are loans modified for the purpose of alleviating temporary impairments to the borrower’s financial condition or cash flows. A workout plan between us and the borrower is designed to provide a bridge for borrower cash flow shortfalls in the near term. A TDR loan may be returned to accrual status when the loan is brought current, has performed in accordance with the contractual restructured terms for a time frame of at least six months and the ultimate collectability of the total contractual restructured principal and interest is no longer in doubt. These loans, while no longer considered a TDR, are still considered impaired loans.

Loan Origination Fees and Costs

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

Investment in Unconsolidated Subsidiaries

Investment in unconsolidated subsidiaries is stated at cost. The unconsolidated subsidiaries are comprised of two grantor trusts established in 2002 and 2004 in connection with our issuance of subordinated debentures in each of those years. Prior to 2004, we organized two business trusts, under the names PMB Statutory Trust III and PMB Capital Trust III, to facilitate our issuance of \$7.2 million and \$10.3 million, respectively, principal amount of junior subordinated debentures with maturity dates in 2032 and 2034, respectively. The principal amounts remain outstanding as of December 31, 2018.

Other Real Estate Owned

Other real estate owned (“OREO”) consists of real properties acquired by us through foreclosure or in lieu of foreclosure in satisfaction of loans. OREO is recorded at fair value less estimated selling costs at the time of acquisition or foreclosure. Loan balances in excess of fair value, less selling costs, are charged to the ALLL prior to foreclosure. Any subsequent operating expenses or income, reductions in estimated fair values and gains or losses on disposition of such properties are charged or credited to current operations.

Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation and amortization which are charged to expense on a straight-line basis over the estimated useful lives of the assets or, in the case of leasehold improvements, over the term of the leases, whichever is shorter. For income tax purposes, accelerated depreciation methods are used. Maintenance and repairs are charged directly to expense as incurred. Improvements to premises and equipment that extend their useful lives are capitalized.

When such an asset is disposed of, the applicable costs and accumulated depreciation thereon are removed from the accounts and any resulting gain or loss is included in current operations. Rates of depreciation and amortization are based on the following estimated useful lives:

Furniture and equipment	Three to seven years
Leasehold improvements	Lesser of the lease term or estimated useful life

Income Taxes

Deferred income taxes and liabilities are determined using the asset and liability method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax basis of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

We record as a deferred tax asset on our balance sheet an amount equal to the tax credit and tax loss carryforwards and tax deductions (“tax benefits”) that we believe will be available to us to offset or reduce the amount of our income taxes in future periods. Under applicable federal and state income tax laws and regulations, such tax benefits will expire if not used within specified periods of time. Accordingly, the ability to fully use our deferred tax asset depends on the amount of taxable income that we generate during those time periods. At least once each year, or more frequently, if warranted, we make estimates of future taxable income that we believe we are likely to generate during those future periods. If we conclude, on the basis of those estimates and

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

the amount of the tax benefits available to us, that it is more likely than not that we will be able to fully utilize those tax benefits prior to their expiration, we recognize the deferred tax asset in full on our balance sheet. On the other hand, if we conclude on the basis of those estimates and the amount of the tax benefits available to us that it has become more likely than not that we will be unable to utilize those tax benefits in full prior to their expiration, then, we would establish (or increase any existing) valuation allowance to reduce the deferred tax asset on our balance sheet to the amount which we believe we are more likely than not to be able to utilize. Such a reduction is implemented by recognizing a non-cash charge that would have the effect of increasing the provision, or reducing any credit, for income taxes that we would otherwise have recorded in our statement of operations. The determination of whether and the extent to which we will be able to utilize our deferred tax asset involves significant management judgments and assumptions that are subject to period to period changes as a result of changes in tax laws, changes in market or economic conditions that could affect our operating results or variances between our actual operating results and our projected operating results, as well as other factors.

Uncertain tax positions that meet the more likely than not recognition threshold are measured to determine the amount of benefit to recognize. An uncertain tax position is measured at the largest amount of benefit that management believes has a greater than 50% likelihood of realization upon settlement.

Earnings (Loss) Per Share

Basic income (loss) per share for any fiscal period is computed by dividing net income (loss) allocable to our common shareholders for such period by the weighted average number of common shares outstanding during that period. Fully diluted income (loss) per share reflects the potential dilution that could have occurred assuming the conversion of any convertible securities into common stock at conversion prices, and the exercise of all outstanding options and warrants to purchase shares of our common stock at exercise prices, that were less than the market price of our shares, thereby increasing the number of shares outstanding during the period, and is determined using the treasury method. Although accumulated undeclared dividends on our preferred stock are not recorded in the accompanying consolidated statement of operations, such dividends are included for purposes of computing earnings (loss) per share available to our common shareholders.

Stock Option Plans

We follow Financial Accounting Standards Board (“FASB”) Accounting Standard Codification (“ASC”) 718-10, *Share-Based Payment*, which requires entities that grant stock options or other equity compensation awards to employees to recognize in their financial statements the fair values of those options or share awards as compensation cost over their requisite service (vesting) periods of those options or share awards. Since stock-based compensation cost that is recognized in the statements of operations is to be determined based on the equity compensation awards that we expect will ultimately vest, that compensation expense is reduced for any forfeitures of unvested options or unvested share awards that typically occur due primarily to terminations of employment of optionees or recipients of such share awards. In accordance with Accounting Standard Update (“ASU”) 2016-09, forfeitures are recognized as they occur instead of applying an estimated forfeiture rate to each grant, which was the previous practice. For purposes of the determination of stock-based compensation expense for the year ended December 31, 2018, we recognized actual forfeitures of 7,150 and 6,490 shares subject to the stock option and restricted stock awards that were granted to officers and other employees, respectively.

Comprehensive Income (Loss)

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. However, certain changes in assets and liabilities, such as unrealized gains and losses on securities available for sale, are reported as a separate component of the equity in the accompanying consolidated statement of financial condition, net of income taxes, and such items, along with net income, are components of comprehensive income (loss).

Segment Reporting

During the years ended December 31, 2018, 2017 and 2016, we had one reportable segment, which was our commercial banking division, and one non-reportable segment which was our discontinued operations related to our mortgage banking division. In connection with our exit from the mortgage banking business in 2013, the revenues and expenses of our mortgage banking division have been classified as discontinued operations for all periods presented.

Recent Accounting Pronouncements

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “*Revenue from Contracts with Customers (Topic 606)*,” which amended its guidance on revenue recognition to conform with international accounting guidance under the International Accounting Standards Board. The ASU provides a framework for addressing revenue recognition and replaces most existing revenue recognition guidance, as well as requires increased disclosure requirements. In August 2015, the FASB issued ASU 2015-14 to defer the effective date of ASU 2014-09 by one year. Accordingly, this guidance is effective for interim and annual periods beginning after December 15, 2017 with early adoption permitted for interim and annual periods beginning after December 15, 2016. We adopted this guidance on January 1, 2018 using the modified retrospective approach. Adoption of this guidance did not have a significant impact on our financial statements as the accounting for interest income on loans and investments, loan service fee income, prepayment fees, and loan origination fees are excluded from the scope of this standard. Upon implementation of this guidance, the cumulative effect of any adjustments was deemed immaterial and thus not significant. As such, the expanded disclosures required by the guidance, including the disaggregated revenue disclosures, were not deemed necessary since interest income sources are scoped out and there are no additional significant sources of non-interest income to be broken out on the consolidated statement of operations.

In January 2016, the FASB issued ASU 2016-01, “*Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*,” which enhances the reporting model for financial instruments to provide users of financial statements with more useful information. Some of the provisions include: requiring equity investments to be measured at fair value with changes in fair value recognized in net income, simplifying the impairment assessment of equity investments without readily determinable fair values, eliminating the requirement to disclose the method and significant assumptions used to estimate fair value on financial instruments measured at amortized cost on the balance sheet, requiring public business entities to use the exit price notion when measuring the fair value of financial instruments, requiring the reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option, requiring separate presentation of financial assets and liabilities by measurement category and form of financial asset on the balance sheet or notes to the financial statements, and clarifying that the reporting organization should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the organization's other deferred tax assets. This guidance is effective for interim and annual periods beginning after December 15, 2017. Early adoption was not permitted for public companies. We adopted this guidance on January 1, 2018. We recorded a \$97 thousand adjustment to our beginning retained earnings upon adoption of this guidance as we had one available-for-sale equity investment where the change in fair value is currently recognized in net income, as compared to the previous practice of flowing through changes in fair value to other comprehensive income. This investment was sold during the three months ended March 31, 2018, which limited the impact of this accounting change on our consolidated financial statements and on our disclosures related to investments.

In February 2016, the FASB issued ASU 2016-02, “*Leases (Topic 842)*,” which requires lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: a lease liability measured on a discounted basis and a right-of-use asset a specified asset for the lease term. The new standard establishes a right-of-use model (ROU) that requires a lessee to recognize a ROU asset and lease liability on the balance sheet for all leases with a term longer than 12 months. Leases will be classified as finance or operating, with classification affecting the pattern and classification of expense recognition in the income statement. Under the new guidance, lessor accounting is largely unchanged and the accounting for sale and leaseback transactions were simplified. This guidance is effective for interim and annual periods beginning after December 15, 2018. Early adoption is permitted. We will adopt this guidance on January 1, 2019. We expect to elect all of the new standard's available transition practical expedients. We expect that this standard will have a material effect on our financial statements. While we continue to assess all of the effects of adoption, we currently believe the most significant effects relate to (1) the recognition of new ROU assets and lease liabilities on our balance sheet for our office and equipment operating leases; and (2) providing significant new disclosures about our leasing activities. We do not expect a significant change in our leasing activities between now and adoption. On adoption, we currently expect to recognize additional operating liabilities of approximately \$11 million, with corresponding ROU assets of the same amount based on the present value of the remaining minimum rental payments under current leasing standards for existing operating leases. We expect an impact of approximately \$200 thousand to our beginning retained earnings. The new standard also provides practical expedients for an entity's ongoing accounting. We currently expect to elect the short-term lease recognition exemption for all leases that qualify. This means, for those leases that qualify, we will not recognize ROU assets or lease liabilities, and this includes not recognizing ROU assets or lease liabilities for existing short-term leases of those assets in transition. We also currently expect to elect the practical expedient to not separate lease and non-lease components for our equipment leases.

In June 2016, the FASB issued ASU 2016-13, “*Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*,” which requires the measurement of all expected credit losses for financial assets held at the reporting date, based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

will now use forward-looking information to better inform their credit loss estimates. Additionally, the ASU amends the accounting guidance for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. This guidance is effective for interim and annual periods beginning after December 15, 2019. Early adoption is permitted for interim and annual periods beginning after December 15, 2018. We will adopt this guidance on January 1, 2020 and expect that it will have a material impact on the determination of our ALLL. We are unable to estimate the expected impact to the ALLL upon adoption due to various factors, primarily the fine tuning of our qualitative assumptions used within our preliminary model, uncertainty regarding economic conditions and the size and mix of our loan portfolio at the time of adoption, which could impact our historical loss factors. We are currently working with our existing ALLL software provider on further developing the model to perform the ALLL calculations upon adoption and we believe that we currently have in place the internal team capable of handling this implementation.

In August 2016, the FASB issued ASU 2016-15, “*Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*,” which provides guidance for classification of specific items on the statement of cash flows. This guidance is effective for interim and annual periods beginning after December 15, 2017. Early adoption is permitted. We adopted this guidance on January 1, 2018 and it did not have a material impact on our consolidated statement of cash flows.

In May 2017, the FASB issued ASU 2017-09, “*Compensation — Stock Compensation (Topic 718): Scope of Modification Accounting*,” which provides guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting. This guidance is effective for interim and annual periods beginning after December 15, 2017. Early adoption is permitted. We adopted this guidance on January 1, 2018 and it did not have an impact on our consolidated financial statements and disclosures.

In July 2018, the FASB issued ASU 2018-11, “*Leases (Topic 842): Targeted Improvements*,” which provides an additional transition method upon adoption of ASU 2016-02. The guidance allows an entity to apply the new leases standard at the adoption date and recognize a cumulative-effect adjustment to beginning retained earnings in the period of adoption. This guidance is effective upon an entity's adoption of the leases standard. We plan to adopt this guidance on January 1, 2019 and expect it will not have a material impact on our consolidated financial statements and disclosures.

In August 2018, the FASB issued ASU 2018-13, “*Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement*,” which amends the disclosure requirements related to fair value. The guidance removes disclosure related to transfers between Level 1 and Level 2 of the fair value hierarchy, the timing of these transfers and the valuation processes for Level 3 fair value measurements. Additional disclosures required as a result of adoption of this ASU will include the change in Level 3 unrealized gains and losses included in other comprehensive income and the range and weighted average of significant observable inputs used to develop Level 3 fair value measurements. This guidance is effective for interim and annual periods beginning after December 15, 2019. Early adoption is permitted. An entity is permitted to early adopt any removed or modified disclosures upon issuance of ASU 2018-13 and delay adoption of the additional disclosure requirements until their effective date. We are currently evaluating this guidance to determine the date of adoption and impact on the Company.

Subsequent Events

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

The Company has evaluated events subsequent to the balance sheet date through the date these consolidated financial statements were filed with the SEC.

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

3. Fair Value Measurements

Under FASB ASC 820-10, we group assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1	Valuation is based upon quoted prices for identical instruments traded in active markets.
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 3	Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect 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.

Risks with Fair Value Measurements

Fair value estimates are made at a discrete point in time based on relevant market information and other information about the financial instruments. Because no active market exists for a significant portion of our financial instruments, fair value estimates are based in large part on judgments we make primarily regarding current economic conditions, risk characteristics of various financial instruments, prepayment rates, and future expected loss experience. These estimates are subjective in nature and invariably involve some inherent uncertainties. Additionally, the occurrence of unexpected events or changes in circumstances can occur that could require us to make changes to our assumptions and which, in turn, could significantly affect and require us to make changes to our previous estimates of fair value.

In addition, the fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of existing and anticipated future customer relationships and the value of assets and liabilities that are not considered financial instruments, such as premises and equipment and OREO.

Measurement Methodology

Cash and Cash Equivalents. The fair value of cash and cash equivalents approximates its carrying value.

Interest-Bearing Deposits with Financial Institutions. The fair values of interest-bearing deposits maturing within one year approximate their carrying values.

