



VISION

We will earn our independence by delivering strong and sustainable returns to our shareholders that maximize the long-term value of our company.

PURPOSE

To be a catalyst for successful growth in our people, our company, and our community.

CORE VALUES

INTEGRITY

OWNERSHIP

RESPECT

EXCELLENCE

TEAMWORK

bank of
commerce
HOLDINGS

TO THE SHAREHOLDERS OF BANK OF COMMERCE HOLDINGS,

The year just ended has been very positive for the Company and we are proud to present our accomplishments in this 2018 Annual Report. It was a year where we executed on our promise to deploy capital through steady quality growth and to enhance our return on assets and equity. By almost any metric, we delivered our most successful year in the company's history and we credit all of our employees for making these successes possible.

Net income for 2018 totaled \$15.7 million (\$0.96 per share), our most profitable year. This was an increase of \$8.4 million (114%) compared with the \$7.3 million (\$0.48 per share) we earned in 2017, and enabled us to increase our cash dividend. For 2018, ROAA totaled 1.22%, ROAE totaled 12.08% and our efficiency ratio improved to 62.5%.

Our sales teams again delivered outstanding performances. Average loans increased \$97.2 million (12%) and average earning assets increased \$95.6 million (9%). Average total deposits increased \$56.9 million (5%), but more importantly, core deposits increased \$94.4 million (11%) while reliance on time deposits decreased \$37.5 million (18%). Each of these accomplishments contributed to the continued improvement in our net interest margin.

In October 2018, we announced our pending acquisition of The Merchants National Bank of Sacramento, the oldest bank in Sacramento with a customer base that mirrored our own. Approximately two months ago we successfully completed that transaction, our first; and with the integration of Merchants Bank, assets now total \$1.5 billion, the loan portfolio totals \$1.0 billion and deposits total \$1.3 billion. Our company is well positioned for growth and we look forward to engaging in future strategic partnerships.

We continue to face difficult challenges during this era of dynamic technological innovation and rapid consolidation within the financial services industry. As you know, the equity markets at year-end were volatile and our stock valuation declined, as did many others in our industry. We cannot control the markets. But we can, and do remain focused on achieving our core business objectives and on meeting our primary responsibility which is to deliver consistent competitive returns to our shareholders. As always, we thank our employees, customers and shareholders for placing their trust in us.



RANDALL S. ESLICK

President & CEO



JAMES A. SUNDQUIST

Executive Vice President & CFO

LEADERSHIP

DIRECTORS

ORIN N. BENNETT

Founder and Senior Advisor
Bennett Engineering Services

GARY R. BURKS

General Manager
Blach Beverage LLC

RANDALL S. ESLICK

President and Chief Executive Officer
Bank of Commerce Holdings

JOSEPH Q. GIBSON

Insurance Agent
George Petersen Insurance

JON W. HALFIDE

Vice Chairman of the Board
Retired President
Dignity Healthcare North State Service Area
and St. Elizabeth Community Hospital

DAVID J. INDERKUM

Owner
Coast Line Supply and Equipment

LINDA J. MILES

Retired Executive Vice President
Chief Operating Officer
Bank of Commerce Holdings

KARL L. SILBERSTEIN

Retired Senior Vice President
Financial Operations
Dignity Health

TERENCE J. STREET

General Manager
General Contracting Division
Clark Pacific

LYLE L. TULLIS

Chairman of the Board
President
Tullis, Inc.

EXECUTIVE OFFICERS

RANDALL S. ESLICK

President &
Chief Executive Officer

JAMES A. SUNDQUIST

Executive Vice President
& Chief Financial Officer

SAMUEL D. JIMENEZ

Executive Vice President
& Chief Operating Officer

ROBERT H. MUTTERA

Executive Vice President
& Chief Credit Officer



The Company's **MANY SUCCESSES**
in 2018 are demonstrative
of our commitment to deliver
CONSISTENT COMPETITIVE RETURNS
to our shareholders.

— **Randall S. Eslick** | PRESIDENT AND CEO,
BANK OF COMMERCE HOLDINGS

5-YEAR FINANCIAL SUMMARY

The selected consolidated financial data set forth below for the five years ended December 31, 2018 have been derived from the Company's audited Consolidated Financial Statements and should be read in conjunction with "Management's Discussion And Analysis Of Financial Condition And Results Of Operations" and the Company's audited Consolidated Financial Statements and notes thereto, included in our 2018 Form 10-K.

	2018	2017	2016	2015	2014
STATEMENTS OF INCOME					
<i>Amounts in thousands (except ratios and per share data)</i>					
Interest income	\$ 52,701	\$ 45,949	\$ 41,009	\$ 38,753	\$ 36,693
Net interest income	\$ 47,546	\$ 41,362	\$ 36,231	\$ 33,770	\$ 32,601
Provision for loan and lease losses	\$ —	\$ 950	\$ —	\$ —	\$ 3,175
Noninterest income	\$ 4,019	\$ 4,824	\$ 3,486	\$ 3,183	\$ 4,307
Noninterest expense	\$ 32,206	\$ 30,964	\$ 32,500	\$ 24,905	\$ 26,426
Net income available to common shareholders	\$ 15,730	\$ 7,344	\$ 5,259	\$ 8,295	\$ 5,527
BALANCE SHEETS					
Total assets	\$ 1,307,104	\$ 1,269,421	\$ 1,140,992	\$ 1,015,441	\$ 997,192
Average total assets	\$ 1,288,841	\$ 1,198,251	\$ 1,079,750	\$ 992,731	\$ 973,807
Total gross loans	\$ 946,251	\$ 879,835	\$ 804,211	\$ 716,639	\$ 660,898
Allowance for loan and lease losses	\$ 12,292	\$ 11,925	\$ 11,544	\$ 11,180	\$ 10,820
Total deposits	\$ 1,131,716	\$ 1,102,732	\$ 1,004,666	\$ 803,735	\$ 789,035
Total shareholders' equity	\$ 138,321	\$ 127,264	\$ 94,106	\$ 90,522	\$ 103,602
RATIOS¹					
Return on average assets ²	1.22%	0.61%	0.49%	0.86%	0.59%
Return on average shareholders' equity ³	12.08%	6.34%	5.68%	8.10%	5.59%
Average equity to average assets	10.10%	9.67%	8.57%	10.68%	10.51%
Common equity Tier 1 capital ratio ⁴	12.79%	12.26%	9.43%	10.06%	n/a
Tier 1 capital ratio ⁴	13.71%	13.23%	10.42%	11.16%	13.91%
Total capital ratio ⁴	15.82%	15.44%	12.68%	13.52%	15.16%
Tier 1 leverage ratio ⁴	11.21%	10.86%	9.13%	10.03%	11.60%
Net interest margin ⁵	3.93%	3.78%	3.71%	3.77%	3.71%
Average earning assets to total average assets	94.67%	93.85%	93.34%	93.43%	93.81%
Nonperforming assets to total assets ⁶	0.32%	0.46%	1.06%	1.53%	2.22%
Net (recoveries) charge-offs to average loans	(0.04%)	0.07%	(0.05%)	(0.05%)	1.04%
Allowance for loan and lease losses to gross loans	1.30%	1.36%	1.44%	1.56%	1.64%
Nonperforming loans to allowance for loan and lease losses	33.73%	48.63%	98.64%	126.09%	200.30%
Efficiency ratio ⁷	62.5%	67.0%	81.8%	67.4%	71.6%
SHARE DATA					
Average common shares outstanding — basic	16,248	15,207	13,367	13,331	13,475
Average common shares outstanding — diluted	16,332	15,310	13,425	13,365	13,520
Book value per common share	\$ 8.47	\$ 7.82	\$ 7.00	\$ 6.76	\$ 6.29
Book value per common share — tangible ⁸	\$ 8.36	\$ 7.70	\$ 6.83	\$ 6.76	\$ 6.29
Basic earnings per share	\$ 0.97	\$ 0.48	\$ 0.39	\$ 0.62	\$ 0.41
Diluted earnings per share	\$ 0.96	\$ 0.48	\$ 0.39	\$ 0.62	\$ 0.41
Cash dividends per common share	\$ 0.15	\$ 0.12	\$ 0.12	\$ 0.12	\$ 0.12

¹Regulatory Capital Ratios and Asset Quality Ratios are end-of-period ratios. With the exception of end-of-period ratios, all ratios are based on average daily balances during the indicated period.

²Return on average assets is net income (which included preferred stock costs in 2015 and 2014) divided by average total assets.

³Return on average shareholders' equity is net income (which included preferred stock costs in 2015 and 2014) divided by average shareholders' equity.

⁴See Item 7—Management's Discussion And Analysis Of Financial Condition And Results Of Operations and Note 18 Regulatory Capital in the Notes to Consolidated Financial Statements in our 2018 Form 10-K for a discussion of the regulatory capital guidelines.

⁵Net interest margin equals net interest income on a tax equivalent basis, divided by average interest-earning assets.

⁶Nonperforming assets include all nonperforming loans (nonaccrual loans, loans 90 days past due and still accruing interest and restructured loans that are nonperforming) and real estate acquired by foreclosure or transfer to OREO.

⁷The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income and presented based on results from continuing operations.

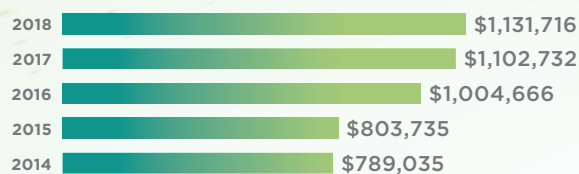
⁸Tangible book value per share is computed by dividing total shareholders' equity less goodwill and core deposit intangible, net by shares outstanding. Management believes that tangible book value per share is meaningful because it is a measure that the Company and investors commonly use to assess capital adequacy.

FINANCIALS AT A GLANCE

IN THOUSANDS (EXCEPT RATIOS AND PER SHARE DATA)

AT DECEMBER 31

Total Deposits



FOR THE YEAR

Tax-Equivalent Net Interest Margin



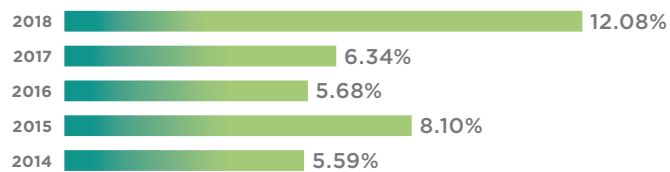
AT DECEMBER 31

Total Gross Loans



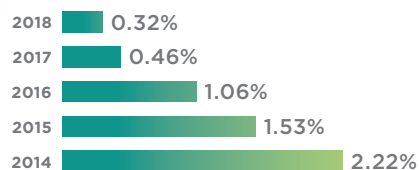
FOR THE YEAR

Return on Average Shareholders' Equity



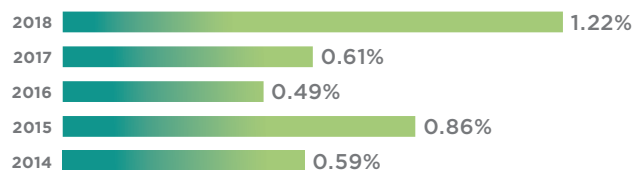
AT DECEMBER 31

Nonperforming Assets to Total Assets



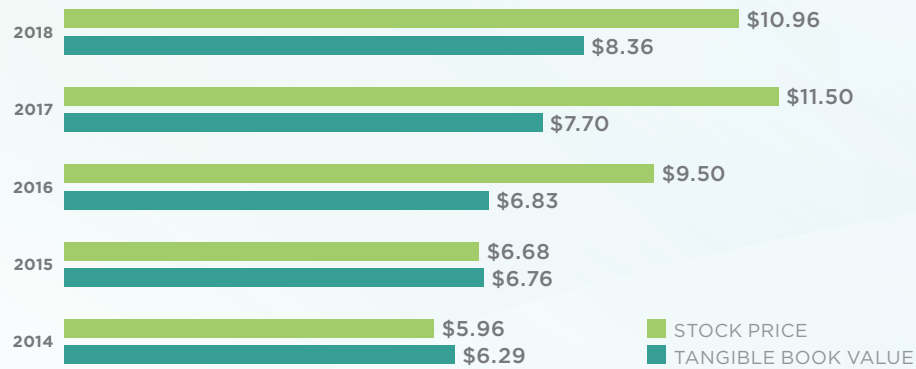
FOR THE YEAR

Return on Average Assets



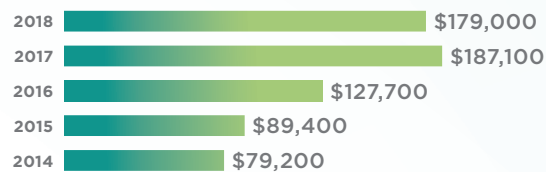
AT DECEMBER 31

Stock Price and Tangible Book Value Per Share



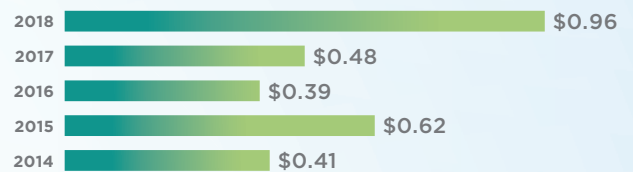
AT DECEMBER 31

Total Market Capitalization



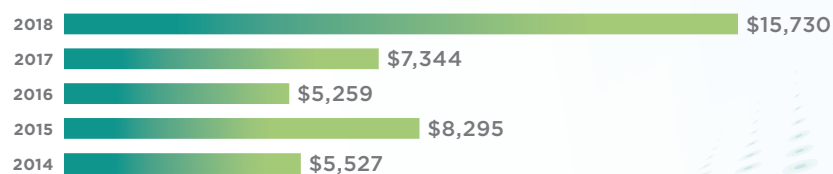
FOR THE YEAR

Diluted Earnings Per Share



FOR THE YEAR

Net Income



COMMUNITY REINVESTMENT

Taking action to improve the well being of others is a responsibility and commitment we have upheld since our Company's inception. In 2018, we contributed time, finances and emotional energy to a number of worthwhile organizations in the areas in which we live and do business. Our efforts are vital to the communities we serve to help ensure that housing is safe and affordable; essential services such as financial education, social services, and job skills development are available for those in need; and distressed neighborhoods are improved and revitalized. We are proud of the positive impact our efforts are making.

\$25,836,505

Community Development
Investment Portfolio

4,120

Volunteer Hours

\$334,165

Donations, Sponsorships
and Scholarships

\$48,899,858

Community Development
Projects Financed

We welcome **the opportunity**
to support and serve these
communities in Northern California.

- Sacramento
- Redding
- Orland
- Willows
- Yreka
- Corning
- Colusa



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

Form 10-K

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

For the fiscal year ended December 31, 2018

Commission File Number 0-25135

Bank of Commerce Holdings

(Exact name of Registrant as specified in its charter)

California
(State or jurisdiction of
incorporation or organization)

94-2823865
(I.R.S. Employer
Identification Number)

555 Capitol Mall, Suite 1255
Sacramento, California
(Address of principal executive offices)

95814
(Zip Code)

Registrant's telephone number, including area code: (800) 421-2575

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

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

Common Stock, No Par Value per share

NASDAQ Global Market

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

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

Note – Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Exchange Act from their obligations under those Sections.

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 the Registrant's knowledge, in definitive proxy or information statements incorporated by reference to Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller Reporting Company ☐

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

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter.

As of the last day of the second fiscal quarter of 2018, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$196,081,982 based on the closing sale price of \$12.75 as reported on the NASDAQ Global Market as of June 30, 2018.

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date.

The number of shares of the registrant's no par value Common Stock outstanding as of March 6, 2019 was 18,213,334.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement of the registrant for its 2019 Annual Meeting of Shareholders, which will be subsequently filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates, are incorporated by reference into Part III of this Annual Report on Form 10-K.

Bank of Commerce Holdings Form 10-K

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Part I

Special Note Regarding Forward-Looking Statements

This report includes forward-looking statements within the meaning of the Securities Exchange Act of 1934 (“Exchange Act”) and the Private Securities Litigation Reform Act of 1995. These statements are based on management’s current beliefs and assumptions, and on information available to management as of the date of this document. Forward-looking statements include the information concerning possible or assumed future results of operations of the Company set forth under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

Forward-looking statements may also include statements in which words such as “expects,” “anticipates,” “intends,” “plans,” “believes,” “estimates,” “considers” or similar expressions or conditional verbs such as “will,” “should,” “would” and “could” and other comparable words or phrases of a future- or forward-looking nature, are intended to identify such forward-looking statements. Forward-looking statements are not guarantees of future performance. They involve risks, uncertainties and assumptions. The Company’s actual future results and shareholder values may differ materially from those anticipated and expressed in these forward-looking statements. Many of the factors that will determine these results and values are beyond the Company’s ability to control or predict. Except as specifically noted herein all references to the “Company” refer to Bank of Commerce Holdings, a California corporation, and its consolidated subsidiaries.

The following factors, among others, could cause our actual results to differ materially from those expressed in such forward-looking statements:

- The strength of the United States economy in general and the strength of the local economies in California in which we conduct operations;
- Our failure to realize all of the anticipated benefits of our acquisition of Merchants Holding Company;
- Difficulties in integrating the acquired bank branches of Merchants Holding Company;
- Our inability to successfully manage our growth or implement our growth strategy;
- The effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System, or the Federal Reserve Board;
- Volatility in the capital or credit markets;
- Changes in the financial performance and/or condition of our borrowers;
- Our concentration in real estate lending;
- Developments and changes in laws and regulations, including the recent federal Tax Cuts and Jobs Act, and increased regulation of the banking industry through legislative action and revised rules and standards applied by the Federal Reserve Board, the Federal Deposit Insurance Corporation and the California Department of Business Oversight;
- Changes in the cost and scope of insurance from the Federal Deposit Insurance Corporation and other third parties;
- Changes in consumer spending, borrowing and savings habits;
- Deterioration in the reputation of banks and the financial services industry could adversely affect the Company's ability to obtain and retain customers;
- Changes in the level of our nonperforming assets and loan charge-offs;
- Deterioration in values of real estate in California and the United States generally, both residential and commercial;
- Possible other-than-temporary impairment of securities held by us;
- The timely development of competitive new products and services and the acceptance of these products and services by new and existing customers;
- The willingness of customers to substitute competitors’ products and services for our products and services;
- Technological changes could expose us to new risks, including potential systems failures or fraud;
- The effect of changes in accounting policies and practices, as may be adopted from time-to-time by bank regulatory agencies, the Securities and Exchange Commission (“SEC”), the Public Company Accounting Oversight Board, the Financial Accounting Standards Board (“FASB”) or other accounting standards setters;
- The risks presented by continued public stock market volatility, which could adversely affect the market price of the Company's common stock and the ability to raise additional capital;
- Inability to attract deposits and other sources of liquidity at acceptable costs;
- Changes in the competitive environment among financial and bank holding companies and other financial service providers;
- Consolidation in the financial services industry in the Company's markets resulting in the creation of larger financial institutions that may have greater resources could change the competitive landscape and the influx of fintech companies competing for business;
- The loss of critical personnel and the challenge of hiring qualified personnel at reasonable compensation levels;
- Natural disasters, such as earthquakes, volcanic eruptions, tsunamis, wildfires, droughts, floods, mudslides, hurricanes, tornados and other geologic processes;
- A natural disaster outside California, could negatively impact our purchased loan portfolio or our third party loan servicers;
- Unauthorized computer access, computer hacking, cyber-attacks, electronic fraudulent activity, attempted theft of financial assets, computer viruses, phishing schemes and other security problems;
- Geopolitical conditions, including acts or threats of war or terrorism, actions taken by the United States or other governments in response to acts or threats of war or terrorism and/or military conflicts, which could impact business and economic conditions in the United States and abroad;
- Our inability to manage the risks involved in the foregoing; and
- The effects of any reputational damage to the Company resulting from any of the foregoing.

Additional factors that could cause actual results to differ materially from those expressed in the forward-looking statements are discussed in the sections entitled “RISK FACTORS,” “BUSINESS” and in “MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS” in this Form 10-K.

If our assumptions regarding one or more of the factors affecting our forward-looking information and statements proves incorrect, then our actual results, performance or achievements could differ materially from those expressed in, or implied by, forward-looking information and statements contained in this document and in the information incorporated by reference in this document. Therefore, we caution you not to place undue reliance on our forward-looking information and statements. We do not undertake any obligation to publicly correct, revise, or update any forward-looking statement if we later become aware that actual results are likely to differ materially from those expressed in such forward-looking statement, except as required under federal securities laws.

Item 1 - Business

Bank of Commerce Holdings (“Company,” “Holding Company,” “we,” or “us”) is a corporation organized under the laws of California and a bank holding company (“BHC”) registered under the Bank Holding Company Act of 1956, as amended (“BHC Act”) with its principal offices in Sacramento, California. The Holding Company’s principal business is to serve as a holding company for Redding Bank of Commerce (the “Bank” and together with the Holding Company, the “Company”) which operates under three separate names (Redding Bank of Commerce, Sacramento Bank of Commerce, a division of Redding Bank of Commerce and The Merchants Bank of Sacramento, a division of Redding Bank of Commerce) and Bank of Commerce Mortgage (inactive). We have an unconsolidated subsidiary in Bank of Commerce Holdings Trust II, which was organized in connection with our prior issuance of trust-preferred securities. Our common stock is traded on the NASDAQ Global Market under the symbol “BOCH.”

We commenced banking operations in 1982 and grew organically to four branches before purchasing five Bank of America branches in 2016. With our recent acquisition of Merchants Holding Company, we now operate ten full service facilities and one limited service facility in northern California. We also operate a “cyber office” as identified in our summary of deposits reporting filed with the FDIC. We provide a wide range of financial services and products for business and retail customers which are competitive with those traditionally offered by banks of similar size in California. As of December 31, 2018, we operated under one primary business segment: Community Banking. Additional information regarding operating segments can be found in Note 2 *Summary of Significant Accounting Policies* in the *Notes to Consolidated Financial Statements* in this document.

We continuously seek expansion opportunities through internal growth, strategic alliances, acquisitions, establishing new offices or the delivery of new products and services. Periodically, we reevaluate the short and long-term profitability of all of our lines of business, and do not hesitate to reduce or eliminate unprofitable locations or lines of business. We remain a viable, independent bank committed to enhancing shareholder value. This commitment has been fostered by proactive management and dedication to staff, customers and the markets we serve.

On January 31, 2019 we completed the acquisition of Merchants Holding Company (“Merchants”), to extend our presence in the Sacramento marketplace. Merchants, headquartered in Sacramento, California, was the parent company of The Merchants National Bank of Sacramento (“Merchants Bank”), a 97-year-old bank with approximately \$211.7 million in assets as of January 31, 2019. See Note 23 *Acquisition* in the *Notes to Consolidated Financial Statements*.

On May 10, 2017, we closed an underwritten public offering of 2,738,096 shares of our common stock at a public offering price of \$10.50 per share, with net proceeds of approximately \$26.8 million, after underwriting discounts and estimated expenses.

Our governance structure enables us to manage all major aspects of our business effectively through an integrated process that includes financial, strategic, risk and leadership planning. Our management processes, structures and policies and procedures help to ensure compliance with laws and regulations and provide clear lines of authority for decision-making and accountability. Results are important, but we are equally concerned with how we achieve those results. Our core values and our commitment to high ethical standards are material to sustaining public trust and confidence in our Company.

Our primary business strategy is to provide comprehensive banking and related services to businesses, not-for-profit organizations, professional service providers and consumers in northern California. We continue to emphasize the diversity of our product lines and high levels of personal service. Through our technology, we offer convenient access typically associated with larger financial institutions, while maintaining the local decision-making authority and market knowledge, typical of a local community bank. Management intends to continue to pursue our business strategy through the following initiatives:

Utilize the Strength of Our Management Team. We believe the experience, depth and knowledge of our management team represent one of our greatest strengths and competitive advantages.

Leverage Our Existing Foundation for Additional Growth. Based on certain infrastructure investments, we believe that we will be able to take advantage of certain economies of scale typically enjoyed by larger organizations to expand our operations both organically and through strategic cost-effective avenues. We believe that the investments we have made in data processing, our staff, our risk and compliance function, and our branch network will support a much larger asset base. We are committed, however, to control any additional growth within acceptable risk limits and to maintain appropriate capital ratios.

Maintain Local Decision-Making and Accountability. We believe we have a competitive advantage over larger national and regional financial institutions by providing superior customer service with experienced, knowledgeable management, localized decision-making capabilities and prompt credit decisions. We believe that our customers want to deal directly with the people who make the ultimate credit decisions and have provided our Bank officers and relationship managers with authority commensurate with their experience and responsibilities, which we believe strikes the right balance between local decision-making and sound banking practice.

Focus on Asset Quality and Strong Underwriting. We consider asset quality to be of primary importance and have taken measures to ensure that credit risks are managed effectively to safeguard shareholder value. As part of our efforts, we utilize a third party loan review service to evaluate our loan portfolio on a quarterly basis and recommend action on certain loans if deemed appropriate.

Build a Stable Core Deposit Base. We continue to focus on increasing a stable core deposit base of business and retail customers. Our Branch Acquisition in 2016 allowed us to reduce our historic reliance on Federal Home Loan Bank of San Francisco borrowings and our former reliance on nonlocal time deposits. Our recently completed acquisition of Merchants Bank further enhanced our core deposit base by adding \$152.2 million in demand and savings accounts. We intend to continue our practice of developing full deposit relationships with each of our loan customers, their business partners, and key employees.

Principal Market

We operate under the name Redding Bank of Commerce, except in the greater Sacramento region where we operate under the names Sacramento Bank of Commerce, a division of Redding Bank of Commerce and The Merchants Bank of Sacramento, a division of Redding Bank of Commerce.

Principal Products and Services

Most of our current customers are small to medium-sized businesses and retail consumers. No single person or group of persons provides a material portion of the Bank’s deposits or loans, the loss of any one or more of which would have a materially adverse effect on the business of the Bank.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

We provide a wide range of financial services and products for businesses and consumers. The services we offer include those traditionally offered by banks of similar size and character in California. Our principal deposit products include the following types of accounts; checking, interest-bearing checking, money market, savings and certificates of deposit. We also offer sweep arrangements, commercial loans, construction loans, term loans, consumer loans, safe deposit boxes, and electronic banking services. We currently do not offer trust services or international banking services.