FHLB and FRBSF Stock. The Bank is a member of the Federal Home Loan Bank of San Francisco (“FHLB”) and the FRBSF. As members, we are required to own stock of the FHLB and the FRBSF, the amount of which is based primarily on the level of our borrowings from those institutions. We also have the right to acquire additional shares of stock in either or both of the FHLB and the FRBSF. During the year ended December 31, 2017, we purchased 378 shares, or \$38 thousand, of FHLB stock and 6,334 shares, or \$317 thousand, of FRBSF stock. During the year ended December 31, 2018, we purchased \$315 thousand, or 3,143 shares of FHLB stock and 8,020 shares, or \$401 thousand, of FRBSF stock. No shares of FHLB stock or FRBSF stock were called during the year ended December 31, 2018. During the year ended December 31, 2017, 8,354 shares, or \$418 thousand, of FRBSF stock was called. The fair values of the FHLB and FRBSF stock are equal to their respective carrying amounts, are classified as restricted securities and are periodically evaluated for impairment based on our assessment of the ultimate recoverability of our investments in that stock. Any cash or stock dividends paid to us on such stock are reported as income.

Investment Securities Available for Sale. Fair value measurement for our investment securities available for sale is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security’s credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 investment securities include those traded on an active exchange, such as the New York Stock Exchange, and U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 investment securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Equity Investments Without Readily Determinable Fair Value. Equity investments without readily determinable fair value are accounted for under the measurement alternative method of accounting. These investments are measured at cost, less any impairment, plus or minus any changes resulting from observable price changes in orderly transactions for an identical or similar investment of the same issuer. Any cash or stock dividends paid to us on such investments are reported as noninterest income.

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Impaired Loans. Loans measured for impairment are measured at an observable market price (if available), or the fair value of the loan's collateral (if the loan is collateral dependent). The fair value of an impaired loan may be estimated using one of several methods, including collateral value, market value of similar debt, liquidation value and discounted cash flows. Those impaired loans not requiring a specific loan loss reserve represent loans for which the fair value of the expected repayments or collateral exceeds the recorded investments in such loans. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan at Level 2. When an appraised value is not available or we determine that the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the impaired loan at Level 3.

Loans. The fair value for loans with variable interest rates less a credit discount is the carrying amount. The fair value of fixed rate loans is derived by calculating the present value of expected future cash flows discounted at the loan's original interest rate by the various homogeneous categories of loans. All loans have been adjusted to reflect changes in credit risk and represent the exit price of the loans. Changes are not recorded directly as an adjustment to current earnings or comprehensive income, but rather as an adjustment component in determining the overall adequacy of the loan loss reserve.

Other Real Estate Owned. OREO is reported at its net realizable value (fair value less estimated costs to sell) at the time any real estate collateral is acquired by the Bank in satisfaction of a loan. Subsequently, OREO is carried at the lower of carrying value or fair value less estimated costs to sell. Fair value is determined based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the foreclosed asset at Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the foreclosed asset at Level 3.

Other Foreclosed Assets. Other foreclosed assets are reported at their net realizable value (fair value less estimated costs to sell) at the time any collateral other than real estate is acquired by the Bank in satisfaction of a loan. Subsequently, other foreclosed assets are carried at the lower of carrying value or fair value less estimated costs to sell. Fair value is determined based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the foreclosed asset at Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the foreclosed asset at Level 3.

Deposits. Deposits are carried at historical cost. The carrying amounts of deposits from savings and money market accounts are deemed to approximate fair value as they either have no stated maturities or short-term maturities. Certificates of deposit are estimated utilizing discounted cash flow techniques. The interest rates applied are rates currently being offered for similar certificates of deposit.

Borrowings. The fair value of borrowings is the carrying amount for those borrowings that mature on a daily basis. The fair value of term borrowings is derived by calculating the discounted value of future cash flows expected to be paid out by the Company. We classify our borrowings in Level 2 of the fair value hierarchy.

Junior Subordinated Debentures. The fair value of the junior subordinated debentures is based on quoted market prices of the underlying securities. These securities are variable rate in nature and repriced quarterly. We classify our junior subordinated debentures in Level 2 of the fair value hierarchy.

Commitments to Extend Credit and Standby Letters of Credit. The fair value of commitments to extend credit and standby letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

Interest Receivable and Interest Payable. The carrying amounts of our accrued interest receivable and accrued interest payable are deemed to approximate fair value.

Assets Recorded at Fair Value on a Recurring Basis

The following tables show the recorded amounts of assets and liabilities measured at fair value on a recurring basis at December 31, 2018 and 2017.

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands)	At December 31, 2018			
	Total	Level 1	Level 2	Level 3
Assets at Fair Value:				
Debt securities available for sale				
U.S. Treasury securities	\$ 2,980	\$ —	\$ 2,980	\$ —
Commercial mortgage backed securities issued by U.S. Agencies	4,534	—	4,534	—
Residential mortgage backed securities issued by U.S. agencies	23,717	—	23,717	—
Total debt securities available for sale at fair value	<u>\$ 31,231</u>	<u>\$ —</u>	<u>\$ 31,231</u>	<u>\$ —</u>

(Dollars in thousands)	At December 31, 2017			
	Total	Level 1	Level 2	Level 3
Assets at Fair Value:				
Debt securities available for sale				
U.S. Treasury securities	\$ 2,971	\$ —	\$ 2,971	\$ —
Residential mortgage backed securities issued by U.S. agencies	30,122	—	30,122	—
Asset-backed security ⁽¹⁾	1,741	—	—	1,741
Total debt securities available for sale	34,834	—	33,093	1,741
Equity securities				
Mutual funds ⁽¹⁾	4,904	4,904	—	—
Total debt and equity securities available for sale at fair value	<u>\$ 39,738</u>	<u>\$ 4,904</u>	<u>\$ 33,093</u>	<u>\$ 1,741</u>

(1) These investments were sold during the year ended December 31, 2018. Refer to *Note 4, Investments* for further detail regarding these sales.

The changes in Level 3 assets measured at fair value on a recurring basis are summarized as follows for the year ended December 31, 2018:

	Asset Backed Securities
	(Dollars in thousands)
Balance of recurring Level 3 instruments at December 31, 2017	\$ 1,741
Total gains or losses (realized/unrealized):	
Included in earnings-realized	53
Included in other comprehensive income	251
Sales	(2,054)
Settlements	9
Balance of recurring Level 3 instruments at December 31, 2018	<u>\$ —</u>

Assets Recorded at Fair Value on a Nonrecurring Basis

We may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. Information regarding assets measured at fair value on a nonrecurring basis is set forth in the table below.

(Dollars in thousands)	At December 31, 2018				At December 31, 2017			
	Total	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3
Assets at Fair Value:								
Impaired loans	\$ 4,226	\$ —	\$ —	\$ 4,226	\$ 6,360	\$ —	\$ —	\$ 6,360
Other foreclosed assets	91	—	91	—	—	—	—	—
Other real estate owned	1,173	—	1,173	—	—	—	—	—
Total	<u>\$ 5,490</u>	<u>\$ —</u>	<u>\$ 1,264</u>	<u>\$ 4,226</u>	<u>\$ 6,360</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 6,360</u>

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Significant Unobservable Inputs and Valuation Techniques of Level 3 Fair Value Measurements

For our fair value measurements classified in Level 3 of the fair value hierarchy as of December 31, 2018, a summary of the significant unobservable inputs and valuation techniques is as follows:

	Fair Value Measurement as of December 31, 2018	Valuation Techniques	Unobservable Inputs	Range	Weighted Average
(Dollars in thousands)					
Assets					
Impaired loans	4,226	Third-Party Pricing	Discounted cash flow		N/A ⁽²⁾
	<u>\$ 4,226</u>				

- (1) As part of our process, we obtain appraisals for our various properties included within impaired loans which primarily rely upon market comparisons. These market comparisons support our assumption that the carrying value of the respective loans either requires or does not require additional impairment.
- (2) As of December 31, 2018, there has been no change to our valuation techniques or the types of unobservable inputs used in the calculation of fair value from December 31, 2017.

Fair Value Measurements for Other Financial Instruments

The table below provides estimated fair values and related carrying amounts of our financial instruments as of December 31, 2018 and December 31, 2017, excluding financial assets and liabilities which are recorded at fair value on a recurring basis.

	Estimated Fair Value									
	At December 31, 2018					At December 31, 2017				
	Carrying Value	Total	Level 1	Level 2	Level 3	Carrying Value	Total	Level 1	Level 2	Level 3
(Dollars in thousands)										
Financial assets:										
Cash and cash equivalents	\$ 187,718	\$ 187,718	\$ 187,718	\$ —	\$ —	\$ 198,208	\$ 198,208	\$ 198,208	—	—
Interest-bearing deposits with financial institutions	2,420	2,420	2,420	—	—	2,920	2,920	2,920	—	—
Federal Reserve Bank of San Francisco and Federal Home Loan Bank stock	8,822	8,822	8,822	—	—	8,107	8,107	8,107	—	—
Loans, net	1,083,240	1,066,147	—	—	1,066,147	1,053,201	1,046,171	—	—	1,046,171
Accrued interest receivable	4,003	4,003	4,003	—	—	3,872	3,872	3,872	—	—
Financial liabilities:										
Noninterest bearing deposits	340,406	340,406	340,406	—	—	338,273	338,273	338,273	—	—
Interest-bearing deposits	795,596	794,321	—	794,321	—	801,120	800,169	—	800,169	—
Borrowings	40,000	39,976	—	39,976	—	40,866	41,238	—	41,238	—
Junior subordinated debentures	17,527	17,527	—	17,527	—	17,527	17,527	—	17,527	—
Accrued interest payable	361	361	361	—	—	397	397	397	—	—

4. Investments

Securities Available For Sale, at Fair Value

The following table sets forth the major components of securities available for sale and compares the amortized costs and estimated fair market values of, and the gross unrealized gains and losses on, these securities at December 31, 2018 and December 31, 2017:

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands)	December 31, 2018				December 31, 2017			
	Amortized Cost	Gross Unrealized		Estimated Fair Value	Amortized Cost	Gross Unrealized		Estimated Fair Value
		Gain	Loss			Gain	Loss	
Securities Available for Sale								
U.S. Treasury securities	\$ 2,999	\$ —	\$ (19)	\$ 2,980	\$ 2,996	\$ —	\$ (25)	\$ 2,971
Commercial mortgage backed securities issued by U.S. Agencies ⁽¹⁾	4,495	40	(1)	4,534	—	—	—	—
Residential mortgage backed securities issued by U.S. Agencies ⁽²⁾	24,739	1	(1,023)	23,717	30,894	5	(777)	30,122
Asset backed security ⁽³⁾	—	—	—	—	1,992	—	(251)	1,741
Mutual funds ⁽⁴⁾	—	—	—	—	5,000	11	(107)	4,904
Total	\$ 32,233	\$ 41	\$ (1,043)	\$ 31,231	\$ 40,882	\$ 16	\$ (1,160)	\$ 39,738

(1) Secured by first liens on commercial apartment building mortgages.

(2) Secured by closed-end first liens on 1-4 family residential mortgages.

(3) Comprised of a security that represented an interest in a pool of trust preferred securities issued by U.S.-based banks and insurance companies. This investment was sold during the year ended December 31, 2018.

(4) Consisted primarily of mutual fund investments in closed-end first liens on 1-4 family residential mortgages. As a result of the adoption of ASU 2016-01 effective January 1, 2018, the change in fair value for all equity securities is required to be recorded within the income statement and would no longer be included in this table. However, this investment was sold during the year ended December 31, 2018 so the only impact from the adoption of ASU 2016-01 in 2018 relates to the adjustment to beginning retained earnings for the \$97 thousand gross unrealized loss as of December 31, 2017.

At December 31, 2018 and 2017, U.S. agency mortgage backed securities and collateralized mortgage obligations with an aggregate fair market value of \$18.2 million and \$22.7 million, respectively, were pledged to secure FHLB borrowings, repurchase agreements, local agency deposits and treasury, tax and loan accounts.

The amortized cost and estimated fair values of securities available for sale at December 31, 2018 and December 31, 2017 are shown in the tables below by contractual maturities taking into consideration historical prepayments based on the prior twelve months of principal payments. Expected maturities will differ from contractual maturities and historical prepayments, particularly with respect to collateralized mortgage obligations, primarily because prepayment rates are affected by changes in conditions in the interest rate market and, therefore, future prepayment rates may differ from historical prepayment rates.

(Dollars in thousands)	At December 31, 2018 Maturing in				
	One year or less	Over one year through five years	Over five years through ten years	Over ten Years	Total
Securities available for sale, amortized cost	\$ 7,874	\$ 13,466	\$ 9,971	\$ 922	\$ 32,233
Securities available for sale, estimated fair value	7,663	12,934	9,710	924	31,231
Weighted average yield	1.46%	1.62%	2.22%	3.13%	1.81%

(Dollars in thousands)	At December 31, 2017 Maturing in				
	One year or less	Over one year through five years	Over five years through ten years	Over ten Years	Total
Securities available for sale, amortized cost ⁽¹⁾	\$ 5,685	\$ 23,772	\$ 8,956	\$ 2,469	\$ 40,882
Securities available for sale, estimated fair value ⁽¹⁾	5,543	23,253	8,727	2,215	39,738
Weighted average yield ⁽¹⁾	1.49%	1.60%	1.63%	3.86%	1.73%

(1) Included within these balances are equity securities that consisted primarily of mutual fund investments in closed-end first liens on 1-4 family residential mortgages. As a result of the adoption of ASU 2016-01 effective January 1, 2018, the change in fair value for all equity securities is required to be recorded within the income statement and would no longer be included in this table. However, this investment was sold during the year ended December 31, 2018 so the only impact from the adoption of ASU 2016-01 in 2018 relates to the adjustment to beginning retained earnings for the \$97 thousand gross unrealized loss as of December 31, 2017.

During the years ended December 31, 2018 and 2017, we purchased \$4.5 million and \$3.0 million, respectively, of securities available for

sale. No securities available for sale were purchased during the year ended December 31, 2016. During the years ended December 31, 2018 and 2017, we had \$2.1 million and \$382 thousand, respectively, of proceeds from sales of securities

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

available for sale, for a total net gain of \$53 thousand and net loss of \$4 thousand, respectively. We had no sales of securities available for sale during the year ended December 31, 2016.