The majority of the loans we originate are direct loans made to individuals and small businesses in our principal market. We accept as collateral for loans, real estate, listed and unlisted securities, savings and time deposits, automobiles, machinery and equipment and other general business assets such as accounts receivable and inventory. In addition to direct lending, our loan portfolio includes loans that were purchased as pools of loans, or participations where a portion of a loan was originated by another lending institution.

Regulatory Capital

Our regulators measure capital adequacy by using a risk-based capital framework and by monitoring compliance with minimum leverage ratio guidelines. The guidelines are “risk-based,” meaning that they are designed to make capital requirements more sensitive to differences in risk profiles among banks and bank holding companies.

As of December 31, 2018, the most recent notification from the FDIC categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. There are no conditions or events since the notification that management believes have changed the Bank’s risk category. See Item 7 - *Management’s Discussion And Analysis Of Financial Condition And Results Of Operations* and Note 18 *Regulatory Capital* in the *Notes to Consolidated Financial Statements* in this document for a discussion of the regulatory capital guidelines.

Competition

We engage in the highly competitive financial services industry. Generally, our market and our lines of activity involve competition with other banks, thrifts, credit unions and other non-bank financial institutions, such as investment banking firms, investment advisory firms, brokerage firms, investment companies and insurance entities which offer financial services, located both domestically and through alternative delivery channels such as the Internet. Many of these competitors enjoy fewer regulatory constraints and some may have lower cost structures. Our ability to compete is focused on various factors such as customer service, interest rates on loans and deposits, lending limits, customer convenience and technological advances.

Securities firms, insurance companies and brokerage houses that elect to become financial holding companies may acquire banks and other financial institutions. Combinations of this type will significantly change the competitive environment in which we conduct business.

In order to compete with major banks and other competitors in our primary service areas, we rely upon;

- The experience of our executive and senior officers;
- Our specialized services and local promotional activities;
- The personal contacts made by our officers, directors and employees;
- Third party referral sources.

Employees

As of December 31, 2018, we employed 197 full-time equivalent employees. None of the employees are subject to a collective bargaining agreement and management believes its relations with employees to be good. Information regarding employment agreements with our executive officers is contained in Item 11 – *Executive Compensation* below, which is incorporated by reference to our proxy statement for the 2019 annual meeting of shareholders.

Government Supervision and Regulation

Supervision and Regulation

The Holding Company and the Bank are subject to extensive regulation under federal and state law. In general, this regulatory framework is designed to protect depositors, the federal deposit insurance fund (the “DIF”) and the federal and state banking system as a whole; it does not exist for the protection of shareholders. As the breadth and scope of regulatory requirements increase, our costs to identify, monitor and comply with these requirements increase, as well.

This section provides a general overview of the federal and state regulatory framework applicable to the Holding Company and the Bank. It is not intended to summarize all applicable laws and regulations. To the extent that this section describes statutory and regulatory provisions, it is qualified by reference to those provisions. These statutes and regulations, as well as related policies, continue to be subject to change (or interpretation) by Congress, state legislatures and federal and state regulators. Numerous changes to the statutes, regulations and regulatory policies applicable to us (including their interpretation or implementation) have been proposed but cannot be predicted and could have a material effect on our business or operations.

The Holding Company is subject to regulation and supervision by the Federal Reserve (as a bank holding company) and regulation by the State of California (as a California corporation). The Holding Company is also subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, both as administered by the SEC. As a listed company on the NASDAQ Global Market, the Holding Company is subject to the rules of the NASDAQ for listed companies. The Bank is subject to regulation and examination by the Federal Deposit Insurance Corporation (“FDIC”) and by the California Department of Business Oversight (“CDBO”).

Federal Bank Holding Company Regulation

General

As a bank holding company, the Holding Company is subject to regulation under the Bank Holding Company Act of 1956, as amended (the “BHC Act”) and to inspection, examination and supervision by its primary regulator, the Board of Governors of the Federal Reserve System (“Federal Reserve” or “FRB”). In general, the BHC Act limits the business of bank holding companies to owning or controlling banks and engaging in other activities closely related to the business of banking. In addition, the Holding Company must file reports with and provide the Federal Reserve with such additional information as it may require.

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Holding Company Bank Ownership

The BHC Act requires every bank holding company to obtain the prior approval of the Federal Reserve before (i) acquiring, directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares; (ii) acquiring all or substantially all of the assets of another bank or bank holding company; or (iii) merging or consolidating with another bank holding company.

Holding Company Control of Nonbanks

With some exceptions, the BHC Act also prohibits a bank holding company from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities that, by federal statute, agency regulation or by order, have been identified as activities closely related to the business of banking or of managing or controlling banks.

Transactions with Affiliates

Subsidiary banks of a bank holding company are subject to restrictions imposed by the Federal Reserve Act on extensions of credit to the holding company or its subsidiaries, on investments in their securities and on the use of their securities as collateral for loans to any borrower. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") further expanded the definition of an "affiliate" and treats credit exposure arising from derivative transactions, securities lending, and borrowing transactions as a covered transaction under the regulations. It also expands the scope of covered transactions required to be collateralized, requires collateral to be maintained at all times for covered transactions required to be collateralized, and places limits on acceptable collateral. These regulations and restrictions may limit the Holding Company's ability to obtain funds from the Bank for its cash needs, including funds for payment of dividends, interest and operational expenses.

Tying Arrangements

We are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with certain exceptions, neither the Holding Company nor its subsidiaries may condition an extension of credit to a customer on either (i) a requirement that the customer obtain additional services provided by us; or (ii) an agreement by the customer to refrain from obtaining other services from a competitor.

Support of Subsidiary Banks

Under Federal Reserve policy and the Dodd-Frank Act, the Holding Company is required to act as a source of financial and managerial strength to the Bank. This means that the Holding Company is required to commit, as necessary, capital and resources to support the Bank, including at times when the Holding Company may not be in a financial position to provide such resources, or when it may not be in the Holding Company's or its shareholders' best interests to do so. Any capital loans a bank holding company makes to its subsidiary banks are subordinate to deposits and to certain other indebtedness of those subsidiary banks.

State Law Restrictions

As a California corporation, the Holding Company is subject to certain limitations and restrictions under applicable California corporate law. For example, state law restrictions in California include limitations and restrictions relating to indemnification of directors, distributions to shareholders, transactions involving directors, officers or interested shareholders, maintenance of books, records and minutes and observance of certain corporate formalities.

Federal and State Regulation of the Bank

General

Deposits in the Bank, a California chartered commercial bank, are insured by the FDIC. As a result, the Bank is subject to primary supervision, periodic examination and regulation by the CDBO and the FDIC. These agencies have the authority to prohibit banks from engaging in what they believe constitute unsafe or unsound banking practices. The federal laws that apply to the Bank regulate, among other things, the scope of its business, its investments, its reserves against deposits, the timing of the availability of deposited funds, and the nature, amount of, and collateral for loans. Federal laws also regulate community reinvestment and insider credit transactions and impose safety and soundness standards. In addition to these federal laws, the Bank is also subject to the laws of the State of California.

Consumer Protection

Although the Bank is not supervised directly by the Consumer Financial Protection Bureau ("CFPB"), our consumer banking activities are subject to regulation by the CFPB. The Bank is subject to a variety of federal and state consumer protection laws and regulations that govern its relationships and interactions with consumers including laws and regulations that impose certain disclosure requirements and regulate the manner in which we take deposits, make and collect loans, and provide other services. In recent years, examination and enforcement by state and federal banking agencies for non-compliance with consumer protection laws and their implementing regulations have increased and become more intense. Failure to comply with these laws and regulations may subject the Bank to various penalties, including but not limited to, enforcement actions, injunctions, fines, civil monetary penalties, criminal penalties, punitive damages, and the loss of certain contractual rights. The Bank has established a compliance system to ensure consumer protection.

Community Reinvestment

The Community Reinvestment Act of 1977 (the "CRA") requires that, in connection with examinations of financial institutions within their jurisdiction, federal bank regulators evaluate the record of financial institutions in meeting the credit needs of its local communities, including low and moderate-income neighborhoods, consistent with the safe and sound operation of those institutions. A bank's community reinvestment record is also considered by the applicable banking agencies in evaluating mergers, acquisitions and applications to open a branch or facility. In some cases, a bank's failure to comply with the CRA or CRA protests filed by interested parties during applicable comment periods can result in the denial or delay of such transactions. The Bank received a "satisfactory" rating in its most recent CRA examination.

Insider Credit Transactions

Banks are also subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to executive officers, directors, principal shareholders or any related interests of such persons. Extensions of credit (i) must be made on substantially the same terms (including interest rates and collateral) and follow credit underwriting procedures that are at least as stringent as those prevailing at the time for comparable transactions with persons not related to the lending bank; and (ii) must not involve more than the normal risk of repayment or present other unfavorable features. Banks are also subject to certain lending limits and restrictions on overdrafts to insiders. A violation of these restrictions may result in the assessment of substantial civil monetary penalties, regulatory enforcement actions, and other regulatory sanctions. The Dodd-Frank Act and federal regulations place additional restrictions on loans to insiders and generally prohibit loans to senior officers other than for certain specified purposes.

Regulation of Management

Federal law (i) sets forth circumstances under which officers or directors of a bank may be removed by the institution's federal supervisory agency; (ii) as discussed above, places restraints on lending by a bank to its executive officers, directors, principal shareholders, and their related interests; and (iii) generally prohibits management personnel of a bank from serving as directors or in other management positions of another financial institution whose assets exceed a specified amount or which has an office within a specified geographic area.

Safety and Soundness Standards

Certain non-capital safety and soundness standards are also imposed upon banks. These standards cover, among other things, internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, such other operational and managerial standards as the agency determines to be appropriate, and standards for asset quality, earnings and stock valuation. In addition, each insured depository institution must implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the institution's size and complexity and the nature and scope of its activities. The information security program must be designed to ensure the security and confidentiality of customer information, protect against unauthorized access to or use of such information and ensure the proper disposal of customer and consumer information. An institution that fails to meet these standards may be required to submit a compliance plan, or be subject to regulatory sanctions, including restrictions on growth. The Bank has established policies and risk management procedures to ensure the safety and soundness of the Bank.

State Law Restrictions

California state-chartered banks are subject to various requirements relating to operations and administration (including the maintenance of branch offices and automated teller machines), capital and reserve requirements, declaration of dividends, deposit taking, shareholder rights and duties, borrowing limits, and investment and lending activities.

Under California law, the amount a bank generally may borrow may not exceed its shareholders' equity without the consent of the CDBO, except for borrowings from the Federal Home Loan Bank of San Francisco and the Federal Reserve Bank. The Bank is required to invest its funds as limited by California law and in investments that are legal investments for banks, subject to any other limitations under general law. The Commissioner of the CDBO may take possession of the Bank if certain conditions exist, such as insufficient shareholders' equity, unsafe or unauthorized operations, or violations of law.

Interstate Banking and Branching

The Dodd-Frank Act eliminated interstate branching restrictions that were implemented as part of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Interstate Act"), and removed many restrictions on de novo interstate branching by state and federally chartered banks. Federal regulators now have authority to approve applications by such banks to establish de novo branches in states other than the bank's home state if the host state's banks could establish a branch at the same location. The Interstate Act requires regulators to consult with community organizations before permitting an interstate institution to close a branch in a low-income area. Federal banking agency regulations prohibit banks from using their interstate branches primarily for deposit production and the federal banking agencies have implemented a loan-to-deposit ratio screen to ensure compliance with this prohibition.

Cash Dividends

Our ability to pay cash dividends is dependent on having sufficient cash and satisfying various regulatory and contractual requirements and restrictions. Our principal source of cash is dividends received from the Bank. Regulatory authorities may prohibit banks and bank holding companies from paying dividends in a manner that would constitute an unsafe or unsound banking practice or would reduce capital below an amount necessary to meet minimum applicable regulatory capital requirements. Basel III (discussed below) introduces additional restrictions on dividends.

Our ability to pay dividends from the Bank to the Holding Company is also subject to certain requirements under California law. Banks chartered under California law generally may only pay a cash dividend to the extent such payment does not exceed the lesser of (i) retained earnings of the bank or (ii) the bank's net income for its last three fiscal years less any distributions to shareholders during such period. As a result, future dividends from the Bank to the Holding Company will generally depend on the level of earnings at the Bank.

The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies which expresses the view that although no specific regulations restrict dividend payments by bank holding companies other than state corporate laws, a bank holding company should not pay cash dividends unless the company's net income for the past year is sufficient to cover both the cash dividends and a prospective rate of earnings retention that is consistent with the bank holding company's capital needs, asset quality and overall financial condition.

On December 10, 2015, we issued and sold \$10.0 million in aggregate principal amount of fixed to floating rate Subordinated Notes pursuant to a private placement with certain institutional investors. On that same date we also entered into a loan agreement pursuant to which we obtained \$10.0 million in senior debt secured by a pledge of all of the stock of the Bank. The Subordinated Notes and debt agreements limit the payment of cash dividends to our common shareholders if the Company is not well capitalized, or if there is an event of default as described by the agreements.

Capital Adequacy and Prompt Corrective Action

Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal regulatory agencies, which involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting, and other factors. The capital requirements are intended to ensure that institutions have adequate capital given the risk levels of assets and off-balance sheet financial instruments and are applied separately to the Holding Company and the Bank.