The tables below indicate, as of December 31, 2018 and December 31, 2017, the gross unrealized losses and fair values of our investments, aggregated by investment category, and length of time that the individual securities have been in a continuous unrealized loss position.

(Dollars in thousands)	Securities with Unrealized Loss at December 31, 2018					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury securities	\$ —	\$ —	\$ 2,980	\$ (19)	\$ 2,980	\$ (19)
Commercial mortgage backed securities issued by U.S. Agencies	999	(1)	—	—	999	(1)
Residential mortgage backed securities issued by U.S. Agencies	361	(3)	23,299	(1,020)	23,660	(1,023)
Total	\$ 1,360	\$ (4)	\$ 26,279	\$ (1,039)	\$ 27,639	\$ (1,043)

(Dollars in thousands)	Securities with Unrealized Loss at December 31, 2017					
	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury securities	\$ 2,971	\$ (25)	\$ —	\$ —	\$ 2,971	\$ (25)
Residential mortgage backed securities issued by U.S. Agencies	1,400	(15)	28,241	(762)	29,641	(777)
Asset-backed security	—	—	1,740	(251)	1,740	(251)
Mutual funds ⁽¹⁾	1,485	(15)	2,658	(92)	4,143	(107)
Total	\$ 5,856	\$ (55)	\$ 32,639	\$ (1,105)	\$ 38,495	\$ (1,160)

(1) Consisted primarily of mutual fund investments in closed-end first liens on 1-4 family residential mortgages. As a result of the adoption of ASU 2016-01 effective January 1, 2018, the change in fair value for all equity securities is required to be recorded within the income statement and would no longer be included in this table. However, this investment was sold during the year ended December 31, 2018 so the only impact from the adoption of ASU 2016-01 in 2018 relates to the adjustment to beginning retained earnings for the \$97 thousand gross unrealized loss as of December 31, 2017.

We regularly monitor investments for significant declines in fair value. We have determined that declines in the fair values of these investments below their respective amortized costs, as set forth in the tables above, are temporary because (i) those declines were due to interest rate changes and not to a deterioration in the creditworthiness of the issuers of those investment securities, and (ii) we have the ability to hold those securities until there is a recovery in their values or until their maturity.

Through the impairment assessment process, we determined that there were no available-for-sale debt securities that were other-than-temporarily impaired at December 31, 2018. We recorded no impairment credit losses on available-for-sale debt securities in our consolidated statements of operations for the year ended December 31, 2018 and 2017.

We have made a determination that the remainder of our securities with respect to which there were unrealized losses as of December 31, 2018 are not other-than-temporarily impaired, because we have concluded that we have the ability to continue to hold those securities until their respective fair market values increase above their respective amortized costs or, if necessary, until their respective maturities. In reaching that conclusion we considered a number of factors and other information, which included: (i) the significance of each such security, (ii) the amount of the unrealized losses attributable to each such security, (iii) our liquidity position, (iv) the impact that retention of those securities could have on our capital position and (v) our evaluation of the expected future performance of these securities (based on the criteria discussed above).

Equity Investments Without Readily Determinable Fair Value

As of December 31, 2018, we had two investments in limited partnerships without a readily determinable fair value. As of December 31, 2018, we owned less than 3% of the total investment in each partnership. Under ASU 2016-01, we elected to measure these equity investments using the measurement alternative, which requires that these investments are measured at cost, less any impairment, plus or minus any changes resulting from observable price changes in orderly transactions for an identical or similar investment of the same issuer. During the year ended ended December 31, 2018, these investments were not impaired and there were no observable price changes. As a result, the balance shown below as of December 31, 2018 represents the cost

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

of the investments and is included within other assets on the consolidated statements of financial condition. Prior to the adoption of ASU 2016-01, these investments were accounted for under the cost method of accounting and included within other assets on the consolidated statements of financial condition. During the year ended December 31, 2018, we had \$364 thousand of capital contributions to these investments, partially offset by \$17 thousand return of principal. We had \$227 thousand of capital contributions to these investments during the year ended December 31, 2017. As of December 31, 2018 and December 31, 2017, our equity investments without readily determinable fair value were as follows:

	December 31, 2018	December 31, 2017
	(Dollars in thousands)	
Equity investments without readily determinable fair value	\$ 1,240	\$ 893

5. Loans and Allowance for Loan and Lease Losses

The loan portfolio consisted of the following at:

(Dollars in thousands)	December 31, 2018		December 31, 2017	
	Amount	Percent	Amount	Percent
Commercial loans	\$ 444,441	40.6%	\$ 394,493	37.1%
Commercial real estate loans – owner occupied	211,645	19.3%	214,365	20.1%
Commercial real estate loans – all other	226,441	20.7%	228,090	21.4%
Residential mortgage loans – multi-family	97,173	8.9%	114,302	10.7%
Residential mortgage loans – single family	21,176	1.9%	24,848	2.3%
Construction and land development loans	38,496	3.5%	34,614	3.3%
Consumer loans	54,514	5.0%	53,918	5.1%
Gross loans	1,093,886	100.0%	1,064,630	100.0%
Deferred fee (income) costs, net	2,860		2,767	
Allowance for loan and lease losses	(13,506)		(14,196)	
Loans, net	\$ 1,083,240		\$ 1,053,201	

At December 31, 2018 and 2017, real estate loans of approximately \$807 million and \$669 million, respectively, were pledged to secure borrowings obtained from the FHLB. During the year ended December 31, 2018, we sold \$15.1 million of commercial real estate loans - all other at par value. No loans were sold during the years ended December 31, 2017 or 2016. We purchased \$10.0 million of performing commercial real estate - owner occupied, commercial real estate - all other and residential mortgage - multifamily loans during the year ended December 31, 2018, \$30.1 million of performing commercial real estate - owner occupied and commercial real estate - all other loans during the year ended December 31, 2017 and \$85.8 million of performing residential multi-family mortgage and commercial real estate - all other loans during the year ended December 31, 2016.

Allowance for Loan and Lease Losses

The ALLL represents our estimate of credit losses in our loan and lease portfolio that are probable and estimable at the balance sheet date. We employ economic models that are based on bank regulatory guidelines, industry standards and our own historical loan loss experience, as well as a number of more subjective qualitative factors, to determine both the sufficiency of the ALLL and the amount of the provisions that are required to increase or replenish the ALLL.

The ALLL is first determined by (i) analyzing all classified loans (graded as “Substandard” or “Doubtful” under our internal asset quality grading parameters) on non-accrual status for loss exposure and (ii) establishing specific reserves as needed. ASC 310-10 defines loan impairment as the existence of uncertainty concerning collection of all principal and interest in accordance with the contractual terms of a loan. For collateral dependent loans, impairment is typically measured by comparing the loan amount to the fair value of collateral, less estimated costs to sell, with any “shortfall” amount charged off. Other methods can be used in estimating impairment, including market price and the present value of expected future cash flows discounted at the loan’s original interest rate. We are an active lender with the U.S. Small Business Administration and collection of a percentage of the loan balance of many of the loans originated is guaranteed. The ALLL reserves are calculated against the non-guaranteed loan balances.

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

On a quarterly basis, we utilize a classification based loan loss migration model as well as review individual loans in determining the adequacy of the ALLL for homogenous pools of loans that are not subject to specific reserve allocations. Our loss migration analysis utilizes a series of nineteen staggered 16-quarter migration periods of loan loss history and industry loss factors to determine historical losses by classification category for each loan type, except certain consumer loans (automobile, mortgage and credit cards). We then apply these calculated loss factors, together with qualitative factors based on external economic conditions and trends and internal assessments, to the outstanding loan balances in each homogenous group of loans, and then, using our internal asset quality grading parameters, we grade the loans as “Pass,” “Special Mention,” “Substandard” or “Doubtful”. We analyze impaired loans individually. This grading is based on the credit classifications of assets as prescribed by government regulations and industry standards and is separated into the following groups:

- **Pass:** Loans classified as pass include current loans performing in accordance with contractual terms, installment/consumer loans that are not individually risk rated, and loans which exhibit certain risk factors that require greater than usual monitoring by management.
- **Special Mention:** Loans classified as special mention, while generally not delinquent, have potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank’s credit position at some future date.
- **Substandard:** Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
- **Doubtful:** Loans classified as doubtful have all the weaknesses inherent in a substandard loan, and may also be at delinquency status and have defined weaknesses based on currently existing facts, conditions and values making collection or liquidation in full highly questionable and improbable.

Set forth below is a summary of the activity in the ALLL, by portfolio type, during the years ended December 31, 2018, 2017 and 2016.

(Dollars in thousands)	Commercial	Real Estate	Construction and Land Development	Consumer and Single Family Mortgages	Unallocated	Total
ALLL in the year ended December 31, 2018:						
Balance at beginning of year	\$ 9,155	\$ 2,906	\$ 650	\$ 1,043	\$ 442	\$ 14,196
Charge offs	(2,757)	—	—	(8)	—	(2,765)
Recoveries	1,959	69	—	47	—	2,075
Provision	(286)	668	(224)	208	(366)	—
Balance at end of year	<u>\$ 8,071</u>	<u>\$ 3,643</u>	<u>\$ 426</u>	<u>\$ 1,290</u>	<u>\$ 76</u>	<u>\$ 13,506</u>
ALLL in the year ended December 31, 2017:						
Balance at beginning of year	\$ 11,276	\$ 4,226	\$ 343	\$ 642	\$ 314	\$ 16,801
Charge offs	(4,124)	(432)	—	(179)	—	(4,735)
Recoveries	1,852	72	27	179	—	2,130
Provision	151	(960)	280	401	128	—
Balance at end of year	<u>\$ 9,155</u>	<u>\$ 2,906</u>	<u>\$ 650</u>	<u>\$ 1,043</u>	<u>\$ 442</u>	<u>\$ 14,196</u>
ALLL in the year ended December 31, 2016:						
Balance at beginning of year	\$ 6,639	\$ 5,109	\$ 282	\$ 686	\$ —	\$ 12,716
Charge offs	(15,390)	(1,119)	—	(540)	—	(17,049)
Recoveries	1,189	1	57	17	—	1,264
Provision	18,838	235	4	479	314	19,870
Balance at end of year	<u>\$ 11,276</u>	<u>\$ 4,226</u>	<u>\$ 343</u>	<u>\$ 642</u>	<u>\$ 314</u>	<u>\$ 16,801</u>

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Set forth below is information regarding loan balances and the related ALLL, by portfolio type, as of December 31, 2018 and December 31, 2017.

(Dollars in thousands)	Commercial	Real Estate	Land Development	Consumer and Single Family Mortgages	Unallocated	Total
ALLL balance at December 31, 2018 related to:						
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	\$ 8,071	\$ 3,643	\$ 426	\$ 1,290	\$ 76	\$ 13,506
Total	<u>\$ 8,071</u>	<u>\$ 3,643</u>	<u>\$ 426</u>	<u>\$ 1,290</u>	<u>\$ 76</u>	<u>\$ 13,506</u>
Loans balance at December 31, 2018 related to:						
Loans individually evaluated for impairment	\$ 3,352	\$ 831	\$ —	\$ 43	\$ —	\$ 4,226
Loans collectively evaluated for impairment	441,089	534,428	38,496	75,647	—	1,089,660
Total	<u>\$ 444,441</u>	<u>\$ 535,259</u>	<u>\$ 38,496</u>	<u>\$ 75,690</u>	<u>\$ —</u>	<u>\$ 1,093,886</u>
ALLL balance at December 31, 2017 related to:						
Loans individually evaluated for impairment	\$ 7	\$ —	\$ —	\$ —	\$ —	\$ 7
Loans collectively evaluated for impairment	\$ 9,148	\$ 2,906	\$ 650	\$ 1,043	\$ 442	\$ 14,189
Total	<u>\$ 9,155</u>	<u>\$ 2,906</u>	<u>\$ 650</u>	<u>\$ 1,043</u>	<u>\$ 442</u>	<u>\$ 14,196</u>
Loans balance at December 31, 2017 related to:						
Loans individually evaluated for impairment	\$ 3,672	\$ 2,461	\$ —	\$ 227	\$ —	\$ 6,360
Loans collectively evaluated for impairment	390,821	554,296	34,614	78,539	—	1,058,270
Total	<u>\$ 394,493</u>	<u>\$ 556,757</u>	<u>\$ 34,614</u>	<u>\$ 78,766</u>	<u>\$ —</u>	<u>\$ 1,064,630</u>

Credit Quality

The amounts of nonperforming assets and delinquencies that occur within our loan portfolio factors in our evaluation of the adequacy of the ALLL.

The following table provides a summary of the delinquency status of loans by portfolio type at December 31, 2018 and 2017:

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days and Greater	Total Past Due	Current	Total Loans Outstanding	Loans >90 Days and Accruing
At December 31, 2018							
Commercial loans	\$ —	\$ 3,705	\$ 4,273	\$ 7,978	\$ 436,463	\$ 444,441	\$ 1,278
Commercial real estate loans – owner-occupied	—	831	—	831	210,814	211,645	—
Commercial real estate loans – all other	—	—	—	—	226,441	226,441	—
Residential mortgage loans – multi-family	—	—	—	—	97,173	97,173	—
Residential mortgage loans – single family	—	—	—	—	21,176	21,176	—
Land development loans	—	—	—	—	38,496	38,496	—
Consumer loans	13	—	—	13	54,501	54,514	—
Total	\$ 13	\$ 4,536	\$ 4,273	\$ 8,822	\$ 1,085,064	\$ 1,093,886	\$ 1,278
At December 31, 2017							
Commercial loans	\$ 1,387	\$ —	\$ 2,125	\$ 3,512	\$ 390,981	\$ 394,493	\$ —
Commercial real estate loans – owner-occupied	—	—	—	—	214,365	214,365	—
Commercial real estate loans – all other	—	936	—	936	227,154	228,090	—
Residential mortgage loans – multi-family	—	—	—	—	114,302	114,302	—
Residential mortgage loans – single family	—	—	—	—	24,848	24,848	—
Land development loans	—	—	—	—	34,614	34,614	—
Consumer loans	—	—	—	—	53,918	53,918	—
Total	\$ 1,387	\$ 936	\$ 2,125	\$ 4,448	\$ 1,060,182	\$ 1,064,630	\$ —

Generally, the accrual of interest on a loan is discontinued when principal or interest payments become more than 90 days past due, unless we believe that the loan is adequately collateralized and it is in the process of collection. There were \$1.3 million loans 90 days or more past due and still accruing interest at December 31, 2018 and none outstanding at December 31, 2017. In certain instances, when a loan is placed on non-accrual status, previously accrued but unpaid interest is reversed against current income. Subsequent collections of cash are applied as principal reductions when received, except when the ultimate collectability of principal is probable, in which case such payments are applied to accrued and unpaid interest, which is credited to income. Non-accrual loans may be restored to accrual status when principal and interest become current and full repayment becomes expected.