Federal regulations require insured depository institutions and bank holding companies to meet several minimum capital standards, including: (i) a common equity Tier 1 capital to risk-based assets ratio of 4.5%; (ii) a Tier 1 capital to risk-based assets ratio of 6%; (iii) a total capital to risk-based assets ratio of 8%; and (iv) a 4% Tier 1 capital to total assets leverage ratio. These minimum capital requirements became effective in January 2015 and were the result of final rules implementing certain regulatory amendments based on the recommendation of the Basel Committee on Banking Supervision and certain requirements of the Dodd-Frank Act (the "Final Rules"). The Final Rules also require a new capital conservation buffer designed to absorb losses during periods of economic stress, change the risk-weights of certain assets for purposes of the risk-based capital ratios and phase out certain instruments as qualifying capital.

The Final Rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on an insured depository institution if its capital levels begin to show signs of weakness. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions will be required to meet the following increased capital level requirements to qualify as "well capitalized": (i) a Tier 1 common equity capital ratio of at least 6.5%; (ii) a Tier 1 capital ratio of at least 8%; (iii) a total capital ratio of at least 10%; (iv) a Tier 1 leverage ratio of at least 5%; and (v) not be subject to any order or written directive requiring a specific capital level. The FDIC's rules (as amended by the Final Rules) contain other capital classification categories, such as "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized," each of which are based on certain capital ratios. An institution may be downgraded to a category lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition, or if the institution receives an unsatisfactory examination rating. As of December 31, 2018, the most recent notification from the FDIC categorized the Bank as "well capitalized".

The application of the Final Rules may result in lower returns on invested capital, require the raising of additional capital or require regulatory action if the Bank were unable to comply with such requirements. In addition, management may be required to modify its business strategy due to the changes to the asset risk-weights for risk-based capital calculations and the requirement to meet the capital conservation buffers. The imposition of liquidity requirements in connection with these rules could also cause the Bank to increase its holdings of liquid assets, change its business strategy, and make other changes to the terms of its funding.

The Crapo Bill, signed into law in May 2018, simplifies the regulatory capital rules for financial institutions and their holding companies with total consolidated assets of less than \$10 billion and instructed the federal banking regulators to establish a single "Community Bank Leverage Ratio" of between 8% and 10%. On November 21, 2018, the FDIC published a proposed Community Bank Leverage Ratio of 9%. Any qualifying depository institution or its holding company that exceeds the Community Bank Leverage Ratio will be considered to have met generally applicable leverage and risk-based regulatory capital requirements and considered to be "well capitalized" under the prompt corrective action rules discussed above. It is difficult at this time to predict when or how the new standards under the Crapo Bill will ultimately be applied to us or what specific impact the Crapo Bill (and any implementing rules and regulations) will have on community banks.

Regulatory Oversight and Examination

Inspections

The Federal Reserve conducts periodic inspections of bank holding companies, which are performed both onsite and offsite. The supervisory objectives of the Federal Reserve's inspection program are to ascertain whether the financial strength of the bank holding company is being maintained on an ongoing basis and to determine the effects or consequences of transactions between a bank holding company or its non-banking subsidiaries and its subsidiary banks. For holding companies under \$10.0 billion in assets, the inspection type and frequency typically varies depending on asset size, complexity of the organization, and the bank holding company's rating at its last inspection.

Examinations

Banks are subject to periodic examinations by their primary regulator. The Bank's primary regulator is the FDIC. In assessing a bank's condition, bank examinations have evolved from reliance on transaction testing in assessing a bank's condition to a risk-focused approach. These examinations are extensive and cover the entire breadth of operations of the bank. Generally, safety and soundness examinations occur on a 12-month cycle. Examinations alternate between the federal and state bank regulatory agencies, and in some cases they may occur on a combined schedule. The frequency of consumer compliance and CRA examinations is linked to the size of the institution and its compliance and CRA ratings at its most recent examinations. However, the examination authority of the Federal Reserve and the FDIC allows them to examine supervised institutions as frequently as deemed necessary based on the condition of the bank or as a result of certain triggering events.

Commercial Real Estate Ratios

The federal banking regulators recently issued guidance reminding financial institutions to re-examine existing regulations regarding concentrations in commercial real estate lending. The purpose of the guidance is to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. The banking agencies are directed to examine each bank's exposure to commercial real estate loans that are dependent on cash flow from the real estate held as collateral and to focus their supervisory resources on institutions that may have significant commercial real estate loan concentration risk. The guidance provides that the strength of an institution's lending and risk management practices with respect to such concentrations will be taken into account in evaluating capital adequacy and does not specifically limit a bank's commercial real estate lending to a specified concentration level.

Corporate Governance and Accounting

The Sarbanes-Oxley Act of 2002 (the "SOX Act") addresses, among other things, corporate governance, auditing and accounting, enhanced and timely disclosure of corporate information, and penalties for non-compliance. Generally the SOX Act (i) requires chief executive officers and chief financial officers to certify to the accuracy of periodic reports filed with the SEC; (ii) imposes specific and enhanced corporate disclosure requirements; (iii) accelerates the time frame for reporting of insider transactions and periodic disclosures by public companies; (iv) requires companies to adopt and disclose information about corporate governance practices,

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including whether or not they have adopted a code of ethics for senior financial officers and whether the audit committee includes at least one “audit committee financial expert”; and (v) requires the SEC, based on certain enumerated factors, to regularly and systematically review corporate filings.

As a publicly reporting company, the Holding Company is subject to the requirements of the SOX Act and related rules and regulations issued by the SEC and NASDAQ. After enactment of the SOX Act, the Holding Company updated its policies and procedures to comply with the SOX Act's requirements and has found that such compliance, including compliance with Section 404 relating to the Holding Company's internal controls over financial reporting, has resulted in additional expenses for the Holding Company. The Holding Company will continue to incur additional expenses in connection with its ongoing compliance with these requirements.

Anti-Money Laundering and Anti-Terrorism

The Bank Secrecy Act and the USA Patriot Act of 2001

The Bank Secrecy Act (the “BSA”) requires all financial institutions to (among other requirements) establish a risk-based system of internal controls reasonably designed to prevent money laundering and the financing of terrorism. The BSA also sets forth various recordkeeping and reporting requirements (such as reporting suspicious activities that may signal criminal activity), and certain due diligence and “know your customer” documentation requirements.

Further, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, intended to combat terrorism, was renewed with certain amendments in 2006 (the “Patriot Act”). The Patriot Act, in relevant part, (i) prohibits banks from providing correspondent accounts directly to foreign shell banks; (ii) imposes due diligence requirements on banks opening or holding accounts for foreign financial institutions or wealthy foreign individuals; (iii) requires financial institutions to establish an anti-money-laundering compliance program; and (iv) eliminates civil liability for persons who file suspicious activity reports. The Patriot Act also includes provisions providing the government with power to investigate terrorism, including expanded government access to bank account records. Regulators are directed to consider a bank holding company's and a bank's effectiveness in combating money laundering when reviewing and ruling on applications under the BHC Act and the Bank Merger Act. The Holding Company and the Bank have established compliance programs designed to comply with the requirements of the BSA and Patriot Act.

Financial Services Modernization

Gramm-Leach-Bliley Act of 1999

The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (the “GLBA”) brought about significant changes to the laws affecting banks and bank holding companies. Generally, the GLBA (i) repeals historical restrictions on preventing banks from affiliating with securities firms; (ii) provides a uniform framework for the activities of banks, savings institutions and their holding companies; (iii) broadens the activities that may be conducted by national banks and banking subsidiaries of bank holding companies; (iv) provides an enhanced framework for protecting the privacy of consumer information and requires notification to consumers of bank privacy policies; and (v) addresses a variety of other legal and regulatory issues affecting both day-to-day operations and long-term activities of financial institutions. The Bank is subject to FDIC regulations implementing the privacy protection provisions of the GLBA. These regulations require a bank to disclose its privacy policy, including informing consumers of the bank's information sharing practices and their right to opt out of certain practices.

Deposit Insurance

FDIC Insured Deposits

The Bank's deposits are insured under the Federal Deposit Insurance Act, up to the maximum applicable limits and are subject to deposit insurance assessments by the FDIC, which are designed to tie what banks pay for deposit insurance to the risks they pose. The Dodd-Frank Act redefined the assessment base used for calculating deposit insurance assessments by requiring the FDIC to determine assessments based on assets instead of deposits. Assessments are now based on the average consolidated total assets less average tangible equity capital of a financial institution. In addition, the Dodd-Frank Act (i) raised the minimum designated reserve ratio (the FDIC is required to set the reserve ratio each year) of the Deposit Insurance Fund (DIF) from 1.15% to 1.35%; (ii) required that the DIF reserve ratio meet 1.35% by 2020; and (iii) eliminated the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. The FDIC has established a higher reserve ratio of 2.00% as a long-term goal beyond what is required by statute. The Dodd-Frank Act made banks with \$10 billion or more in total assets responsible for the increase from 1.15% to 1.35%. On September 30, 2018, the DIF reached 1.36%, ahead of Dodd Frank's 2020 deadline to meet the 1.35% reserve ratio. As a result, certain institutions will receive credits for the portions of their regular assessments that contributed to growth in the reserve ratio between 1.15% and 1.35%, to be applied when the reserve ratio is at or above 1.38%. No institution may pay a dividend if it is in default on its federal deposit insurance assessment. The FDIC may also prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the DIF.

Safety and Soundness

The FDIC may terminate the deposit insurance of any insured depository institution if the FDIC determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. Management is not aware of any existing circumstances that would result in termination of the Bank's deposit insurance.

Insurance of Deposit Accounts

The Dodd-Frank Act permanently increased FDIC deposit insurance from \$100,000 to \$250,000 per depositor. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category.

Brokered Deposits

On November 13, 2015, the FDIC updated guidance on identifying, accepting and reporting brokered deposits (“Deposit Guidance”), which appears to adopt an expansive view on what constitutes “facilitating the placement of deposits.” To the extent the FDIC takes a broader view of what constitutes “brokered deposits”, this

could impact our use of brokered deposits in the future. Under FDIC deposit insurance rules, banks may be assessed higher premiums if they have a high level of brokered deposits. For calendar quarters prior to April 1, 2018, CDARS and ICS reciprocal deposits were considered to be brokered deposits by regulatory authorities and were reported as such on quarterly Call Reports. With passage of The Crapo bill, however, these deposits are no longer classified as brokered. At December 31, 2018, we have \$83.7 million in deposits which are part of the CDARS and ICS programs.

The Dodd-Frank Act

General

The Dodd-Frank Act was signed into law in July of 2010. The Dodd-Frank Act significantly changed the bank regulatory structure and is affecting the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies, including the Holding Company and the Bank. Some of the provisions of the Dodd-Frank Act that may impact the Company's and the Bank's business and operations are summarized below.

Corporate Governance

The Dodd-Frank Act requires publicly traded companies to provide their shareholders with (i) a non-binding shareholder vote on executive compensation, (ii) a non-binding shareholder vote on the frequency of such vote, (iii) disclosure of "golden parachute" arrangements in connection with specified change in control transactions, and (iv) a non-binding shareholder vote on golden parachute arrangements in connection with these change in control transactions. In 2015, the SEC adopted a rule mandated by the Dodd-Frank Act that requires a public company to disclose the ratio of the compensation of its Chief Executive Officer ("CEO") to the median compensation of its employees. This rule is intended to provide shareholders with information that they can use to evaluate a CEO's compensation.

Prohibition Against Charter Conversions of Troubled Institutions

The Dodd-Frank Act generally prohibits a depository institution from converting from a state to federal charter, or vice versa, while it is the subject to an enforcement action unless the depository institution seeks prior approval from its primary regulator and complies with specified procedures to ensure compliance with the enforcement action.

Consumer Financial Protection Bureau

The Dodd-Frank Act established the CFPB and empowered it to exercise broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws. The Bank is subject to consumer protection regulations issued by the CFPB, but as a financial institution with assets of less than \$10.0 billion, the Bank is generally not subject to supervision and examination by the CFPB. The CFPB has issued and continues to propose and issue numerous regulations that will increase the compliance burden of the Bank. Significant recent CFPB developments that may affect the Bank's operations and compliance costs include:

- Positions taken by the CFPB on fair lending, including applying the disparate impact theory which could make it more difficult for lenders to charge different rates or to apply different terms to loans to different customers.
- The CFPB's final rule amending Regulation C, which implements the Home Mortgage Disclosure Act, requiring most lenders to report expanded information in order for the CFPB to more effectively monitor fair lending concerns and other information shortcomings identified by the CFPB.
- Positions taken by the CFPB regarding the Electronic Fund Transfer Act and Regulation E, which require companies to obtain consumer authorizations before automatically debiting a consumer's account for pre-authorized electronic funds transfers.
- Focused efforts on enforcing certain compliance obligations the CFPB deems a priority, such as automobile loan servicing, debt collection, mortgage origination and servicing, remittances, and fair lending, among others.

Repeal of Demand Deposit Interest Prohibition

The Dodd-Frank Act repealed federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Recent and Proposed Legislation

The economic and political environment of the past several years has led to a number of proposed legislative, governmental and regulatory initiatives that may significantly impact the banking industry. Other regulatory initiatives by federal and state agencies may also significantly impact our business. We cannot predict whether these or any other proposals will be enacted or the ultimate impact of any such initiatives on our operations, competitive situation, financial conditions, or results of operations. While recent history has demonstrated that new legislation or changes to existing laws or regulations typically result in a greater compliance burden (and therefore increase the general costs of doing business), the current Administration has expressed a desire to reduce regulatory burden.