The following table provides information with respect to loans on nonaccrual status, by portfolio type, as of December 31, 2018 and 2017:

	December 31,	
	2018	2017
(Dollars in thousands)		
Nonaccrual loans:		
Commercial loans	\$ 3,352	\$ 3,222
Commercial real estate loans – owner occupied	831	893
Commercial real estate loans – all other	—	1,568
Residential mortgage loans – single family	—	171
Consumer loans	43	56
Total ⁽¹⁾	\$ 4,226	\$ 5,910

(1) Nonaccrual loans may include loans that are currently considered performing loans.

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

We classify our loan portfolio using internal credit quality ratings. The following table provides a summary of loans by portfolio type and our internal credit quality ratings as of December 31, 2018 and 2017, respectively.

(Dollars in thousands)	December 31,		
	2018	2017	Increase (Decrease)
Pass:			
Commercial loans	\$ 428,287	\$ 375,024	\$ 53,263
Commercial real estate loans – owner occupied	205,914	207,094	(1,180)
Commercial real estate loans – all other	226,441	226,522	(81)
Residential mortgage loans – multi family	97,173	114,302	(17,129)
Residential mortgage loans – single family	21,176	24,677	(3,501)
Construction and land development loans	38,496	34,614	3,882
Consumer loans	54,415	53,862	553
Total pass loans	\$ 1,071,902	\$ 1,036,095	\$ 35,807
Special Mention:			
Commercial loans	\$ 10,411	\$ 11,009	\$ (598)
Commercial real estate loans – owner occupied	4,900	6,378	(1,478)
Total special mention loans	\$ 15,311	\$ 17,387	\$ (2,076)
Substandard:			
Commercial loans	\$ 5,743	\$ 8,094	\$ (2,351)
Commercial real estate loans – owner occupied	831	893	(62)
Commercial real estate loans – all other	—	1,568	(1,568)
Residential mortgage loans – single family	—	171	(171)
Consumer loans	99	56	43
Total substandard loans	\$ 6,673	\$ 10,782	\$ (4,109)
Doubtful:			
Commercial loans	\$ —	\$ 366	\$ (366)
Total doubtful loans	\$ —	\$ 366	\$ (366)
Total Loans:	\$ 1,093,886	\$ 1,064,630	\$ 29,256

Impaired Loans

A loan generally is classified as impaired and placed on nonaccrual status when, in our opinion, principal or interest is not likely to be collected in accordance with the contractual terms of the loan agreement. We measure for impairments on a loan-by-loan basis, using either the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the loan is collateral dependent.

The following table sets forth information regarding impaired loans, at December 31, 2018 and December 31, 2017:

(Dollars in thousands)	December 31,	
	2018	2017
Impaired loans:		
Nonaccruing loans	\$ 4,226	\$ 5,101
Nonaccruing restructured loans	—	809
Accruing restructured loans ⁽¹⁾	—	450
Total impaired loans	\$ 4,226	\$ 6,360
Impaired loans less than 90 days delinquent and included in total impaired loans	\$ 1,359	\$ 3,994

(1) See "Troubled Debt Restructurings" below for a description of accruing restructured loans at December 31, 2018 and December 31, 2017.

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The table below contains additional information with respect to impaired loans, by portfolio type, as of December 31, 2018 and 2017:

	December 31, 2018			December 31, 2017		
	Recorded Investment	Unpaid Principal Balance	Related Allowance (1)	Recorded Investment	Unpaid Principal Balance	Related Allowance (1)
(Dollars in thousands)						
No allowance recorded:						
Commercial loans	\$ 3,352	\$ 4,516	\$ —	\$ 3,222	\$ 5,910	\$ —
Commercial real estate loans – owner occupied	831	925	—	893	945	—
Commercial real estate loans – all other	—	—	—	1,568	1,965	—
Residential mortgage loans – single family	—	—	—	171	185	—
Consumer loans	43	65	—	56	73	—
Total	4,226	5,506	—	5,910	9,078	—
With allowance recorded:						
Commercial loans	\$ —	\$ —	\$ —	\$ 450	\$ 450	\$ 7
Total	—	—	—	450	450	7
Total						
Commercial loans	\$ 3,352	\$ 4,516	\$ —	\$ 3,672	\$ 6,360	\$ 7
Commercial real estate loans – owner occupied	831	925	—	893	945	—
Commercial real estate loans – all other	—	—	—	1,568	1,965	—
Residential mortgage loans – single family	—	—	—	171	185	—
Consumer loans	43	65	—	56	73	—
Total	4,226	5,506	—	6,360	9,528	7

(1) When the discounted cash flows, collateral value or market price equals or exceeds the recorded investment in the loan, then specific reserves are not required to be set aside for the loan within the ALLL. This typically occurs when the impaired loans have been partially charged-off and/or there have been interest payments received and applied to the balance of the principal outstanding.

At December 31, 2018 and December 31, 2017, there were \$4.2 million and \$5.9 million, respectively, of impaired loans for which no specific reserves had been allocated because these loans, in our judgment, were sufficiently collateralized. Of the impaired loans at December 31, 2018 for which no specific reserves were allocated, \$874 thousand had been deemed impaired in the prior year.

Average balances and interest income recognized on impaired loans, by portfolio type, for the year ended December 31, 2018, 2017 and 2016 were as follows:

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Year Ended December 31,					
	2018		2017		2016	
	Average Balance	Interest Income Recognized	Average Balance	Interest Income Recognized	Average Balance	Interest Income Recognized
No allowance recorded:						
Commercial loans	\$ 4,289	\$ 101	\$ 10,178	\$ 128	\$ 13,686	\$ 437
Commercial real estate loans – owner occupied	856	—	1,215	—	2,455	3
Commercial real estate loans – all other	370	—	1,616	—	4,413	—
Residential mortgage loans – multi-family	—	—	—	—	350	—
Residential mortgage loans – single family	—	—	183	—	339	9
Construction and land development loans	—	—	—	—	871	—
Consumer loans	48	—	80	5	173	—
Total	5,563	101	13,272	133	22,287	449
With allowance recorded:						
Commercial loans	96	—	3,150	33	4,728	457
Commercial real estate loans – owner occupied	—	—	—	—	962	—
Total	96	—	3,150	33	5,690	457
Total						
Commercial loans	4,385	101	13,328	161	18,414	894
Commercial real estate loans – owner occupied	856	—	1,215	—	3,417	3
Commercial real estate loans – all other	370	—	1,616	—	4,413	—
Residential mortgage loans – multi-family	—	—	—	—	350	—
Residential mortgage loans – single family	—	—	183	—	339	9
Construction and land development loans	—	—	—	—	871	—
Consumer loans	48	—	80	5	173	—
Total	\$ 5,659	\$ 101	\$ 16,422	\$ 166	\$ 27,977	\$ 906

The interest that would have been earned had the impaired loans remained current in accordance with their original terms was \$362 thousand in 2018, \$462 thousand in 2017 and \$1.2 million in 2016.

Troubled Debt Restructurings

Pursuant to the FASB's ASU No. 2011-2, *A Creditor's Determination of whether a Restructuring is a Troubled Debt Restructuring*, the Company's TDRs totaled \$0 and \$1.3 million at December 31, 2018 and December 31, 2017, respectively. TDRs consist of loans to which modifications have been made for the purpose of alleviating temporary impairments of the borrower's financial condition and cash flows. Those modifications have come in the forms of changes in amortization terms, reductions in interest rates, interest only payments and, in limited cases, concessions to outstanding loan balances. The modifications are made as part of workout plans we enter into with the borrower that are designed to provide a bridge for the borrower's cash flow shortfalls in the near term. If a borrower works through the near term issues, then in most cases, the original contractual terms of the borrower's loan will be reinstated.

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents loans restructured as TDRs during the years ended December 31, 2018, 2017 and 2016:

<u>(Dollars in thousands)</u>	Year Ended December 31,								
	2018			2017			2016		
	Number of loans	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Number of loans	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Number of loans	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Performing									
Commercial loans	—	\$ —	\$ —	1	\$ 450	\$ 450	—	\$ —	\$ —
	—	—	—	1	450	450	—	—	—
Nonperforming									
Commercial loans	—	—	—	1	1,329	809	—	—	—
	—	—	—	1	1,329	809	—	—	—
Total troubled debt restructurings ⁽¹⁾	—	\$ —	\$ —	2	\$ 1,779	\$ 1,259	—	\$ —	\$ —

(1) No loans were restructured during the years ended December 31, 2018 or December 31, 2016.

During the years ended December 31, 2018, 2017 and 2016, TDRs that were modified within the preceding 12-month period which subsequently defaulted were as follows:

	Year Ended December 31,					
	2018		2017		2016	
	Number of loans	Recorded Investment	Number of loans	Recorded Investment	Number of loans	Recorded Investment
<u>(Dollars in thousands)</u>						
Commercial real estate - owner occupied ⁽¹⁾	—	\$ —	—	\$ —	1	\$ 753

(1) During the years ended December 31, 2018 or December 31, 2017, no TDRs were modified within the preceding 12-month period which subsequently defaulted.

6. Premises and Equipment

The major classes of premises and equipment are as follows:

<u>(Dollars in thousands)</u>	December 31,	
	2018	2017
Furniture and equipment	\$ 3,170	\$ 6,549
Leasehold improvements	42	23
	3,212	6,572
Accumulated depreciation and amortization	(2,173)	(5,478)
Total	\$ 1,039	\$ 1,094

The amount of depreciation and amortization included in operating expense was \$405,000, \$428,000 and \$485,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

7. Deposits

Asset

At December 31, 2018, we had \$174.5 million in interest bearing deposits at other financial institutions, as compared to \$186.0 million at December 31, 2017. The weighted average percentage yields on these deposits for each of the years ended December 31, 2018 and December 31, 2017 was 1.92% and 1.12%, respectively. Interest bearing deposits with financial institutions can be withdrawn on demand and are considered cash equivalents for purposes of the consolidated statements of cash flows.

At December 31, 2018 and December 31, 2017, we had \$2.4 million and \$2.9 million, respectively, of interest-bearing time deposits at other financial institutions, which were scheduled to mature within one year or had no stated maturity date. The

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

weighted average percentage yields on these deposits were 2.04% and 1.07% for the years ended December 31, 2018 and December 31, 2017, respectively.

Liability

The aggregate amount of time deposits in denominations of \$250,000 or more at December 31, 2018 and 2017 was \$95.2 million and \$94.1 million, respectively.

The scheduled maturities of time deposits in denominations of \$250,000 or more at December 31, 2018 were as follows:

<u>(Dollars in thousands)</u>	<u>At December 31, 2018</u>
2019	\$ 93,898
2020	5,340
2021	254
2022	2,462
2023 and beyond	250
Total	<u>\$ 102,204</u>

8. Borrowings and Contractual Obligations

At December 31, 2018 and 2017, our borrowings and contractual obligations consisted of the following:

<u>(Dollars in thousands)</u>	<u>December 31,</u>	
	<u>2018</u>	<u>2017</u>
FHLB advances—short-term	\$ 40,000	\$ 40,000
Other borrowings—short-term ⁽¹⁾	—	866
Total	<u>\$ 40,000</u>	<u>\$ 40,866</u>

(1) Borrowings had an interest rate of 15% as of December 31, 2017. This represented the portion of a participated loan that was required under GAAP to be recorded as other borrowings as of December 31, 2017. The participated portion of this loan was repurchased during the first quarter of 2018 and is no longer required to be recorded in other borrowings.

The table below sets forth the amounts of, the interest rates we pay on, and the maturity dates of these FHLB borrowings. These borrowings had a weighted-average annualized interest rate of 2.54% for the year ended December 31, 2018.

<u>Principal Amounts</u>	<u>Interest Rate</u>	<u>Maturity Dates</u>
<u>(Dollars in thousands)</u>		
10,000	2.31%	January 15, 2019
10,000	2.55%	March 4, 2019
10,000	2.66%	May 28, 2019
10,000	2.65%	June 26, 2019

At December 31, 2018, \$807 million of loans were pledged to support our FHLB borrowings and our unfunded borrowing capacity. As of December 31, 2018, we had unused borrowing capacity of \$365 million with the FHLB. The highest amount of borrowings outstanding at any month-end during the year ended December 31, 2018 was \$40.9 million.

As of December 31, 2017, we had \$40.0 million of outstanding short-term borrowings and no outstanding long-term borrowings that we had obtained from the FHLB. These borrowings had a weighted-average annualized interest rate of 1.65% for the year ended December 31, 2017. As of December 31, 2017 we had unused borrowing capacity of \$285 million with the FHLB. The highest amount of borrowings outstanding at any month-end during the year ended December 31, 2017 was \$40.9 million.

These FHLB borrowings were obtained in accordance with the Company's asset/liability management objective to reduce the Company's exposure to interest rate fluctuations and increase our contingent funding.

Junior Subordinated Debentures. We formed two grantor trusts to sell and issue to institutional investors floating junior trust preferred securities ("trust preferred securities"). The net proceeds from the sales of the trust preferred securities was used in exchange for our issuance to the grantor trusts for the principal amount of our junior subordinated floating rate debentures (the "Debentures"). The payment terms of the Debentures are used by the grantor trusts to make the payments that come due to the

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

holders of the trust preferred securities pursuant to the terms of those securities. The Debentures also were pledged by the grantor trusts as security for the payment obligations of the grantor trusts under the trust preferred securities.

Set forth below are the respective principal amounts, and certain other information regarding the terms of the Debentures that remained outstanding as of December 31, 2018 and 2017:

<u>Original Issue Dates</u>	<u>Principal Amount</u>	<u>Interest Rate⁽¹⁾</u>	<u>Maturity Dates</u>
	<u>(In thousands)</u>		
September 2002	\$ 7,217	LIBOR plus 3.40%	September 2032
October 2004	10,310	LIBOR plus 2.00%	October 2034
Total	<u>\$ 17,527</u>		

(1) Interest rate resets quarterly.

These Debentures require quarterly interest payments, which are used to make quarterly distributions required to be paid on the corresponding trust preferred securities. Subject to certain conditions, we have the right, at our discretion, to defer those interest payments, and the corresponding distributions on the trust preferred securities, for up to five years. Exercise of this deferral right does not constitute a default of our obligations to pay the interest on the Debentures or the corresponding distributions that are payable on the trust preferred securities. As of December 31, 2018, we were current on all interest payments. We have committed to obtaining approval from the FRB and the CDBO prior to making any distributions representing interest, principal or other sums on subordinated debentures or trust preferred securities. There can be no assurance that our regulators will approve such payments in the future.

9. Related Party Transactions

Per ASC 850-10-20, a related party is defined under GAAP to include: affiliates, principal owners and their immediate family members, management and their immediate families, other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests, and other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. GAAP requires disclosure of all material related party transactions, excluding compensation arrangements, expense allowances, and items eliminated in consolidation. Occasionally, we participate in loans with our affiliates through the ordinary course of business. These loan participations are not considered material transactions. Excluding these loan participations, the equity transactions described in Note 14, Shareholders' Equity, and the transactions noted below, we have no other related party transactions.

Deposits maintained by members of the Board of Directors and executive officers at the Bank totaled \$218 thousand and \$272 thousand at December 31, 2018 and 2017, respectively.

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

10. Income Taxes

The components of income tax (benefit) expense from continuing operations consisted of the following for the years ended December 31:

<u>(Dollars in thousands)</u>	<u>2018</u>	<u>2017</u>	<u>2016</u>
Current taxes:			
Federal	\$ —	\$ (125)	\$ —
State	97	34	(5)
Total current taxes	97	(91)	(5)
Deferred taxes:			
Federal	(6,065)	—	10,044
State	(4,784)	—	6,793
Total deferred taxes	(10,849)	—	16,837
Total income tax (benefit) expense	<u>\$ (10,752)</u>	<u>\$ (91)</u>	<u>\$ 16,832</u>

The reasons for the differences between the statutory federal income tax rates and our effective tax rates are summarized in the following table:

	<u>Year Ended December 31,</u>		
	<u>2018</u>	<u>2017</u>	<u>2016</u>
Federal income tax based on statutory rate	21.0 %	34.0 %	34.0 %
State franchise tax net of federal income tax benefit	8.6	7.2	7.2
Permanent differences	(0.3)	(0.4)	—
Other	2.0	1.4	(0.1)
Valuation allowance	(96.1)	(43.1)	(135.6)
Total effective tax rate	<u>(64.8)%</u>	<u>(0.9)%</u>	<u>(94.5)%</u>

At December 31, 2018, we have a net deferred tax asset of \$10.9 million. At December 31, 2017, we had a net deferred tax asset of \$0 as a result of the full valuation allowance recorded against our gross deferred tax asset. Adjustments to our deferred tax valuation allowance could be required in the future if we were to conclude, on the basis of our assessment of the realizability of the deferred tax asset, that the amount of that asset which is more-likely-than-not, to be available to offset or reduce future taxes has decreased. Any such decrease would result in income tax expense. The components of our net deferred tax asset are as follows at:

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands)	December 31,	
	2018	2017
Deferred tax asset:		
Allowance for loan and lease losses	\$ 3,996	\$ 4,207
Other than temporary impairment on securities	—	56
State taxes	20	—
Deferred compensation	641	693
Litigation reserve	81	131
Other accrued expenses	504	927
Charitable contributions	127	241
Reserve for unfunded commitments	103	103
Tax credits	368	60
Net operating loss carry forward	5,642	9,754
Stock based compensation	166	363
Unrealized losses on securities	296	338
Total deferred tax assets	11,944	16,873
Deferred tax liabilities:		
Depreciation and amortization	(163)	(133)
Other	(846)	(803)
Total deferred tax liabilities	(1,009)	(936)
Valuation allowance	—	(15,937)
Total net deferred tax asset	\$ 10,935	\$ —

During the year ended December 31, 2016, we had income tax expense of \$16.8 million as a result of the establishment of a full valuation allowance during 2016 on the balance of our deferred tax asset, which includes current and historical losses that may be used to offset taxes on future profits. Accounting rules specify that management must evaluate the deferred tax asset on a recurring basis to determine whether enough positive evidence exists to determine whether it is more-likely-than-not that the deferred tax asset will be available to offset or reduce future taxes. Negative evidence included the significant losses incurred during the second and third quarters of 2016, an increase in our nonperforming assets from December 31, 2015, and our accumulated deficit. Positive evidence included our forecast of our taxable income, the time period in which we have to utilize our deferred tax asset and the current economic conditions. The tax code allows net operating losses to be carried forward for 20 years from the date of the loss, and while management believed that the Company would be able to realize the deferred tax asset within that period, we were unable to assert the timing as to when that realization would occur. As a result of this conclusion and due to the hierarchy of evidence that the accounting rules specify, a valuation allowance had been recorded as of December 31, 2016 to offset the deferred tax asset.

During the year ended December 31, 2017, we had an income tax benefit of \$91 thousand. The income tax benefit for the year ended December 31, 2017 represents the reclassification of the alternative minimum tax credit carryforward from a deferred tax asset to an income tax receivable as required by the Tax Cuts and Jobs Act signed into law on December 22, 2017. This was partially offset by the payment to the State of California for the cost of doing business within the state. No additional income tax expense was recorded as a result of our full valuation allowance, discussed further below. The year ended December 31, 2017 results reflect the estimated impact of the enactment of the new tax law, which resulted in a minimal increase in net income due to the elimination of the corporate alternative minimum tax. Additionally, as part of the newly enacted tax law, the decrease in our deferred tax asset and corresponding valuation allowance as of December 31, 2017 is primarily attributable to the Federal corporate tax rate decreasing from 35% to 21%, which caused us to decrease our gross deferred tax asset and the related valuation allowance to \$15.9 million from \$21.7 million as of September 30, 2017. Accounting rules specify that management must evaluate the deferred tax asset on a recurring basis to determine whether enough positive evidence exists to determine whether it is more-likely-than-not that the deferred tax asset will be available to offset or reduce future taxes. The tax code allows net operating losses to be carried forward for 20 years from the date of the loss, and while management believes that the Company will be able to realize the deferred tax asset within the period that our net operating losses may be carried forward, we are unable to assert the timing as to when that realization will occur. Due to the hierarchy of evidence that the accounting rules specify, management determined that a full valuation allowance that was previously established on the balance of our deferred tax asset was still required at December 31, 2017.

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

During the year ended December 31, 2018, we had an income tax benefit of \$10.8 million. The income tax benefit during the year ended December 31, 2018 is as a result of our net income during the year and the release of our full valuation allowance of \$11.1 million on our net deferred tax asset during the second quarter of 2018, discussed further below. Accounting rules specify that management must evaluate the deferred tax asset on a recurring basis to determine whether enough positive evidence exists to determine whether it is more-likely-than-not that the deferred tax asset will be available to offset or reduce future taxes. The tax code allows net operating losses incurred prior to December 31, 2017 to be carried forward for 20 years from the date of the loss, and based on its evaluation, management believes that the Company will be able to realize the deferred tax asset within the period that our net operating losses may be carried forward. Due to the hierarchy of evidence that the accounting rules specify, management determined that there continued to be enough positive evidence to support no valuation allowance on our deferred tax asset at December 31, 2018. Significant positive evidence included our three-year cumulative income position, continued improvement in asset quality, and the expectation that we will continue to have positive earnings based on eight trailing quarters of positive income and our forecast. Negative evidence included our accumulated deficit. Due to the hierarchy of evidence that the accounting rules specify, management determined that there continued to be enough positive evidence to support no valuation allowance on our deferred tax asset at December 31, 2018.

As of December 31, 2018, we had net operating loss carryforwards of \$12.0 million and \$36.4 million for federal and state tax purposes, respectively, which are available to offset future taxable income. If not used, these carryforwards begin expiring in 2032 and would fully expire in 2036. Refer to the table below for the amount and expiration of our net operating loss carryforwards:

	Federal	State	Expiration
	(amounts in thousands)		
2009 ⁽¹⁾	—	6,894	12/31/2032
2010 ⁽¹⁾	—	5,258	12/31/2032
2012	—	774	12/31/2032
2013	—	8,727	12/31/2033
2015	—	280	12/31/2035
2016	12,027	14,453	12/31/2036
2017	—	—	12/31/2037
2018 ⁽²⁾	—	—	12/31/2038
	\$ 12,027	\$ 36,386	

(1) California net operating loss carryforwards were suspended by the Franchise Tax Board during these periods and the carryover was extended.

(2) As a result of the Tax Cuts and Jobs Act, federal net operating loss carryforwards do not expire starting with any losses sustained during 2018 or later. California net operating loss carryforwards begin to expire on the date listed.

We file income tax returns with the U.S. federal government and the State of California. As of December 31, 2018, we were subject to examination by the Internal Revenue Service with respect to our U.S. federal tax returns for the 2015 to 2017 tax years and the Franchise Tax Board for California state income tax returns for the 2014 to 2017 tax years. Net operating losses on our U.S. federal and California state income tax returns may be carried forward up to 20 years. As of December 31, 2018, we do not have any unrecognized tax benefits.

Our policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of tax expense. We did not have any accrued interest or penalties associated with any unrecognized tax benefits, and no interest expense was recognized during the years ended December 31, 2018, 2017 and 2016.

11. Stock-Based Employee Compensation Plans

In May 2010, our shareholders approved the adoption of our 2010 Equity Incentive Plan (the "2010 Incentive Plan"), which authorized and set aside a total of 400,000 shares of our common stock for issuance on the exercise of stock options or the grant of restricted stock or other equity incentives to our officers, and other key employees and directors. An additional 158,211 shares of common stock were also set aside which was equal to the total of the shares that were available for the grant of equity incentives under our shareholder-approved 2008 and 2004 Equity Incentive Plans (the "Previously Approved Plans") at the time of the adoption of the 2010 Incentive Plan. Options to purchase a total of 66,442 shares of our common stock granted under the Previously Approved Plans were outstanding at December 31, 2018. The 2010 Incentive Plan provides that if any of these outstanding options under the Previously Approved Plans expire or are terminated for any reason, then the number of shares that would become available for grants or awards of equity incentives under the 2010 Incentive Plan would be increased by an equivalent

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

number of shares. At the Annual Shareholders meeting held in May 2013, our shareholders approved an additional 800,000 share increase in the maximum number of shares of our common stock that may be issued pursuant to grants or exercises of options or restricted shares or other equity incentives under the 2010 Incentive Plan, of which 64,204 shares of restricted stock vested during the year ended December 31, 2018, thereby decreasing the maximum number of shares authorized under the 2010 Incentive Plan. As a result, as of December 31, 2018, the maximum number of shares that were authorized for the grant of options or other equity incentives under the 2010 Incentive Plan totaled 1,116,256 (assuming that all 66,442 shares of our common stock subject to options under the Previously Approved Plans expire or are terminated), or approximately 5% of the shares of our common stock then outstanding.

A stock option entitles the recipient to purchase shares of our common stock at a price per share that may not be less than 100% of the fair market value of the Company's shares on the date the option is granted. Restricted shares may be granted at such purchase prices and on such other terms, including restrictions and Company repurchase or reacquisition rights, as are fixed by the Compensation Committee at the time rights to purchase such restricted shares are granted. Stock Appreciation Rights ("SARs") entitle the recipient to receive a cash payment in an amount equal to the difference between the fair market value of the Company's shares on the date of vesting and a "base price" (which, in most cases, will be equal to the fair market value of the Company's shares on the date the SAR is granted), subject to the right of the Company to make such payment in shares of its common stock at their then fair market value. Options, restricted shares and SARs may vest immediately or in installments over various periods generally ranging up to five years, subject to the recipient's continued employment or service or the achievement of specified performance goals, as determined by the Compensation Committee at the time it grants or awards the options, the restricted shares or the SARs. Stock options and SARs may be granted for terms of up to 10 years after the date of grant, but will terminate sooner upon or shortly after a termination of service occurring prior to the expiration of the term of the option or SAR. The Company will become entitled to repurchase any unvested restricted shares, at the same price that was paid for the shares by the recipient, or to cancel those shares in the event of a termination of employment or service of the holder of such shares or if any performance goals specified in the award are not satisfied. To date, the Company has not granted any SARs.

Under FASB ASC 718-10, we are required to recognize, in our financial statements, the fair value of the options or any restricted shares that we grant as compensation cost over their respective service periods. The fair values of the options that were outstanding at December 31, 2018 under the 2010 Incentive Plan were estimated as of their respective dates of grant using the Black-Scholes option-pricing model. The Company, under the 2010 Incentive Plan, granted restricted stock for the benefit of its employees. These restricted shares vest over a period of three years. The recipients of restricted shares have the right to vote all shares subject to such grant and receive all dividends with respect to such shares whether or not the shares have vested. The recipients do not pay any cash consideration for the shares.

Stock Options

The table below summarizes the weighted average assumptions used to determine the fair values of the options granted during the following periods:

<u>Assumptions with respect to:</u>	<u>Year Ended December 31,</u>		
	<u>2018</u>	<u>2017</u>	<u>2016</u>
Expected volatility	30%	33%	38%
Risk-free interest rate	2.69%	1.98%	1.70%
Expected dividends	—%	—%	—%
Expected term (years)	5.8	5.7	6.3
Weighted average fair value of options granted during period	\$ 2.81	\$ 2.84	\$ 2.78

The following table summarizes the stock option activity under the Company's equity incentive plans during the years ended December 31, 2018, 2017 and 2016, respectively.