In May of 2018, President Trump signed into law the Crapo Bill which will modify or remove certain financial reform rules and regulations, including some of those implemented under the Dodd-Frank Act to provide regulatory relief to certain financial institutions. While the Crapo Bill maintains most of the regulatory structure established by the Dodd-Frank Act, it amends certain aspects of the regulatory framework for small depository institutions with assets of less than \$10 billion and for large banks with assets of more than \$50 billion. Many of these changes could result in meaningful regulatory changes for community banks.

The Crapo Bill, simplifies the regulatory capital rules for financial institutions and their holding companies with total consolidated assets of less than \$10 billion by instructing the federal banking regulators to establish a single "Community Bank Leverage Ratio" of between 8% and 10%. Any qualifying depository institution or its holding company that exceeds the "Community Bank Leverage Ratio" will be considered to have met generally applicable leverage and risk-based regulatory capital requirements and any qualifying depository institution that exceeds the new ratio will be considered to be "well capitalized" under the prompt corrective action rules discussed above. In addition, the Crapo Bill includes regulatory relief for community banks regarding regulatory examination cycles, call reports, the Volcker Rule (proprietary trading prohibitions), mortgage disclosures and risk weights for certain high-risk commercial real estate. It is difficult at this time to predict when or how the new standards under the Crapo Bill will ultimately be applied to us or what specific impact the Crapo Bill (and any implementing rules and regulations) will have on community banks.

Effects of Federal Government Monetary Policy

The Holding Company's earnings and growth are affected not only by general economic conditions, but also by the fiscal and monetary policies of the federal government, particularly the Federal Reserve. The Federal Reserve implements national monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates. Through its open market operations in U.S. government securities, control of the discount rate applicable to borrowings, establishment of reserve requirements against certain deposits, and control of the interest rate applicable to excess reserve balances and reverse repurchase agreements, the Federal Reserve influences the availability and cost of money and credit and, ultimately, a range of economic variables including employment, output, and the prices of goods and services. The nature and impact of future changes in monetary policies and their impact on the Holding Company and the Bank cannot be predicted with certainty.

Available Information

The Company files annual, quarterly and current reports, proxy statements and other business and financial information with the SEC. The SEC maintains an Internet site that contains the Company's SEC filings, as well as reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, located at <http://www.sec.gov>. These filings are also accessible free of charge at the Company's website at www.bankofcommerceholdings.com as soon as reasonably practicable after filing with the SEC. By making this reference to the Company's website, the Company does not intend to incorporate into this report any information contained in the website. The website should not be considered part of this report.

Our principal executive office is located at 555 Capitol Mall, Suite 1255, Sacramento, California 95814 and the telephone number is (800) 421-2575.

Annual Disclosure Statement

This Annual Report on Form 10-K also serves as the annual disclosure statement of the Bank pursuant to Part 350 of the FDIC's rules and regulations. This statement has not been reviewed or confirmed for accuracy or relevance by the FDIC.

Item 1a - Risk Factors

Company

The following is a discussion of what the Company believes are the most significant risks and uncertainties that may affect the Company's business, financial condition and future results.

National and global economic and geopolitical conditions could adversely affect our future results of operations or market price of our stock.

Our business is impacted by factors such as economic, political and market conditions, broad trends in industry and finance, changes in government monetary and fiscal policies, inflation, and market volatility, all of which are beyond our control. National and global economies are constantly in flux, as evidenced by recent market volatility resulting from, among other things, a relatively new presidential administration and new tax and economic policies associated therewith, the uncertain future relationship between the European Union and United Kingdom, and the ever-changing landscape of the energy industry. Future economic conditions cannot be predicted, and any renewed deterioration in the economies of the nation as a whole or in our market could have an adverse effect, which could be material, on our business, financial condition, results, operations and prospects, and could cause the market price of our stock to decline.

Our business is subject to geographic risks that could adversely impact our results of operations and financial condition.

We conduct banking operations principally in northern California. As a result, our business results are dependent in large part upon the business activity, population, income levels, deposits and real estate activity in northern California. Any future deterioration in economic conditions, particularly within our geographic region, could result in the following consequences, any of which could have a material adverse effect on our business, prospects, financial condition and results of operations:

- Loan delinquencies may increase causing increases in our provision for loan and lease losses and in our Allowance for Loan and Lease Losses ("ALLL");
- Financial sector regulators may adopt more restrictive practices or interpretations of existing regulations, or adopt new regulations;
- Collateral for loans made by the Bank, especially real estate related, may decline in value, which in turn could reduce a client's borrowing power, and reduce the value of assets and collateral associated with our loans held for investment;
- Consumer confidence levels may decline and cause adverse changes in payment patterns, resulting in increased delinquencies and default rates on loans and other credit facilities and decreased demand for our products and services;
- Demand for loans and other products and services may decrease;
- Low cost or non-interest-bearing deposits may decrease; and
- Performance of the underlying loans in the private label mortgage backed securities we hold may deteriorate, potentially causing other-than-temporary impairment markdowns to our investment portfolio.

Our inability to successfully manage our growth or implement our growth strategy could affect our results of operations and financial condition.

We may not be able to successfully implement our growth strategy if we are unable to expand market share in our existing market or identify attractive new markets, locations or opportunities to expand in the future. In addition, our ability to manage growth successfully will depend on whether we can maintain adequate capital levels, maintain cost controls, effectively manage asset quality and successfully integrate any expanded business divisions or acquired businesses into our operations.

As we continue to implement our growth strategy by opening new branches or acquiring branches or banks, we expect to incur increased personnel, occupancy, and other operating expenses. In the case of new branches, we must absorb higher expenses while we begin to generate new deposits. In the case of acquired branches, we must absorb higher expenses while we begin deploying the newly assumed deposit liabilities. With either new branches opened or branches acquired, there could be a lag time involved in deploying new deposits into attractively priced loans and other higher yielding earning assets. Thus, expansion could depress earnings in the short-term, even if an efficiently executed branching strategy leads to long-term financial benefits.

We may fail to realize all of the anticipated benefits of our acquisition of Merchants Holding Company.

Although we acquired five branches from Bank of America in 2016, we have not previously been involved in a whole-bank acquisition such as our current acquisition of Merchants Holding Company which we completed in the first quarter of 2019. Inherent uncertainties exist in integrating the operations of the acquired company. We may lose existing customers or key personnel from our company or from The Merchants National Bank of Sacramento; and we may not be able to control the incremental increase in noninterest expense arising from the acquisition in a manner that improves our overall operating efficiencies. Our ability to achieve anticipated results from the acquisition is dependent on the extent of deposit and loan attrition and our ability to successfully deploy the acquired deposits into loans, which is, in part, related to the state of economic and financial markets. These factors could contribute to not achieving the expected benefits from the acquisition within desired time frames, if at all and could have a dilutive effect on our earnings per share.

The value of goodwill and other intangible assets may decline in the future

We have goodwill and core deposit intangible assets from business acquisitions. A significant decline in the expected future cash flows, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of our common stock could necessitate taking charges in the future related to the impairment of goodwill or other intangible assets. If we were to conclude that a write-down of goodwill or other intangible assets is necessary, we would record the appropriate charge, which could have a material adverse effect on our business, financial condition and results of operations.

The loan portfolio includes a significant amount of purchased loans and a significant amount of loans serviced by other companies.

Purchased loans included in the loan portfolio totaled \$126.4 million or 13% of gross portfolio loans as of December 31, 2018. The loans were purchased as a pool of loans, individual loans or as purchased participations from other institutions. The majority of the loans are located outside our principal market. The loans were purchased under several different contracts and, \$82.6 million or 9% of our gross portfolio loans are serviced by two unrelated third party servicing companies. A disruption to the operations of either of the loan servicing companies could reduce the value of the assets that we own. In addition, if we were forced to service these loans ourselves, we would incur additional monitoring and servicing costs due to the geographic disbursement of the portfolio, which would adversely affect our noninterest expense.

We have a concentration risk in real estate related loans.

A substantial portion of our lending is tied to real estate. As of December 31, 2018, approximately 81% of our loan portfolio was secured by real estate as follows:

- 68% was commercial real estate (non-owner occupied and owner-occupied),
- 4% was residential ITIN,
- 4% was residential 1-4 family mortgage,
- 3% was residential equity lines and
- 2% was construction and land development.

A large percentage of our loan portfolio is comprised of commercial real estate loans which generally carry larger loan balances and historically have involved a greater degree of financial and credit risks than residential first mortgage loans. These loans are primarily made based on and repaid from the cash flow of the borrower (which may be unpredictable) and secondarily on the underlying collateral provided by the borrower. Any decline in the economy in general, material increases in interest rates, changes in tax policies, tightening credit or refinancing markets, or a decline in real estate values in our principal market areas in particular, could have an adverse impact on the repayment of these loans. Further, our ability to recover on these loans by selling or disposing of the underlying real estate collateral would be adversely impacted by any decline in real estate values, which increases the likelihood that we would suffer losses on defaulted loans secured by real estate beyond the amounts provided for in the ALLL. Any increase in net charge-offs and in the ALLL could also have a material adverse effect on our business, financial condition, and results of operations and prospects.

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

We generally do not record interest income on nonperforming loans or other real estate owned, thereby adversely affecting our income, and increasing our loan administration costs. When we take collateral in foreclosures and similar proceedings, we are required to mark the related asset to the then fair market value of the collateral, which may result in a loss. An increase in the level of nonperforming assets increases our risk profile and consequently may impact the capital levels our regulators believe are appropriate.

While we reduce problem assets through loan sales, workouts, restructurings and otherwise, decreases in the value of the underlying collateral or in these borrowers' performance or financial condition, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and our directors, which can be detrimental to the performance of their other responsibilities. We expect the level of non-performing assets and losses relating to such assets to continue to decline, however there can be no assurance that we will not experience future increases in nonperforming assets.

Future loan and lease losses may exceed the allowance for loan and lease losses.

We have established an allowance for possible losses expected in connection with loans in the credit portfolio. This allowance reflects estimates of the collectability of certain identified loans, as well as an overall risk assessment of gross loans outstanding.

The determination of the amount of the allowance for loan and lease losses is subjective. Although the method for determining the amount of the allowance uses criteria such as risk ratings and historical loss rates, these factors may not be adequate predictors of future loan performance. Accordingly, we cannot offer assurances that these estimates ultimately will prove correct or that the loan and lease loss allowance will be sufficient to protect against losses that ultimately may occur. If the allowance for loan and lease losses proves to be inadequate, we will need to make additional provisions to the allowance, which is accounted for as charges to income, which would adversely impact results of operations and financial condition. Moreover, federal and state banking regulators, as an integral part of their supervisory function, periodically review our loan portfolio and the adequacy of our allowance. These regulatory authorities may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from our judgments. Any increase in the allowance could have an adverse effect, which could be material, on our financial condition and results of operations.

The Financial Accounting Standards Board has adopted a new accounting standard update ("ASU") 2016-13 which for us will be effective January 1, 2020. This standard, referred to as Current Expected Credit Loss, or CECL, will require us to determine periodic estimates of lifetime expected credit losses on loans, and recognize the expected credit losses as allowances for credit losses. This will change the current method of providing allowances for credit losses that are probable, may require us to increase our allowance for loan losses and may greatly increase the types of data we would need to collect and review to determine the appropriate level of the allowance for credit losses. More information on this ASU can be found under the heading *Recent Accounting Pronouncements*, in Note 2 *Summary of Significant Accounting Policies* in the *Notes to Consolidated Financial Statements*.

Defaults may negatively impact us.

Risk arises from the possibility that losses will be sustained if a significant number of borrowers, guarantors and related parties fail to perform in accordance with the terms of their loans. We have adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the adequacy of the allowance for loan and lease losses, which management believes are appropriate to minimize risk by assessing the likelihood of nonperformance, tracking loan performance and diversifying the loan portfolio. These policies and procedures, however, may not prevent unexpected losses that could materially affect our results of operations.

Interest rate fluctuations, which are out of our control, could harm profitability.

Our income is highly dependent on "interest rate spreads" (i.e., the difference between the interest income earned on our interest-earning assets such as loans and securities, and the interest expense paid on our interest-bearing liabilities such as deposits and borrowings). The underlying interest rates are highly sensitive to many factors, many of which are beyond our control, including general economic conditions, inflation, recession and the policies of various governmental and regulatory agencies, in particular, the Federal Reserve Board. The Federal Reserve raised its target Federal funds rate in .25% increments three times during 2017 and four times during 2018. In recent years, we originated higher volumes of longer term fixed rate loans. These loans, combined with the structure of our investment portfolio and funding mix caused the Company to become slightly to moderately liability sensitive.

The interest rates we pay on deposits and the interest rates we earn on loans are determined in large part by the rates paid and charged by our competitors. In addition, changes in monetary policy including changes in interest rates influence the origination of loans, the purchase of investments and the generation of deposits. These

changes affect the rates received on loans and securities and paid on deposits, which could have a material adverse effect on our business, financial condition and results of operations.

Changes in the fair value of our securities may reduce our shareholders' equity and net income.