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Number of Shares	Weighted-Average Exercise Price Per Share	Number of Shares	Weighted-Average Exercise Price Per Share	Number of Shares	Weighted-Average Exercise Price Per Share
	2018		2017		2016	
Outstanding – January 1,	792,577	\$ 6.41	1,066,914	\$ 6.35	838,696	\$ 6.20
Granted	154,011	8.20	3,700	8.21	402,051	6.89
Exercised	(75,108)	4.95	(205,970)	5.89	(97,292)	4.66
Forfeited/Canceled	(7,150)	6.47	(72,067)	7.06	(76,541)	9.74
Outstanding – December 31,	<u>864,330</u>	6.86	<u>792,577</u>	6.41	<u>1,066,914</u>	6.35
Options Exercisable – December 31,	588,873	6.49	537,229	6.17	604,970	5.95
Options Vested – December 31,	588,873	\$ 6.49	537,229	\$ 6.17	604,970	\$ 5.95

Options to purchase 75,108, 205,970, and 97,292 shares of our common stock were exercised during the years ended December 31, 2018, 2017 and 2016, respectively. The aggregate intrinsic value of options exercised during the years ended December 31, 2018, 2017 and 2016, was \$356 thousand, \$405 thousand and \$249 thousand, respectively. The fair values of options vested during the years ended December 31, 2018, 2017 and 2016 were \$360 thousand, \$401 thousand and \$311 thousand, respectively.

The following table provides additional information regarding the vested and unvested options that were outstanding at December 31, 2018.

	Options Outstanding as of December 31, 2018				Options Exercisable as of December 31, 2018 ⁽¹⁾		
	Vested	Unvested	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Shares	Weighted Average Exercise Price	
\$2.97 – \$3.99	18,003	—	\$ 3.48	2.45	18,003	\$ 3.48	
\$4.00 – \$4.99	16,000	—	4.34	2.30	16,000	4.34	
\$5.00– \$5.99	15,000	—	5.30	4.47	15,000	5.30	
\$6.00– \$6.99	415,084	81,403	6.61	5.50	415,084	6.57	
\$7.00-\$8.90	124,786	194,054	7.63	7.93	124,786	7.09	
	588,873	275,457	\$ 6.86	6.26	588,873	\$ 6.49	

(1) The weighted average remaining contractual life of the options that were exercisable as of December 31, 2018 was 5.32 years.

The aggregate intrinsic values of options that were outstanding and exercisable under the 2010 Incentive Plan at December 31, 2018 and 2017 was \$388 thousand and \$1.4 million, respectively.

A summary of the status of the unvested options outstanding as of December 31, 2018, 2017 and 2016, and changes in the weighted average grant date fair values of the unvested options during the years ended December 31, 2018, 2017 and 2016, are set forth in the following table.

	For the year ended					
	2018		2017		2016	
	Number of Shares Subject to Options	Weighted Average Grant Date Fair Value	Number of Shares Subject to Options	Weighted Average Grant Date Fair Value	Number of Shares Subject to Options	Weighted Average Grant Date Fair Value
Unvested at the beginning of the year	255,348	\$ 2.80	461,944	\$ 2.79	215,926	\$ 2.93
Granted	154,011	2.81	3,700	2.84	402,051	2.75
Vested	(126,752)	2.84	(141,829)	2.83	(108,820)	2.86
Forfeited/Canceled	(7,150)	2.66	(68,467)	2.68	(47,213)	2.88
Unvested at the end of the year	<u>275,457</u>	\$ 2.79	<u>255,348</u>	\$ 2.80	<u>461,944</u>	\$ 2.79

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At December 31, 2018, the weighted average period over which nonvested awards were expected to be recognized was 2.35 years.

Restricted Stock

We issued 82,217 shares of restricted stock under the 2010 Incentive Plan during the year ended December 31, 2018, at a price of \$8.33 that vest on an annual prorated basis over the next three years. The following table summarizes the activity related to restricted stock granted, vested and forfeited under our equity incentive plans during the years ended December 31, 2018, 2017 and 2016.

	For the year ended					
	2018		2017		2016	
	Number of Shares	Average Grant Date Fair Value	Number of Shares	Average Grant Date Fair Value	Number of Shares	Average Grant Date Fair Value
Outstanding at the beginning of the year	103,508	\$ 7.33	151,298	\$ 6.84	129,283	\$ 6.75
Granted	82,217	8.33	40,907	8.02	121,775	6.79
Vested	(64,204)	7.29	(69,667)	6.80	(67,456)	6.68
Forfeited	(6,490)	7.92	(19,030)	6.82	(32,304)	6.64
Outstanding at the end of the year	<u>115,031</u>	<u>\$ 8.04</u>	<u>103,508</u>	<u>\$ 7.33</u>	<u>151,298</u>	<u>\$ 6.84</u>

Compensation Expense

We expect that the compensation expense that will be recognized during the periods presented below in respect of stock options and restricted stock outstanding at December 31, 2018, will be as follows:

	Estimated Stock Based Compensation Expense Stock Options	Estimated Stock Based Compensation Expense Restricted Stock	Estimated Stock Based Compensation Expense Total
(Dollars in thousands)			
For the years ending December 31,			
2019	\$ 192	\$ 235	\$ 427
2020	153	185	338
2021	45	78	123
2022	19	46	65
2023 and beyond	3	11	14
	<u>\$ 412</u>	<u>\$ 555</u>	<u>\$ 967</u>

The aggregate amounts of stock based compensation expense recognized in our consolidated statements of operations for the years ended December 31, 2018, 2017 and 2016 were \$623 thousand, \$796 thousand and \$1.0 million, respectively, in each case net of taxes.

12. Employee Benefit Plans

The Company has a 401(k) plan that covers substantially all full-time employees. That plan permits voluntary contributions by employees, a portion of which are sometimes matched by the Company. The Company's expenses relating to its contributions to the 401(k) plan for the years ended December 31, 2018, 2017 and 2016 were \$365 thousand, \$248 thousand, and \$342 thousand, respectively.

In January 2001, the Company established an unfunded Supplemental Retirement Plan ("SERP") for our former CEO, Raymond E. Dellerba, who retired from that position in April 2013. The SERP was amended and restated in April 2006 to comply with the requirements of new Section 409A of Internal Revenue Code. The SERP provides that, subject to meeting certain vesting requirements described below, upon reaching age 65, Mr. Dellerba will become entitled to receive 180 equal successive monthly retirement payments, each in an amount equal to 60% of his average monthly base salary during the three years immediately preceding his reaching 65 years old (the "Monthly SERP Benefit"). Mr. Dellerba reached the age of 65 in January 2013 and, as a result, a monthly benefit payment under the SERP to Mr. Dellerba commenced on February 1, 2013.

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

The changes in the projected benefit obligations under the SERP during 2018, 2017 and 2016, its funded status at December 31, 2018, 2017 and 2016, and the amounts recognized in our consolidated statements of financial condition at each of those dates were as follows:

(Dollars in thousands)	At December 31,		
	2018	2017	2016
Change in benefit obligation:			
Benefit obligation at beginning of period	\$ 2,345	\$ 2,511	\$ 2,667
Service cost	—	—	—
Interest cost	131	141	150
Actuarial loss/(gain)	—	—	—
(Benefits paid)	(307)	(307)	(306)
Benefit obligation at end of period	\$ 2,169	\$ 2,345	\$ 2,511
Funded status:			
Amounts recognized in the Statement of Financial Condition			
Unfunded accrued SERP liability—current	\$ (299)	\$ (299)	\$ (299)
Unfunded accrued SERP liability—noncurrent	(1,870)	(2,046)	(2,212)
Total unfunded accrued SERP liability	\$ (2,169)	\$ (2,345)	\$ (2,511)
Net amount recognized in accumulated other comprehensive income			
Prior service cost/(benefit)	\$ —	\$ —	\$ —
Net actuarial loss/(gain)	—	—	—
Total net amount recognized in accumulated other comprehensive income	\$ —	\$ —	\$ —
Accumulated benefit obligation	\$ 2,169	\$ 2,345	\$ 2,511
Components of net periodic SERP cost year to date:			
Service cost	\$ —	\$ —	\$ —
Interest cost	131	141	150
Amortization of prior service cost/(benefit)	—	—	—
Amortization of net actuarial loss/(gain)	—	—	—
Net periodic SERP cost	\$ 131	\$ 141	\$ 150

As of December 31, 2018, \$1.5 million benefits are expected to be paid in the next five years and a total of \$1.3 million of benefits are expected to be paid from year 2024 through year 2028. In 2019, \$120,245 is expected to be recognized in net periodic benefit cost.

13. Earnings Per Share (“EPS”)

Basic EPS excludes dilution and is computed by dividing net income or loss allocable to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if stock options or other contracts to issue common stock were exercised or converted into common stock that would then share in our earnings.

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The following table shows how we computed basic and diluted EPS for the year ended December 31, 2018 and 2017.

(In thousands, except per share data)	For the Year Ended December 31,		
	2018	2017	2016
Basic EPS:			
Net income	\$ 27,339	\$ 10,449	\$ (34,643)
Less dividends on preferred stock	—	—	—
Less dividends on common stock	—	—	—
Less dividends on unvested shares	—	—	—
Net income allocable to common shareholders	\$ 27,339	\$ 10,449	\$ (34,643)
Less earnings allocated to participating securities	648	49	(236)
Earnings allocated to common shareholders	\$ 26,691	\$ 10,400	\$ (34,407)
Weighted average common shares outstanding	22,788	23,072	22,802
Basic earnings per common share	\$ 1.17	\$ 0.45	\$ (1.51)
Diluted EPS:			
Earnings allocated to common shareholders	\$ 27,339	\$ 10,449	\$ (34,643)
Weighted average common shares outstanding	22,788	23,072	22,802
Add dilutive effects of restricted stock grants	115	109	157
Add dilutive effects for assumed conversion of Series A preferred stock	438	—	—
Add dilutive effect for stock options	186	131	—
Weighted average diluted common shares outstanding	23,527	23,312	22,959
Diluted earnings per common share	\$ 1.16	\$ 0.45	\$ (1.51)

(1) The basic and diluted earnings per share amounts for the years ended December 31, 2018, 2017 and 2016 are the same under both the Treasury Stock Method and the Two-Class Method as prescribed in FASB ASC 260-10, *Earnings Per Share*.

The weighted average shares that have an antidilutive effect in the calculation of diluted net income (loss) per share and have been excluded from the computations above were as follows:

	For the Year Ended December 31,		
	2018	2017	2016
Stock options ⁽¹⁾⁽²⁾	138,608	200,824	1,038,317

(1) Stock options were excluded from the computation of diluted earnings per common share for the year ended December 31, 2016 as we reported a net loss from continuing operations.

(2) Stock options were excluded from the computation of diluted earnings per common share for the years ended December 31, 2018 and 2017 because the options were either "out-of-the-money" or the effect of exercise would have been antidilutive.

14. Shareholders' Equity

Preferred Stock

During the year ended December 31, 2018, Carpenter Community BancFund, LP and Carpenter Community BancFund-A, LP ("the Carpenter Funds"), the largest shareholders of PMBC, the holding company of the Bank, sold all of their equity interest in PMBC to certain accredited investors in privately negotiated transactions (the "Carpenter Disposition Transactions"). The Carpenter Disposition Transactions included the sale of 1,467,155 shares of a new series of non-voting preferred stock designated as Series A Non-Voting Preferred Stock (the Series A Non-Voting Preferred Stock) that PMBC issued to the Carpenter Funds in exchange (the Exchange) for 1,467,155 shares of PMBC's common stock owned by the Carpenter Funds. After giving effect to the Exchange, PMBC had 21,917,995 shares of common stock issued and outstanding and 1,467,155 shares of Series A Non-Voting Preferred Stock issued and outstanding. The shares of Series A Non-Voting Preferred Stock were issued to the Carpenter Funds to facilitate the Carpenter Disposition Transactions and have substantially the same rights, preferences and privileges of the common stock, except that the Series A Non-Voting Preferred Stock is not entitled to vote on any matter other than where required under California law and that each share of Series A Non-Voting Preferred Stock has a liquidation preference of \$0.0001 per share over the common stock. The shares of common stock and Series A Non-Voting Preferred Stock purchased by investors from the Carpenter Funds in the Carpenter Disposition Transactions are restricted securities subject to trading restrictions under the federal securities laws.

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The lead investor in the Carpenter Disposition Transactions, Patriot Financial Partners III, L.P., a Delaware limited partnership ("Patriot"), acquired 3,636,363 total common-equivalent shares of PMBC, comprised of 2,169,208 shares of common stock (9.9% of the total voting shares outstanding after giving effect to the Exchange) and 1,467,155 shares of the Series A Non-Voting Preferred Stock. After giving effect to the Carpenter Disposition Transactions (including the Exchange), Patriot holds a 15.6% equity interest in the PMBC.

Accumulated Other Comprehensive Income, net

Accumulated other comprehensive income, net as of December 31, 2018, 2017 and 2016 was as follows:

	Unrealized Gain (Loss) on Securities Available- for-Sale, net of tax	Accumulated Other Comprehensive Income, Net
	(Dollars in thousands)	
Beginning balance as of January 1, 2016	\$ (810)	\$ (810)
Other comprehensive income before reclassifications, net of tax provision of \$739 thousand ⁽¹⁾	(1,032)	(1,032)
Amounts reclassified from accumulated other comprehensive income, net of tax	—	—
Other comprehensive income, net of tax provision of \$739 thousand	(1,032)	(1,032)
Ending balance as of December 31, 2016	<u>\$ (1,842)</u>	<u>\$ (1,842)</u>
Other comprehensive income before reclassifications ⁽²⁾	695	695
Amounts reclassified from accumulated other comprehensive income, net of tax ⁽³⁾	4	4
Other comprehensive income ⁽²⁾	699	699
Ending balance as of December 31, 2017	<u>\$ (1,143)</u>	<u>\$ (1,143)</u>
Other comprehensive income before reclassifications, net of tax of \$142 thousand	(50)	(50)
Amounts reclassified from accumulated other comprehensive loss ⁽⁴⁾	49	49
Other comprehensive loss, net of tax of \$142 thousand	(1)	(1)
Ending balance as of December 31, 2018	<u>\$ (1,144)</u>	<u>\$ (1,144)</u>

(1) Tax impact included in *Deferred tax assets*.

(2) No tax impact as a result of the full valuation allowance recorded against our deferred tax asset at December 31, 2017.

(3) Relates to the realized loss on our securities available for sale. The realized loss is included within *Net loss on sale of securities available for sale*.

(4) This balance consists of the \$48 thousand net gain on sale of available for sale debt securities included in our *consolidated statement of operations* offset by \$97 thousand included in our *consolidated statement of shareholders' equity* as an adjustment to our beginning retained earnings.

Dividends

Payment of Cash Dividends by the Company. California laws place restrictions on the ability of California corporations to pay cash dividends on preferred or common stock. Subject to certain limited exceptions, a California corporation may pay cash dividends only to the extent of (i) the amount of its retained earnings or (ii) the amount by which the fair value of the corporation's assets exceeds its liabilities. We have committed to obtaining approval from the FRB and the CDBO prior to paying any dividends. The Company's ability to pay dividends is also limited by the ability of the Bank to pay cash dividends to the Company. See "*Payment of Dividends by the Bank to the Company*" below.

Payment of Dividends by the Bank to the Company. Generally, the principal source of cash available to a bank holding company consists of cash dividends from its bank subsidiaries. Under California law, the Board of Directors of the Bank may declare and pay cash dividends to the Company, which is its sole shareholder, subject to the restriction that the amount available for the payment of cash dividends may not exceed the lesser of (i) the Bank's retained earnings or (ii) its net income for its last three fiscal years (less the amount of any dividends paid during such period). Cash dividends by the Bank to the Company in excess of that amount may be made only with the prior approval of the California Commissioner of Financial Institutions ("Commissioner"). If the Commissioner finds that the shareholders' equity of the Bank is not adequate, or that the payment by the Bank of cash dividends to the Company would be unsafe or unsound for the Bank, the Commissioner can order the Bank not to pay such dividends.

The ability of the Bank to pay dividends is further restricted under the Federal Deposit Insurance Corporation Improvement Act of 1991, which prohibits an FDIC-insured bank from paying dividends if, after making such payment, the bank would fail to meet any of its minimum capital requirements. Under the Financial Institutions Supervisory Act and Federal Financial Institutions

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Reform, Recovery and Enforcement Act of 1989, federal banking regulators also have authority to prohibit FDIC-insured financial institutions from engaging in business practices which are considered to be unsafe or unsound. Under the authority of these acts, federal bank regulatory agencies, as part of their supervisory powers, generally require FDIC insured banks to adopt dividend policies which limit the payment of cash dividends. We have agreed that the Bank will not, without the FRB and CDBO's prior written approval, pay any dividends to Bancorp.

15. Commitments and Contingencies

Leases

We lease certain facilities and equipment under various non-cancelable operating leases, which generally include 2% to 6% escalation clauses in the lease agreements. Rent expense for the years ended December 31, 2018, 2017 and 2016 was \$2.1 million, \$2.4 million, and \$2.6 million, respectively.

Future minimum non-cancelable lease commitments were as follows at December 31, 2018:

(Dollars in thousands)

2019	\$	2,398
2020		1,242
2021		347
2022		218
2023 and beyond		452
Total	\$	<u>4,657</u>

Commitments

To meet the financing needs of our customers in the normal course of business, we are a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. At December 31, 2018 and 2017, we were committed to fund certain loans including letters of credit amounting to approximately \$302 million and \$295 million, respectively. The contractual amounts of a credit-related financial instrument, such as a commitment to extend credit, a credit-card arrangement or a letter of credit, represents the amount of potential accounting loss should the commitment be fully drawn upon, the customer were to default, and the value of any existing collateral securing the customer's payment obligation becomes worthless. The loss reserve for unfunded loan commitments was \$350 thousand and \$350 thousand at December 31, 2018 and 2017, respectively.

As a result, we use the same credit policies in making commitments to extend credit and conditional obligations as we do for on-balance sheet instruments. Commitments generally have fixed expiration dates; however, since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis, using the same credit underwriting standards that are employed in making commercial loans. The amount of collateral obtained, if any, upon an extension of credit is based on our evaluation of the creditworthiness of the customer. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, residential real estate and income-producing commercial properties.

We are required to purchase stock in the FRBSF in an amount equal to 6% of our capital, one-half of which must be paid currently with the balance due upon request.

The Bank is a member of the FHLB and therefore, is required to purchase FHLB stock in an amount equal to the lesser of 1% of the Bank's real estate loans that are secured by residential properties, or 5% of total advances.

Litigation, Claims and Assessments

We are a defendant in or a party to a number of legal actions or proceedings that arise in the ordinary course of business. In some of these actions and proceedings, claims for monetary damages are asserted against us.

In accordance with applicable accounting guidance, we establish an accrued liability for lawsuits or other legal proceedings when they present loss contingencies that are both probable and estimable. We estimate any potential loss based upon currently available information and significant judgments and a variety of assumptions, and known and unknown uncertainties. Moreover, the facts and circumstances on which such estimates are based will change over time. Therefore, the amount of any losses we might incur in any lawsuits or other legal proceedings may exceed amounts which we had accrued based on our estimates and

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

those estimates do not represent the maximum loss exposure that we may have in connection with any lawsuits or other legal proceedings.

In December 2016, following an ongoing review related to alleged discriminatory practices within our discontinued mortgage banking business, we received notice that the U.S. Department of Justice (“DOJ”) had authorized a potential enforcement action against the Bank. During the year ended December 31, 2018, we settled this matter with the DOJ for \$1.0 million, which we have fully accrued and funded as of December 31, 2018.

Based on our evaluation of the remaining lawsuits and other proceedings that were pending against us as of December 31, 2018, the outcomes in those suits or other proceedings are not expected to have, either individually or in the aggregate, a material adverse effect on our consolidated financial position, results of operations or cash flows. However, in light of the inherent uncertainties involved, some of which are beyond our control, and the very large or indeterminate damages often sought in such legal actions or proceedings, an adverse outcome in one or more of these suits or proceedings could be material to our results of operations or cash flows for any particular reporting period.

16. Capital/Operating Plans

Under federal banking regulations that apply to all United States-based bank holding companies over \$3 billion in total assets and all federally insured banks, the Bank (on a stand-alone basis) must meet specific capital adequacy requirements that, for the most part, involve quantitative measures, primarily in terms of the ratios of their capital to their assets, liabilities, and certain off-balance sheet items, calculated under regulatory accounting practices. The Company (on a consolidated basis) is below the reporting threshold of \$3 billion in total assets and therefore is not subject to the same capital adequacy requirements. Under those regulations, each federally insured bank is determined by its primary federal bank regulatory agency to come within one of the following capital adequacy categories on the basis of its capital ratios:

- well-capitalized
- adequately capitalized
- undercapitalized
- significantly undercapitalized; or
- critically undercapitalized

Certain qualitative assessments also are made by a banking institution’s primary federal regulatory agency that could lead the agency to determine that the banking institution should be assigned to a lower capital category than the one indicated by the quantitative measures used to assess the institution’s capital adequacy. At each successive lower capital category, a banking institution is subject to greater operating restrictions and increased regulatory supervision by its federal bank regulatory agency.

The actual capital amounts and ratios of the Bank at December 31, 2018 and December 31, 2017 are presented in the following tables:

<u>At December 31, 2018</u>	<u>Applicable Federal Regulatory Requirement</u>					
	<u>Actual Capital</u>		<u>For Capital Adequacy Purposes</u>		<u>To be Categorized As Well Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
(Dollars in thousands)						
Total Capital to Risk Weighted Assets:						
Bank	160,372	13.0%	106,072	At least 8.625	\$ 122,982	At least 10.0
Common Equity Tier 1 Capital to Risk Weighted Assets:						
Bank	146,516	11.9%	63,028	At least 5.125	79,938	At least 6.5
Tier 1 Capital to Risk Weighted Assets:						
Bank	146,516	11.9%	81,475	At least 6.625	\$ 98,385	At least 8.0
Tier 1 Capital to Average Assets:						
Bank	146,516	10.8%	54,403	At least 4.0	\$ 68,004	At least 5.0

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

<u>At December 31, 2017</u>	Applicable Federal Regulatory Requirement					
	Actual Capital		For Capital Adequacy Purposes		To be Categorized As Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
Total Capital to Risk Weighted Assets:						
Bank	137,581	11.6%	102,386	At least 8.625	\$ 118,709	At least 10.0
Common Equity Tier 1 Capital to Risk Weighted Assets:						
Bank	123,035	10.4%	60,838	At least 5.125	77,161	At least 6.5
Tier 1 Capital to Risk Weighted Assets:						
Bank	123,035	10.4%	78,645	At least 6.625	\$ 94,967	At least 8.0
Tier 1 Capital to Average Assets:						
Bank	123,035	9.9%	49,801	At least 4.0	\$ 62,251	At least 5.0

As the above tables indicate, at December 31, 2018 and 2017, the Bank (on a stand-alone basis) qualified as a “well—capitalized” institution under federally mandated capital standards and federally established prompt corrective action regulations. Since December 31, 2018, there have been no events or circumstances known to us which have changed or which are expected to result in a change in the Bank’s classification as a well-capitalized institution.

In early July 2013, the Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier 1 capital ratio, increase the minimum Tier 1 capital ratio requirement, and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The final rules took effect for community banks on January 1, 2015, subject to a transition period for certain parts of the rules. At December 31, 2018, the Bank (on a stand-alone basis) continued to qualify as a well-capitalized institution under the capital adequacy guidelines described above.

17. Parent Company Only Information

Condensed Statements of Financial Condition

<u>(Dollars in thousands)</u>	December 31,	
	2018	2017
Assets:		
Due from banks and interest-bearing deposits with financial institutions	\$ 16,699	\$ 13,916
Investment in subsidiaries	151,516	124,550
Other assets	(286)	55
Total assets	\$ 167,929	\$ 138,521
Liabilities and shareholders’ equity:		
Liabilities	\$ 102	\$ 76
Junior subordinated debentures	17,527	17,527
Shareholders’ equity	150,300	120,918
Total liabilities and shareholders’ equity	\$ 167,929	\$ 138,521

Condensed Statements of Operations

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands)	Year Ended December 31,		
	2018	2017	2016
Interest income	\$ 4	\$ 3	\$ 2
Interest expense	(845)	(670)	(582)
Other income	25	24	17
Other expenses	(1,302)	(1,045)	(1,012)
Equity in undistributed earnings (loss) of subsidiaries	29,889	12,195	(33,075)
Income tax (expense) benefit	(432)	(58)	7
Net income (loss)	\$ 27,339	\$ 10,449	\$ (34,643)

Condensed Statements of Cash Flows

(Dollars in thousands)	Year Ended December 31,		
	2018	2017	2016
Cash Flows from Operating Activities:			
Net income (loss)	\$ 27,339	\$ 10,449	\$ (34,643)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Net decrease (increase) in other assets	9	47	(19)
Net decrease in deferred taxes	331	—	38
Stock-based compensation expense	885	796	1,039
Undistributed (income) loss of subsidiary	(29,889)	(12,195)	33,075
Net increase (decrease) in interest payable	26	11	(71)
Net (decrease) increase in other liabilities	(1)	(26)	27
Net cash used in operating activities	(1,300)	(918)	(554)
Cash Flows from Investing Activities:			
Net decrease in loans	—	—	—
Net cash provided by investing activities	—	—	—
Cash Flows from Financing Activities:			
Payments for exchange of preferred stock for common stock	—	—	—
Common stock options exercised	372	1,213	455
Tax effect included in stockholders equity of restricted stock vesting	—	—	(16)
Return of capital from subsidiaries	3,711	15,000	4,000
Capital contribution to subsidiaries	—	(10,000)	(5,000)
Net cash provided by (used in) financing activities	4,083	6,213	(561)
Net increase (decrease) in cash and cash equivalents	2,783	5,295	(1,115)
Cash and Cash Equivalents, beginning of period	13,916	8,621	9,736
Cash and Cash Equivalents, end of period	\$ 16,699	\$ 13,916	\$ 8,621

18. Business Segment Information

We have one reportable business segment, commercial banking. The commercial banking segment provides small and medium-size businesses, professional firms and individuals with a diversified range of products and services such as various types of deposit accounts, various types of commercial and consumer loans, cash management services, and online banking services.

Since our operating segment derives all of its revenues from interest and noninterest income and interest expense constitutes its most significant expense, this segment is reported below using net interest income (interest income less interest expense) and noninterest income (primarily net gains on sales of small business administration loans and fee income). We do not allocate general and administrative expenses or income taxes to our operating segment.

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table sets forth information regarding the net interest income and noninterest income for our commercial banking and discontinued operations segments, respectively, for the years ended December 31, 2018, 2017 and 2016.

(Dollars in thousands)	Commercial		Other⁽¹⁾		Total
Net interest income for the year ended December 31,					
2018	\$	48,150	\$	772	\$ 48,922
2017	\$	42,995	\$	747	\$ 43,742
2016	\$	36,044	\$	(521)	\$ 35,523
Noninterest income for the Year ended December 31,					
2018	\$	4,610	\$	25	\$ 4,635
2017	\$	3,948	\$	426	\$ 4,374
2016	\$	3,438	\$	(501)	\$ 2,937
Segment Assets at:					
December 31, 2018	\$	1,349,097	\$	241	\$ 1,349,338
December 31, 2017	\$	1,320,454	\$	2,150	\$ 1,322,604

(1) Represents net interest income and noninterest income for PMAR and PMBC.