We increase or decrease our shareholders' equity by the amount of change in the unrealized gain or loss (the difference between the fair value and the amortized cost) of our available-for-sale securities portfolio, net of related tax, under the category of accumulated other comprehensive income (loss). A decline in the fair value of this portfolio will result in a decline in reported shareholders' equity, as well as book value per common share. This decrease will occur even though the securities are not sold. In the case of debt securities, if these securities are never sold and there are no credit impairments, the decrease will be recovered over the life of the securities. In the event there are credit loss related impairments, the credit loss component is recognized in earnings.

We own shares of Federal Home Loan Bank of San Francisco stock which are recorded in other assets. The stock is carried at cost and subject to recoverability testing under applicable accounting standards. As of December 31, 2018, we did not recognize an impairment charge related to our Federal Home Loan Bank of San Francisco stock holdings; however, potential negative changes to the financial condition of the Federal Home Loan Bank of San Francisco could require us to recognize an impairment charge with respect to such stock holdings. Any such impairment charge would have an adverse impact on our results of operations and financial condition.

We own investments in Qualified Zone Academy Bonds ("QZAB") which are recorded in other assets. The investments are carried at cost and are subject to recoverability testing under applicable accounting standards. As of December 31, 2018, we did not recognize an impairment charge related to our QZAB investment holdings; however, potential negative changes to the financial condition of the issuing institutions could require us to recognize an impairment charge with respect to such holdings in the future. Any such impairment charge would have an adverse impact on our results of operations and financial condition.

Credit quality for private label mortgage backed securities we hold may deteriorate creating additional credit risk in our investment portfolio.

Our securities portfolio contains private label mortgage backed securities. These securities have more credit risk than the securities in our portfolio that are obligations of the U.S. Government or obligations guaranteed by the U.S. Government. We monitor the credit characteristics of the underlying mortgages to identify potential credit losses, if any, in the portfolio. If there is a decline in fair value due to credit quality concerns for a security we may be required to recognize an other-than-temporarily-impaired in earnings. Our Investment Policy requires that securities at the time of purchase, be rated A3/A- or higher by Moody's, S&P and Fitch rating agencies.

Conditions in the financial markets may limit our access to additional funding to meet our liquidity needs.

Liquidity is essential to our business, as we must maintain sufficient funds to respond to the needs of depositors and borrowers. An inability to raise funds through deposits, repurchase agreements, federal funds purchased, Federal Home Loan Bank of San Francisco advances, the sale or pledging as collateral of securities, loans, and other assets could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could negatively affect our access to liquidity sources include negative operating results, a decrease in the level of our business activity due to a market downturn or negative regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as severe disruption of the financial markets or negative news and expectations about the prospects for the financial services industry as a whole. An inability to borrow funds to meet our liquidity needs could have an adverse impact on our results of operations and financial condition.

The condition of other financial institutions could negatively affect us.

Financial services institutions are interrelated as a result of trading, clearing, counterparty, public perceptions and other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks and other institutional clients.

Many of these transactions expose us to credit risk in the event of a default by a counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due to us. Any such losses could have a material adverse effect on our financial condition and results of operations.

Competition in our market areas may limit future success.

Community banking is a highly competitive business and a consolidating industry. We compete for loans and deposits with other commercial banks, savings and loans, credit unions, finance, insurance and other non-depository companies operating in our market areas. Some of our competitors are not subject to the same regulations and restrictions as are we, and some of our competitors have greater financial resources. If we are unable to effectively compete in our market areas, the Company's business, results of operations, and prospects could be adversely affected.

Derivative financial instruments subject the Company to credit and market risk

We may use derivatives to hedge the risk of changes in market interest rates in order to limit the impact on earnings and cash flows relating to specific groups of assets and liabilities. Our use of derivatives in our risk management activities could expose the Company to mark-to-market losses if interest rates move in a materially different way than we expected when we entered into the related derivative contracts. In addition, we would be exposed to credit risk should the counterparty fail to perform under the terms of the derivative contracts. This could cause us to forfeit the payments due to us or result in settlement delays with the attendant credit and operational risk as well as increased costs to us. Derivative contracts may contain a provision which allows the counterparty to terminate the derivative contract if we failed to maintain our status as a well/adequately capitalized institution or if specific regulatory events occurred. If these contracts were terminated by the counterparty, we would be required to settle our obligations under the agreements, which could also cause operational risk and increased costs to us.

We rely heavily on our management team and the loss of key officers may adversely affect operations.

We are dependent on the successful recruitment and retention of highly qualified personnel. Our ability to implement our business strategies is closely tied to the strengths of our chief executive officer and other key officers. Additionally, business banking, one of our principal lines of business, is dependent on relationship banking in which our personnel develop professional relationships with small business owners and officers of larger business customers who are responsible for the financial management of the companies they represent. If management team members or other key employees were to leave the Company and become employed by a competing bank, we could potentially lose business customers. In addition, we rely on our customer service staff to effectively serve the needs of our customers. The loss of key employees to competitors or otherwise could have an adverse effect on our results of operation and financial condition.

Our future performance will depend on our ability to respond to technological change.

The financial services industry is experiencing rapid technological changes with frequent introductions of new technology-driven products and services. Effective use of technology increases efficiency and enables financial institutions to better serve customers and reduce costs. Many of our competitors have substantially greater resources to invest in technological improvements than we do. Our future success will depend, to some degree, on our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience, as well as create additional efficiencies in our operations. We may not be able to effectively implement new technology-driven products or service, or be successful in marketing such products and services. Additionally, the implementation of technological changes and upgrades to maintain current systems and integrate new ones may cause services interruptions, transaction processing errors and system conversion delays and may cause us to fail to comply with applicable laws. There can be no assurance that we will be able to successfully manage the risks associated with increased dependency on technology.

Internal control systems could fail to detect certain events.

We are subject to many operating risks, including, without limitation, data processing system failures and errors, and customer or employee fraud. There can be no assurance that such an event will not occur, and if such an event is not prevented or detected by our internal controls and does occur, and it is uninsured or is in excess of applicable insurance limits, it could have a significant adverse impact on our reputation in the business community and our business, financial condition, and results of operations.

Our operations could be interrupted if third party technology service providers experience difficulty, terminate their services or fail to comply with banking regulations.

We depend, and will continue to depend to a significant extent, on a number of relationships with third party technology service providers. Specifically, we utilize software and hardware systems for transaction processing, essential web hosting, debit and credit card processing, merchant bankcard processing, internet banking systems and other processing services from third party service providers. If these third party service providers experience difficulties or terminate their services, and we are unable to replace them with other qualified service providers, our operations could be interrupted. If an interruption were to continue for a significant period of time, our business, financial condition and results of operations could be materially adversely affected.

Confidential customer information transmitted through the Bank's online banking service is vulnerable to security breaches and computer viruses which could expose the Bank to litigation and adversely affect its reputation and ability to generate deposits.

We provide our customers the ability to bank online. We rely heavily on the secure processing, storage and transmission of confidential and other information on our computer systems and networks. The secure transmission of confidential information over the Internet is a critical element of online banking. Our network could be vulnerable to unauthorized access, computer hacking, cyber-attacks, electronic fraudulent activity, attempted theft of financial assets, computer viruses, phishing schemes and other security problems. We cannot guarantee that any such failures, interruption or security breaches will not occur, or if they do occur, that they will be adequately addressed. While we have certain protective policies and procedures in place, the nature and sophistication of the threats continue to evolve. We may be required to spend significant capital and other resources to protect against the threat of security breaches and computer viruses, alleviate problems caused by security breaches or viruses or to modify and enhance our protective measures. To the extent that our activities or the activities of our customers involve the storage and transmission of confidential information, security breaches and viruses could expose us to claims, litigation and other possible liabilities. Any inability to prevent cyber-attacks, security breaches or computer viruses could also cause existing customers to lose confidence in our systems and could adversely affect our reputation and our ability to generate deposits.

We are subject to extensive regulation which could adversely affect our business.

Our operations are subject to extensive regulation by federal, state and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of our operations. Because our business is highly regulated, the laws, rules and regulations applicable to us are subject to modification and change. There are currently proposed laws, rules and regulations that, if adopted, would impact our operations. For more information on these issues, refer to the material set forth above under the heading "Government Supervision and Regulation."

The requirements imposed by our regulators and other laws, rules or regulations applicable to us are designed to ensure the integrity of the financial markets and to protect customers and other third parties that transact business with us, and are not designed to protect our shareholders. Consequently, these regulations may: (1) make compliance much more difficult or expensive, (2) restrict our ability to originate, broker or sell loans or accept certain deposits, (3) further limit or restrict the amount of commissions, interest or other charges earned on loans originated or sold by us, or (4) otherwise adversely affect our business or prospects for business. Moreover, banking regulators have significant discretion and authority to address what regulators perceive to be unsafe or unsound practices or violations of laws or regulations by financial institutions and holding companies in the performance of their supervisory and enforcement duties. The exercise of regulatory authority by banking regulators over us may have a negative impact on our financial condition and results of operations. Additionally, in order to conduct certain activities, including acquisitions, we are required to obtain regulatory approval. There can be no assurance that any required approvals can be obtained, or obtained without conditions or on a timeframe acceptable to us.

Changes in accounting standards may impact how we report our consolidated financial condition and consolidated results of operations.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time, the FASB changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be difficult to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in a restatement of prior period financial statements.

Natural disasters, such as earthquakes, volcanic eruptions, tsunamis, wildfires, droughts, floods, mudslides, hurricanes, tornados and other geologic processes could harm our business.

We are susceptible to the risks of natural disasters such as earthquakes, volcanic eruptions, tsunamis, wildfires, droughts, floods, mudslides, hurricanes, tornados and other geologic processes. Historically, California has been vulnerable to natural disasters, and in 2017, California experienced extensive rainfall resulting in significant flooding and landslides, followed later in the year by the largest and most destructive wildfire season in state history. Natural disasters could harm our operations directly through interference with communications, including the interruption or loss of our websites, which would prevent us from gathering deposits, originating loans

and processing and controlling our flow of business, as well as through the destruction of facilities and our operational, financial and management information systems. California has also historically experienced energy shortages, which, if they recur, could impair our business operation and the value of real estate in the areas affected. Although we have implemented several back-up systems and protections and maintain business interruption insurance, these measures may not protect us fully from the effects of a natural disaster. The occurrence of natural disasters or energy shortages in California could have a material adverse effect on our business, prospects, financial condition and results of operations.

A natural disaster outside California could negatively impact our purchased loan portfolio or our third party loan servicers.

Our purchased loan portfolio includes a significant amount of loans made to borrowers outside California. We also rely on third party loan servicers located outside of California. Therefore, we are susceptible to the risks of natural disasters outside California. Natural disasters could impact the operations of our loan servicers directly through interference with communications, including the interruption or loss of websites, destruction of facilities, operational, financial and management information systems which could prevent them from servicing our portfolio. Natural disasters outside California could also impact the underlying collateral and borrower's ability to repay the loans for our purchased loan portfolios.

No assurance can be given that the Subordinated Notes will continue to qualify as Tier 2 Capital.

We believe that our Subordinated Notes meet the requirements of Tier 2 Capital in accordance with the Final Rules and current statutory guidance provided by the Federal Reserve Board. The Federal Reserve Board does not provide prior approval for the Subordinated Notes to be classified as Tier 2 Capital however, we did not receive any indication that the Subordinated Notes did not qualify as tier 2 capital during our most recent examination process with the Federal Reserve Bank of San Francisco. In the event that the Subordinated Notes do not qualify, the Federal Reserve Bank of San Francisco may require the Holding Company to amend certain terms and conditions of the Subordinated Notes in order for such instruments to qualify as Tier 2 Capital. Under the terms of the Subordinated Notes, the Holding Company also has the option to redeem the Subordinated Notes upon the occurrence of such an event.

We cannot give any assurance as to whether the applicable requirements for Tier 2 Capital will change in the future. Even if the Subordinated Notes initially meet the requirements of Tier 2 Capital under the current regulations, if changes are made in the future, and unless the Subordinated Notes are grandfathered into the new regulations, they could become disqualified as Tier 2 Capital.

Our deposits are subject to volatility

Our depositors can always choose to withdraw their deposits from the Bank and place them into alternative investments, which might cause an increase in our funding costs and reduce our net interest income. Checking, savings and money market account balances can decrease when customers perceive that alternative investments provide a better risk/return tradeoff.

At December 31, 2018, time certificates of deposit in excess of \$250,000, excluding brokered time deposits, represented approximately 5% of our total deposit balances. Because these deposits are not covered by FDIC deposit insurance, they are considered volatile and could be subject to withdrawal. Withdrawal of a material amount of such deposits could adversely affect our liquidity, profitability, business prospects, results of operations and cash flows. Our 25 largest deposit relationships account for 24% of our deposits.

Our exposure to operational, technological, and organization risk may adversely affect us.

Similar to other financial institutions, we are exposed to many types of operational and technological risk, including reputation, legal and compliance risk. Our ability to grow and compete is dependent on our ability to build or acquire the necessary operational and technological infrastructure and to manage the cost of that infrastructure while we expand and integrate acquired businesses. Operational risk can manifest itself in many ways, such as errors related to failed or inadequate processes, faulty or disabled computer systems, occurrences of fraud by employees or persons outside our company, and exposure to external events. We are dependent on our operational infrastructure to help manage these risks. From time to time, we may need to change or upgrade our technological infrastructure. We may experience disruption, and we may face additional exposure to these risks during the course of making such changes. If we acquire another financial institution or bank branch operations, we would face additional challenges when integrating different operational platforms, causing integration efforts to be more disruptive and /or more costly than anticipated.