19. Unaudited Quarterly Information

Unaudited quarterly information for each of the three months in the years ended December 31, 2018 and 2017 was as follows:

	Three Months Ended			
	December 31, 2018	September 30, 2018	June 30, 2018	March 31, 2018
	(in thousands, except per share data)			
Total interest income	\$ 16,395	\$ 15,218	\$ 15,914	\$ 15,015
Total interest expense	3,794	3,529	3,467	2,830
Net interest income	12,601	11,689	12,447	12,185
Provision for loan and lease losses	—	—	—	—
Net interest income after provision for loan and lease losses	12,601	11,689	12,447	12,185
Total noninterest income	1,329	1,115	1,136	1,055
Total noninterest expense	9,135	9,002	9,299	9,533
Income before income taxes	4,795	3,802	4,284	3,707
Income tax (benefit) provision	431	(98)	(11,085)	—
Net income allocable to common shareholders	\$ 4,364	\$ 3,900	\$ 15,369	\$ 3,707
Per share data-basic:				
Net income allocable to common shareholders	\$ 0.19	\$ 0.17	\$ 0.66	\$ 0.16
Per share data-diluted:				
Net income allocable to common shareholders	\$ 0.19	\$ 0.17	\$ 0.65	\$ 0.16

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Three Months Ended			
	December 31, 2017	September 30, 2017	June 30, 2017	March 31, 2017
	(in thousands, except per share data)			
Total interest income	\$ 13,812	\$ 14,025	\$ 12,132	\$ 11,604
Total interest expense	2,542	2,020	1,736	1,533
Net interest income	11,270	12,005	10,396	10,071
Provision for loan and lease losses	—	—	—	—
Net interest income after provision for loan and lease losses	11,270	12,005	10,396	10,071
Total noninterest income	1,009	964	1,431	970
Total noninterest expense	10,108	9,176	9,262	9,211
Income before income taxes	2,171	3,793	2,565	1,830
Income tax (benefit) provision	(241)	37	64	49
Net income (loss) allocable to common shareholders	\$ 2,412	\$ 3,756	\$ 2,501	\$ 1,781
Per share data-basic:				
Net income (loss) allocable to common shareholders	\$ 0.10	\$ 0.16	\$ 0.11	\$ 0.08
Per share data-diluted:				
Net income (loss) allocable to common shareholders	\$ 0.10	\$ 0.16	\$ 0.11	\$ 0.08

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

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

As required by SEC rules, an evaluation was performed under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer of the effectiveness, as of December 31, 2018, of the Company’s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2018, the Company’s disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting

Management’s Annual Report on Internal Control Over Financial Reporting

Management of Pacific Mercantile Bancorp is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation

Table of Contents

of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Internal control over financial reporting includes those written policies and procedures that:

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

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

Our management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2018, based on criteria for effective internal control over financial reporting described in "Internal Control – Integrated Framework" (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management's assessment included an evaluation of the design and the testing of the operational effectiveness of the Company's internal control over financial reporting. Management reviewed the results of its assessment with the Audit Committee of our Board of Directors.

Based on that assessment, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2018.

The Company's independent registered public accounting firm, RSM US LLP, has issued an audit report regarding its assessment of the Company's internal control over financial reporting as of December 31, 2018, which appears herein.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting during the quarter ended December 31, 2018 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Except for the information regarding our Code of Business and Ethical Conduct below, the information required by this Item 10 is hereby incorporated by reference to Pacific Mercantile Bancorp's definitive proxy statement, expected to be filed with the SEC on or before April 30, 2019, for its Annual Meeting of Shareholders.

Our Board has adopted a Code of Business and Ethical Conduct (the "Code") that applies to all of our officers and employees and also includes specific ethical policies and principles, that apply to our Chief Executive Officer, Chief Financial Officer, the Bank's Chief Operating Officer and other key accounting and finance personnel. The Code, as applied to our principal executive officer, principal financial officer and principal accounting officer, constitutes our "code of ethics" within the meaning of Section 406 of the Sarbanes-Oxley Act and is our "code of conduct" within the meaning of the listing standards of the Nasdaq Stock Market LLC.

The Code is available in the Investor Relations section of our website at www.pmbank.com. To the extent required by applicable rules of the SEC and the Nasdaq Stock Market LLC, we will disclose on our website any amendments to the Code and any waivers of the requirements of the Code that may be granted to our executive officers, including our principal executive officer, principal financial officer, principal accounting officer or persons performing similar functions.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item 11 is hereby incorporated by reference to Pacific Mercantile Bancorp's definitive proxy statement, expected to be filed with the SEC on or before April 30, 2019, for its Annual Meeting of Shareholders.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 is incorporated herein by reference from our definitive proxy statement expected to be filed with the SEC on or before April 30, 2019, for its Annual Meeting of Shareholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item 13 is hereby incorporated by reference to Pacific Mercantile Bancorp's definitive proxy statement expected to be filed with the SEC on or before April 30, 2019, for its Annual Meeting of Shareholders.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item 14 is hereby incorporated by reference to Pacific Mercantile Bancorp's definitive proxy statement expected to be filed with the SEC on or before April 30, 2019, for its Annual Meeting of Shareholders.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

The following documents are filed as part of this Report:

- (1) Financial Statements. The Consolidated Financial Statements of Pacific Mercantile Bancorp: See Index to Consolidated Financial Statements on Page 59 of this Annual Report.
- (2) Financial Statement Schedules. No financial statement schedules are included in this Annual Report as such schedules are not required or the information that would be included in such schedules is not material or is otherwise furnished.
- (3) Exhibits. See Index to Exhibits below for a list and description of (i) exhibits previously filed by the Company with the Commission and (ii) the exhibits being filed with this Report.

EXHIBIT INDEX

Exhibit No.	Description of Exhibit
3.1	Articles of Incorporation of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.1 to the Registration Statement on Form S-1 filed with the Commission on March 28, 2000.)
3.2	Certificate of Amendment of Articles of Incorporation of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.1 to the Quarterly Report on Form 10-Q filed with the Commission on August 14, 2001.)
3.3	Certificate of Amendment of Articles of Incorporation of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed with the Commission on February 1, 2012.)
3.4	Certificate of Determination of Rights, Preferences, Privileges and Restrictions of Series A Convertible 10% Cumulative Preferred Stock of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed with the Commission on October 13, 2009.)
3.5	Certificate of Amendment of Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series A Convertible 10% Cumulative Preferred Stock of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed with the Commission on February 1, 2012.)
3.6	Certificate of Amendment of Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series A Convertible 10% Cumulative Preferred Stock of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed with the Commission on September 14, 2018.)
3.7	Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series B Convertible 8.4% Noncumulative Preferred Stock of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed with the Commission on August 22, 2011.)
3.8	Certificate of Amendment of Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series B-1 Convertible 8.4% Noncumulative Preferred Stock of Pacific Mercantile Bancorp and Series B-2 Convertible 8.4% Noncumulative Preferred Stock of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed with the Commission on September 14, 2018.)
3.9	Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series C 8.4% Noncumulative Preferred Stock of Pacific Mercantile Bancorp. (Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K (No. 000-30777) dated August 22, 2011.)
3.10	Certificate of Amendment of Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series C 8.4% Noncumulative Preferred Stock of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.3 to the Current Report on Form 8-K filed with the Commission on September 14, 2018.)
3.11	Certificate of Determination of Series A Non-Voting Preferred Stock of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.4 to the Current Report on Form 8-K filed with the Commission on September 14, 2018.)

Table of Contents

3.12	<u>Pacific Mercantile Bancorp Bylaws, amended and restated as of May 16, 2018 (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed with the Commission on May 16, 2018.)</u>
4.1	<u>Specimen form of Pacific Mercantile Bancorp Common Stock Certificate (Incorporated by reference to Exhibit 4.1 to the Registration Statement on Form S-1 filed with the Commission on June 13, 2000.)</u>
10.1	<u>Exchange Agreement, dated as of September 14, 2018, by and among Pacific Mercantile Bancorp, Carpenter Community BancFund, L.P. and Carpenter Community BancFund-A, L.P. (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed with the Commission on September 14, 2018.)</u>
10.2	<u>Investor Rights Agreement, dated as of September 14, 2018, by and among Pacific Mercantile Bancorp and Patriot Financial Partners III, L.P. (Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed with the Commission on September 14, 2018.)</u>
10.3	<u>Registration Rights Agreement, dated as of September 14, 2018, by and among Pacific Mercantile Bancorp and Patriot Financial Partners III, L.P. (Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed with the Commission on September 14, 2018.)</u>
10.4+	<u>Form of Officers and Directors Indemnification Agreement (Incorporated by reference to Exhibit 10.1 to the Registration Statement on Form S-8 filed with the Commission on October 3, 2011.)</u>
10.5+	<u>Pacific Mercantile Bancorp 2004 Stock Incentive Plan (Incorporated by reference to Exhibit 10.19 to the Annual Report on Form 10-K filed with the Commission on March 16, 2005.)</u>
10.6+	<u>Pacific Mercantile Bancorp 2008 Equity Incentive Plan (Incorporated by reference to Appendix A to the 2008 Definitive Proxy Statement on Form DEF-14A filed with the Commission on April 18, 2008.)</u>
10.7+	<u>Pacific Mercantile Bancorp 2010 Equity Incentive Plan, as amended June 5, 2013 (Incorporated by reference to Exhibit 10.1 to the Quarterly Report on Form 10-Q filed with the Commission on November 14, 2013.)</u>
10.8+	<u>Pacific Mercantile Bancorp Change in Control Severance Plan (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed with the Commission on January 27, 2014.)</u>
10.9+	<u>Form of Pacific Mercantile Bancorp Change in Control Severance Plan Participation Agreement (Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed with the Commission on January 27, 2014.)</u>
10.10+	<u>Employment Agreement, dated April 10, 2018, between Pacific Mercantile Bank and Curt A. Christianssen (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed with the Commission on April 11, 2018.)</u>
10.11+	<u>Employment Agreement, dated December 8, 2015, between Pacific Mercantile Bank and Thomas M. Vertin (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed with the Commission on December 10, 2015.)</u>
10.12+	<u>Employment Agreement, dated May 31, 2016, between Pacific Mercantile Bank and Thomas J. Inserra (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed with the Commission on June 3, 2016.)</u>
10.13+	<u>Amended and Restated Employment Agreement, dated January 3, 2019, between Pacific Mercantile Bank and Thomas J. Inserra (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed with the Commission on January 3, 2019.)</u>
10.14+	<u>Change in Control Severance Plan Participation Agreement dated May 27, 2016, between Pacific Mercantile Bank and Thomas J. Inserra (Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed with the Commission on June 3, 2016.)</u>
10.15+	<u>Employment Agreement, dated May 27, 2016, between Pacific Mercantile Bank and Maxwell G. Sinclair (Incorporated by reference to Exhibit 10.15 to the Annual Report on Form 10-K filed with the Commission on March 10, 2017.)</u>
21*	<u>Subsidiaries of the Company</u>
23.1*	<u>Consent of RSM US LLP, Independent Registered Public Accounting Firm</u>
24.1	<u>Power of Attorney (contained on the Signature Page of this Annual Report on Form 10-K)</u>
31.1*	<u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>

Table of Contents

31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1**	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2**	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 101.INS*	XBRL Instance Document
Exhibit 101.SCH*	XBRL Taxonomy Extension Schema Document
Exhibit 101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
Exhibit 101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
Exhibit 101.LAB*	XBRL Taxonomy Extension Labels Linkbase Document
Exhibit 101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith.

** Furnished herewith.

+ Management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to applicable rules of the Securities and Exchange Commission.

ITEM 16. FORM 10-K SUMMARY

None.

other voting interests held by the Company in each of such subsidiaries as of the date of this Annual Report.

Name of Subsidiary	State of Incorporation or Organization	Percentage Ownership
Pacific Mercantile Bank	A California corporation	100%
PMB Statutory Trust III	A Connecticut trust	100%
PMB Capital Trust III	A Delaware trust	100%
PM Asset Resolution, Inc.	A California corporation	100%

[\(Back To Top\)](#)

Section 3: EX-23.1 (EXHIBIT 23.1)

Exhibit 23.1

Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in Registration Statements (Nos. 333-123853, 333-190919, 333-177141 and 333-177142) on Form S-8 and Registration Statements (Nos. 333-185316, 333-191009 and 333-207368) on Form S-3 of Pacific Mercantile Bancorp of our report dated March 11, 2019, relating to our audits of the consolidated financial statements and the effectiveness of internal control over financial reporting that appear in this Annual Report on Form 10-K of Pacific Mercantile Bancorp for the year ended December 31, 2018.

/s/ RSM US LLP

Irvine, CA
March 11, 2019

[\(Back To Top\)](#)

Section 4: EX-31.1 (EXHIBIT 31.1)

Exhibit 31.1

CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER UNDER SECTION 302 OF THE SARBANES-OXLEY ACT

I, Thomas M. Vertin, certify that:

1. I have reviewed this Annual Report on Form 10-K of Pacific Mercantile Bancorp for the fiscal year ended December 31, 2018.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

- (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 11, 2019

/S/ THOMAS M. VERTIN

Thomas M. Vertin

President and Chief Executive Officer

[\(Back To Top\)](#)

Section 5: EX-31.2 (EXHIBIT 31.2)

Exhibit 31.2

CERTIFICATIONS OF CHIEF FINANCIAL OFFICER UNDER SECTION 302 OF THE SARBANES-OXLEY ACT

I, Curt Christianssen, certify that:

- 1. I have reviewed this Annual Report on Form 10-K of Pacific Mercantile Bancorp for the fiscal year ended December 31, 2018.
- 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has

materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 11, 2019

/S/ CURT A. CHRISTIANSEN

Curt A. Christianssen
Chief Financial Officer

[\(Back To Top\)](#)

Section 6: EX-32.1 (EXHIBIT 32.1)

Exhibit 32.1

**CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER
UNDER
SECTION 906 OF THE SARBANES-OXLEY ACT**

PACIFIC MERCANTILE BANCORP

Annual Report on Form 10-K
for the fiscal year ended December 31, 2018

In connection with the accompanying Annual Report on Form 10-K of Pacific Mercantile Bancorp (the "Company") for the fiscal year ended December 31, 2018 (the "Annual Report"), and pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2003, I, Thomas M. Vertin, certify that:

- (1) The Annual Report fully complies with the requirements of Section 13(a) and 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Annual Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 11, 2019

/S/ THOMAS M. VERTIN

Thomas M. Vertin
President and Chief Executive Officer

[\(Back To Top\)](#)

Section 7: EX-32.2 (EXHIBIT 32.2)

Exhibit 32.2

**CERTIFICATIONS OF CHIEF FINANCIAL OFFICER
UNDER
SECTION 906 OF THE SARBANES-OXLEY ACT**

PACIFIC MERCANTILE BANCORP

Annual Report on Form 10-K
for the fiscal year ended December 31, 2018

In connection with the accompanying Annual Report on Form 10-K of Pacific Mercantile Bancorp (the “Company”) for the fiscal year ended December 31, 2018 (the “Annual Report”), and pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2003, I, Curt Christianssen, certify that:

(1) The Annual Report fully complies with the requirements of Section 13(a) and 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Annual Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 11, 2019

/S/ CURT A. CHRISTIANSEN

Curt A. Christianssen
Chief Financial Officer

[\(Back To Top\)](#)