Shareholders

In addition to risks and uncertainties that may affect the Company's business, financial condition and the future results, shareholders may also be subject to the following risks:

There can be no assurance we will be able to continue paying cash dividends on our common stock at recent levels.

We may not be able to continue paying quarterly cash dividends commensurate with recent levels, given that the ability to pay cash dividends on our common stock depends on a variety of factors. The payment of dividends is subject to government regulation in that regulatory authorities may prohibit banks and bank holding companies from paying dividends that would constitute an unsafe or unsound banking practice. The Federal Reserve Board generally prohibits a bank holding company from declaring or paying a cash dividend which would impose undue pressure on the capital of subsidiary banks or would be funded only through borrowing or other arrangements that might adversely affect a financial services holding company's financial position. The Board of Governors of the Federal Reserve System policy is that a bank holding company should not continue its existing rate of cash dividends on its common stock unless its net income is sufficient to fully fund each dividend and its prospective rate of earnings retention appears consistent with its capital needs, asset quality and overall financial condition. The power of the board of directors of an insured depository institution to declare a cash dividend or other distribution with respect to capital is subject to statutory and regulatory restrictions which limit the amount available for such distribution depending upon the earnings, financial condition and cash needs of the institution, as well as general business conditions.

Our ability to pay cash dividends to our shareholders is dependent on our receipt of cash dividends from our subsidiary Bank. In addition to the restrictions imposed under federal law, banks chartered under California law generally may only pay a cash dividend to the extent such payment does not exceed the lesser of (i) retained earnings of the bank or (ii) the bank's net income for its last three fiscal years less any distributions to shareholders during such period. The Bank is also prohibited from paying a dividend to the holding company if it is in default on its federal deposit insurance assessment.

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

Stock price volatility may make it difficult for you to resell your common stock at the time and prices you find attractive. Our stock price can fluctuate significantly in response to a variety of factors including, among other things:

- Actual or anticipated variations in quarterly results of operations;
- Recommendations by securities analysts;
- Operating and stock price performance of other companies that investors deem comparable to us;
- News reports relating to trends, concerns and other issues in the financial services industry, including the failures of other financial institutions;
- Perceptions in the marketplace regarding the Company and/or our competitors;
- Public sentiments toward the financial services and banking industry generally;
- New technology used, or services offered, by competitors;
- Significant acquisitions or business combinations, strategic partnerships, joint ventures or capital commitments by or involving the Company or our competitors;
- Changes in government regulations; and
- Geopolitical conditions such as acts or threats of terrorism or military conflicts.

General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause our stock price to decrease regardless of operating results as evidenced by the recent volatility and disruption of capital and credit markets.

Our common stock is traded on the NASDAQ Global Market under the trading symbol “BOCH” and historically has been a low trading volume stock. The limited trading market for our common stock may cause fluctuations in the market value of our common stock to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market of our common stock. Future sales of substantial amounts of common stock in the public market, or the perception that such sales may occur, could adversely affect the prevailing market price of the common stock. In addition, even if a more active market in our common stock develops, we cannot assure you that such a market will continue.

Anti-takeover provisions in our articles of incorporation could make a third party acquisition of us difficult.

In order to approve a merger or similar business combination with the owner of 20% or more of our common stock (an “Interested Shareholder”), our Articles of Incorporation contain provisions that require a supermajority vote of 66.7% of the outstanding shares of the common stock (excluding the shares held by the Interested Shareholder or its affiliates). These provisions further require that the per share consideration to be paid in such a transaction be equal or exceed the greater of (1) the highest per share price paid by the Interested Shareholder (a) within two years of the transaction proposal announcement date, or (b) the date the Interested Shareholder acquired a 20% -plus ownership interest (if the acquisition occurred less than two years before the transaction announcement) and (2) the fair market value of the Common Stock on (a) the transaction proposal announcement date, or (b) the date the Interested Shareholder acquired a 20% -plus ownership interest (if the acquisition occurred less than two years before the transaction announcement).

These provisions could result in the Company becoming a less attractive target for a would-be acquirer. As a consequence, it is possible that shareholders would lose an opportunity to be paid a premium for their shares in an acquisition transaction, even in circumstances where such action is favored by a majority of the Company's shareholders.

There may be future sales or other dilutions of our equity which may adversely affect the market price of our common stock.

We are not restricted from issuing additional shares of common stock, including securities that are convertible into or exchangeable for, or that represent the right to receive our common stock. In addition, we are not prohibited from issuing additional securities which are senior to our common stock. Because our decision to issue securities in any future offering will depend in part on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of any future offerings.

Future issuance of shares of our common stock, including those that may be issued in connection with our various stock option and equity compensation plans, in acquisitions or in any other offering of our common stock for cash, could have a dilutive effect on the tangible book value of our common stock and could adversely affect our market price. Any future issuances of shares of our common stock may be dilutive to existing shareholders.

The holders of our trust preferred securities have rights that are senior to those of our holders of common stock and that may impact our ability to pay dividends on our common stock to our common shareholders.

At December 31, 2017, our subsidiary Bank of Commerce Holdings Trust II had outstanding \$10.3 million of trust preferred securities. These securities are effectively senior to shares of common stock due to the priority of the underlying junior subordinated debentures. As a result, we must make dividend payments on our trust preferred securities before any dividends can be paid on our common stock; moreover, in the event of our bankruptcy, dissolution, or liquidation, all obligations outstanding with respect to our trust preferred securities must be satisfied before any distributions can be made to our shareholders. While we have the right to defer dividends on the trust preferred securities for a period of up to five years, no dividends may be paid to our common shareholders during that time if any such election has been made.

Our senior and subordinated debt agreements have provisions that may impact our ability to pay dividends on our common stock to our common shareholders

On December 10, 2015, we issued and sold \$10.0 million in aggregate principal amount of fixed to floating rate Subordinated Notes pursuant to a private placement with certain institutional investors. Also on December 10, 2015, we entered into a loan agreement pursuant to which we obtained \$10.0 million in senior debt secured by a pledge of all of the stock of the Bank. The Notes and debt agreements limit the payment of cash dividends to our common shareholders if the Company is not well capitalized or if there is an event of default as described by the agreements.

Item 1b - Unresolved Staff Comments

None to report.

Item 2 - Properties

- The Company's principal executive office consists of 1,594 square feet of leased space located at 555 Capitol Mall, Suite 1255, Sacramento, California 95814; the lease agreement expires on December 31, 2024.
- The Bank has ten full service banking offices:
 - The main office consists of 20,700 square feet of space in a Bank owned building located at 1951 Churn Creek Road, Redding, California 96002.
 - A branch that consists of 11,650 square feet of space in a Bank owned building located at 1177 Placer Street, Redding, California, 96001.
 - A branch that consists of 3,787 square feet of leased space located at 3455 Placer Street, Redding, California 96001. The lease agreement expires on July 31, 2027.
 - A branch that consists of 5,600 square feet of space in a Bank owned building located at 558 Market Street, Colusa, California 95932.
 - A branch that consists of 7,221 square feet of space in a Bank owned building located at 1222 Solano Street, Corning, California 96021.
 - A branch that consists of 9,360 square feet of space in a Bank owned building located at 328 Walker Street, Orland, California 95963.
 - A branch that consists of 8,910 square feet of space in a Bank owned building located at 155 North Tehama Street, Willows, California 95988.
 - A branch that consists of 8,450 square feet of space in a Bank owned building located at 200 South Broadway Street, Yreka, California 96097.
 - A branch that consists of 10,488 square feet of leased space located at 1504 Eureka Road, Suite 100, Roseville, California 95661. The space is leased pursuant a lease expiring on January 31, 2023, and month to month thereafter.
 - A branch that consists of 7,200 square feet of space in a Bank owned building located at 1015 Seventh Street, Sacramento, California 95814.
- The Bank has one limited service branch located at 3939 Walnut Avenue, Suite A, Carmichael, Sacramento, California 95608.
- The Bank operates three free standing remote ATMs:
 - An offsite remote ATM that consists of 150 square feet of leased space located at 125 East Walker Street, Orland, California 95963. The space is leased pursuant a lease expiring on November 19, 2019.
 - An offsite remote ATM that consists of 150 square feet of leased space located at 1920 Solano Street, Corning, California 96021. The space is leased pursuant a lease expiring on January 31, 2023.
 - An offsite remote ATM that consists of 174 square feet of leased space located at 692 E Street, Williams, California 95987. The space is leased pursuant a lease expiring on August 16, 2023.
- The Bank has office space consisting of 12,286 square feet of space in a Bank owned building located at 1901 Churn Creek Road, Redding, California 96002.
- The Bank has office space consisting of 6,163 square feet of leased space located at 330 Hartnell Avenue, Redding, California 96002; the lease agreement expires on February 28, 2022.
- The Bank has office space consisting of 4,430 square feet of leased space located at 1504 Eureka Road, Suite 120, Roseville, California 95661. The space is leased pursuant to a lease expiring on January 31, 2023, and month to month thereafter.
- The Bank has office space consisting of 2,413 square feet of leased space located at 1504 Eureka Road, Suite 130, Roseville, California 95661. The space is leased pursuant to a lease expiring on January 31, 2023, and month to month thereafter.

Item 3 - Legal Proceedings

We are subject to various pending and threatened legal actions arising in the ordinary course of business and, if necessary, maintain reserves for losses from legal actions that are both probable and estimable. There are no legal proceedings adverse to the Company that we believe will have a material effect on our consolidated financial position or results of operations.

Item 4 - Mine Safety Disclosures

Not applicable.

Part II

Item 5 - Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

The principal market on which our common stock is traded is the NASDAQ Global Market. The Holding Company's common stock is listed under the trading symbol "BOCH." There were 2,340 shareholders of the Holding Company's common stock as of December 31, 2018, including those held in street name, and the market price on that date was \$10.96 per share.

Cash Dividends

We declared cash dividends of \$0.15 and \$0.12 during the years ended December 31, 2018 and 2017, respectively. Our ability to pay dividends is subject to certain regulatory requirements. The Federal Reserve Board generally prohibits a bank holding company from declaring or paying a cash dividend which would impose undue pressure on the capital of subsidiary banks or would be funded only through borrowing or other arrangements that might adversely affect a financial services holding company's financial position. The Board of Governors of the Federal Reserve System policy is that a bank holding company should not continue its existing rate of cash dividends on its common stock unless its net income is sufficient to fully fund each dividend and its prospective rate of earnings retention appears consistent with its capital needs, asset quality and overall financial condition. The power of the board of directors of an insured depository institution to declare a cash dividend or other distribution with respect to capital is subject to statutory and regulatory restrictions which limit the amount available for such distribution depending upon the earnings, financial condition and cash needs of the institution, as well as general business conditions.

Our ability to pay dividends is subject to certain contractual requirements. Our trust preferred securities, senior and subordinated debt agreements contain provisions that prohibit us from declaring or paying a dividend if the Company is not "well-capitalized" for regulatory purposes or there exists an event of default as defined by the agreements.

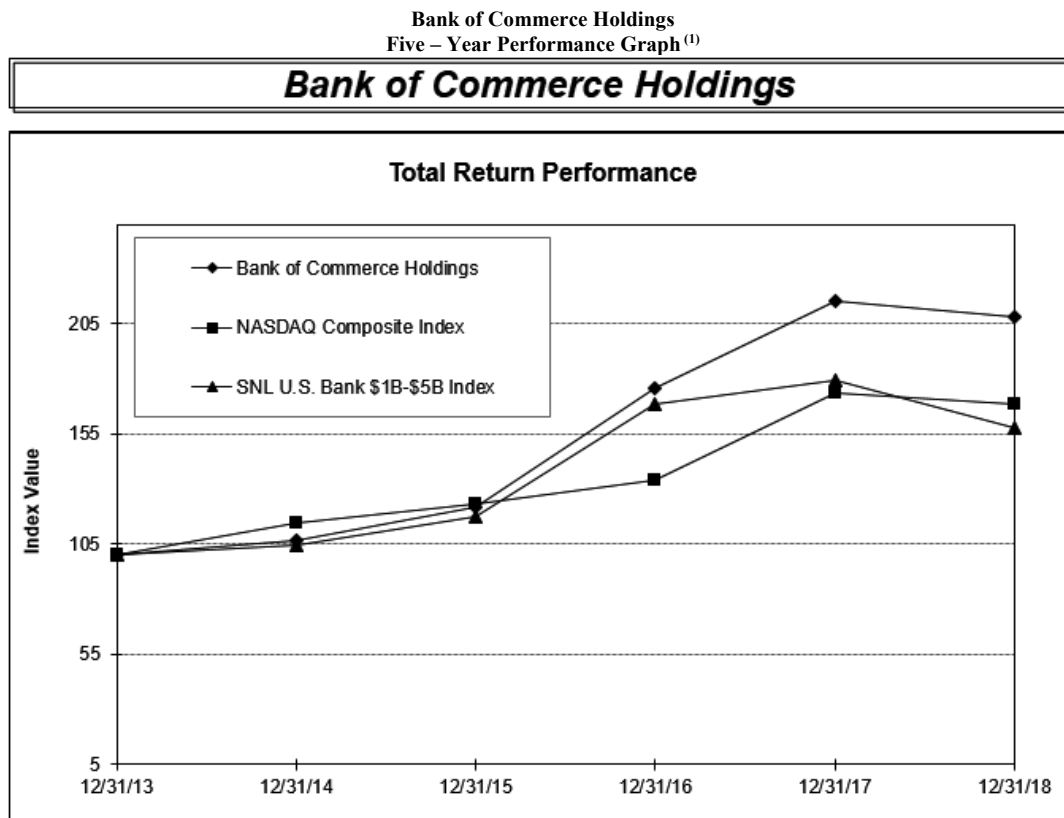
Securities Authorized for Issuance Under Equity Compensation Plans

We currently maintain one equity-based compensation plan which was approved by the shareholders in 2008 and amended in 2010 and 2012. The following table sets forth our equity-based compensation plan, the number of shares of common stock subject to outstanding options, the weighted-average exercise price of outstanding options, and the number of shares available for future award grants as of December 31, 2018.

Plan Category	(c) Number of Securities Remaining Available For Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected In Column (a))		
	(a) Number of Securities To Be Issued Upon Exercise of Outstanding Options	(b) Weighted Average Exercise Price of Outstanding Options	
Equity compensation plans approved by security holders	97,400	\$ 5.02	151,699
Equity compensation plans not approved by security holders	None	None	None
Total	97,400	\$ 5.02	151,699

Stock Performance Graph

The following graph compares the Holding Company's cumulative total return to shareholders during the past five years with that of the NASDAQ Composite Stock Index and the SNL Securities \$1.000 billion - \$5.000 billion Bank Asset-Size Index (the "SNL Securities Index"). The stock price performance shown on the following graph is not necessarily indicative of future performance of our common stock.



(1) Assumes \$100 invested on December 31, 2013, in the Holding Company's common stock, the NASDAQ Composite Index, and the SNL Securities Index. The model assumes reinvestment of dividends. Source: SNL Securities (share prices for the Holding Company's common stock was furnished to SNL Securities through the NASDAQ).

Item 6 - Selected Financial Data

The selected consolidated financial data set forth below for the five years ended December 31, 2018, have been derived from the Company's audited Consolidated Financial Statements and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Company's audited Consolidated Financial Statements and notes thereto, included elsewhere in this report.

<i>Amounts in thousands (except ratios and per share data)</i>	2018	2017	2016	2015	2014
Statements of income					
Interest income	\$ 52,701	\$ 45,949	\$ 41,009	\$ 38,753	\$ 36,693
Net interest income	\$ 47,546	\$ 41,362	\$ 36,231	\$ 33,770	\$ 32,601
Provision for loan and lease losses	\$ —	\$ 950	\$ —	\$ —	\$ 3,175
Noninterest income	\$ 4,019	\$ 4,824	\$ 3,486	\$ 3,183	\$ 4,307
Noninterest expense	\$ 32,206	\$ 30,964	\$ 32,500	\$ 24,905	\$ 26,426
Net income available to common shareholders	\$ 15,730	\$ 7,344	\$ 5,259	\$ 8,295	\$ 5,527
Balance sheets					
Total assets	\$ 1,307,104	\$ 1,269,421	\$ 1,140,992	\$ 1,015,441	\$ 997,192
Average total assets	\$ 1,288,841	\$ 1,198,251	\$ 1,079,750	\$ 992,731	\$ 973,807
Total gross loans	\$ 946,251	\$ 879,835	\$ 804,211	\$ 716,639	\$ 660,898
Allowance for loan and lease losses	\$ 12,292	\$ 11,925	\$ 11,544	\$ 11,180	\$ 10,820
Total deposits	\$ 1,131,716	\$ 1,102,732	\$ 1,004,666	\$ 803,735	\$ 789,035
Total shareholders' equity	\$ 138,321	\$ 127,264	\$ 94,106	\$ 90,522	\$ 103,602
Ratios ¹					
Return on average assets ²	1.22 %	0.61 %	0.49 %	0.86 %	0.59 %
Return on average shareholders' equity ³	12.08 %	6.34 %	5.68 %	8.10 %	5.59 %
Average equity to average assets	10.10 %	9.67 %	8.57 %	10.68 %	10.51 %
Common equity tier 1 capital ratio ⁴	12.79 %	12.26 %	9.43 %	10.06 %	n/a
Tier 1 capital ratio ⁴	13.71 %	13.23 %	10.42 %	11.16 %	13.91 %
Total capital ratio ⁴	15.82 %	15.44 %	12.68 %	13.52 %	15.16 %
Tier 1 leverage ratio ⁴	11.21 %	10.86 %	9.13 %	10.03 %	11.60 %
Net interest margin ⁵	3.93 %	3.78 %	3.71 %	3.77 %	3.71 %
Average earning assets to total average assets	94.67 %	93.85 %	93.34 %	93.43 %	93.81 %
Nonperforming assets to total assets ⁶	0.32 %	0.46 %	1.06 %	1.53 %	2.22 %
Net (recoveries) charge-offs to average loans	(0.04) %	0.07 %	(0.05) %	(0.05) %	1.04 %
Allowance for loan and lease losses to gross loans	1.30 %	1.36 %	1.44 %	1.56 %	1.64 %
Nonperforming loans to allowance for loan and lease losses	33.73 %	48.63 %	98.64 %	126.09 %	200.30 %
Efficiency ratio ⁷	62.5 %	67.0 %	81.8 %	67.4 %	71.6 %
Share data					
Average common shares outstanding – basic	16,248	15,207	13,367	13,331	13,475
Average common shares outstanding – diluted	16,332	15,310	13,425	13,365	13,520
Book value per common share	\$ 8.47	\$ 7.82	\$ 7.00	\$ 6.76	\$ 6.29
Book value per common share - tangible ⁸	\$ 8.36	\$ 7.70	\$ 6.83	\$ 6.76	\$ 6.29
Basic earnings per share	\$ 0.97	\$ 0.48	\$ 0.39	\$ 0.62	\$ 0.41
Diluted earnings per share	\$ 0.96	\$ 0.48	\$ 0.39	\$ 0.62	\$ 0.41
Cash dividends per common share	\$ 0.15	\$ 0.12	\$ 0.12	\$ 0.12	\$ 0.12

1 - Regulatory Capital Ratios and Asset Quality Ratios are end of period ratios. With the exception of end of period ratios, all ratios are based on average daily balances during the indicated period.

2 - Return on average assets is net income (which included preferred stock costs in 2015 and 2014) divided by average total assets.

3 - Return on average shareholders' equity is net income (which included preferred stock costs in 2015 and 2014) divided by average shareholders' equity.

4 - See Item 7 - Management's Discussion And Analysis Of Financial Condition And Results Of Operations and Note 18 Regulatory Capital in the Notes to Consolidated Financial Statements in this document for a discussion of the regulatory capital guidelines.

5 - Net interest margin equals net interest income on a tax equivalent basis, divided by average interest-earning assets.

6 - Nonperforming assets include all nonperforming loans (nonaccrual loans, loans 90 days past due and still accruing interest and restructured loans that are nonperforming) and real estate acquired by foreclosure or transfer to OREO.

7 - The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income and presented based on results from continuing operations.

8 - Tangible book value per share is computed by dividing total shareholders' equity less goodwill and core deposit intangible, net by shares outstanding. Management believes that tangible book value per share is meaningful because it is a measure that the Company and investors commonly use to assess capital adequacy.

Item 7 - Management's Discussion And Analysis Of Financial Condition And Results Of Operations

The following discussion of financial condition as of December 31, 2018, and 2017, and results of operations for each of the years in the three-year period ended December 31, 2018 should be read in conjunction with our Consolidated Financial Statements and related notes, included in Part II Item 8 of this report. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

The disclosures set forth in this item are qualified by important factors detailed in Part I captioned *Forward-Looking Statements* and Item 1A captioned *Risk Factors* of this report and other cautionary statements set forth elsewhere in the report.

EXECUTIVE OVERVIEW

Net Income for the three years ended December 31, 2018, 2017 and 2016 was \$15.7 million or \$0.96 per share diluted, \$7.3 million or \$0.48 per share-diluted, and \$5.3 million or \$0.39 per share-diluted, respectively. Financial performance for all three years includes "selected tax items" which complicates reporting period comparisons. The 2018 results include a \$1.5 million decrease in our income tax provision composed of a \$988 thousand reversal of our reserve for uncertain tax position and a \$484 thousand benefit as a result of our cost segregation study and tangible property review. The 2017 results include a \$2.5 million increase in our income tax provision as a result of the Tax Cuts and Jobs Act of 2017. The 2016 results also include a write-down of a \$363 deferred tax asset. Management believes that our financial results are more comparative excluding the impact of these selected tax items.

Non-GAAP Financial Measures

In addition to results presented in accordance with generally accepted accounting principles in the United States of America (GAAP), this Annual Report on Form 10-K contains certain non-GAAP financial measures. We believe that these non-GAAP financial measures provide investors with information useful in understanding the Company's financial performance; however, readers of this document are urged to review these non-GAAP financial measures in conjunction with the GAAP results as reported.

SELECTED NON-GAAP FINANCIAL INFORMATION - UNAUDITED

(amounts in thousands except per share data)

	For The Twelve Months Ended		
	December 31,		
	2018	2017	2016
Reconciliation of Net Income (GAAP) to Net Income			
Excluding Selected Tax Items (non-GAAP):			
Net income (GAAP)	\$ 15,730	\$ 7,344	\$ 5,259
Selected tax items:			
Reversal of uncertain tax position (GAAP)	(988)	—	—
Benefit from cost segregation study and tangible property review (GAAP)	(484)	—	—
Deferred tax asset write-down (GAAP)	—	2,490	363
Total selected tax items	(1,472)	2,490	363
Net income excluding selected tax items (non-GAAP)	<u>\$ 14,258</u>	<u>\$ 9,834</u>	<u>\$ 5,622</u>
Earnings per share - diluted (GAAP)	\$ 0.96	\$ 0.48	\$ 0.39
Effect of selected tax items	(0.09)	0.16	0.03
Earnings per share - diluted excluding selected tax items (non-GAAP)	<u>\$ 0.87</u>	<u>\$ 0.64</u>	<u>\$ 0.42</u>
Non-GAAP Ratios:			
Return on average assets excluding selected tax items	1.11 %	0.82 %	0.52 %
Return on average equity excluding selected tax items	10.95 %	8.48 %	6.07 %
Effective tax rate excluding selected tax items	26.3 %	31.1 %	22.1 %
GAAP Information:			
Return on average assets	1.22 %	0.61 %	0.49 %
Return on average equity	12.08 %	6.34 %	5.68 %
Effective tax rate	18.7 %	48.5 %	27.1 %

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Significant items for the year ended December 31, 2018 were as follows:

Performance

- Net income of \$15.7 million was an increase of \$8.4 million (114%) from \$7.3 million earned during the same period in the prior year. Earnings of \$0.96 per share – diluted was an increase of \$0.48 (100%) from \$0.48 per share – diluted earned in the prior year and reflects the impact of 2,738,096 shares of common stock sold and issued in the second quarter of 2017.
- Expenses associated with our acquisition of Merchants Holding Company totaled \$844 thousand.
- Net interest income increased \$6.2 million (15%) to \$47.5 million compared to \$41.4 million in the prior year.
- Return on average assets improved to 1.22% compared to 0.61% in the prior year.
- Return on average equity improved to 12.08% compared to 6.34% in the prior year.
- Average loans totaled \$915.4 million, an increase of \$97.2 million (12%) compared to average loans in the prior year.
- Average earning assets totaled \$1.220 billion, an increase of \$96 million (9%) compared to average earning assets in the prior year.
- Average deposits totaled \$1.098 billion, an increase of \$57 million (5%) compared to average deposits in the prior year.
 - Average non-maturing deposits totaled \$930.2 million, an increase of \$94.4 million (11%) compared to average non-maturing deposits in the prior year.
 - Average certificates of deposit totaled \$168.2 million, a decrease of \$37.5 million (18%) compared to average certificates of deposit the prior year.
- The Company's efficiency ratio was 62.5% compared to 67.0% during the prior year.

Capital

- Declared cash dividends of \$0.15 per share for 2018 compared to \$0.12 per share in 2017.
- Book value per common share was \$8.47 at December 31, 2018 compared to \$7.82 at December 31, 2017. Tangible book value per common share (non-GAAP) which excludes goodwill and core deposit intangibles from shareholders' equity was \$8.36 at December 31, 2018 compared to \$7.70 at December 31, 2017. Management believes that tangible book value per share is meaningful because it is a measure that the Company and investors commonly use to assess capital adequacy.
- Average total equity increased by \$14.3 million (12%) to \$130.2 million for the year ended December 31, 2018, compared to \$115.9 million for the year ended December 31, 2017.
- The Bank maintained capital levels in excess of the "well-capitalized" standards for the year ended December 31, 2018.

Credit Quality

- Nonperforming assets at December 31, 2018 totaled \$4.2 million or 0.32% of total assets, a decrease of \$1.7 million (28%) since December 31, 2017.
- There was no provision for loan and lease losses during the current year as a result of continued improved asset quality and net loan loss recoveries. The Company recorded a provision for loan and lease losses of \$950 thousand during the year ended December 31, 2017 reflecting growth in the loan portfolio.

Vision and Objectives

We seek to provide competitive, long-term returns to our shareholders while serving the financial needs of the communities in our market. Management strives to provide those returns while exercising prudent risk management practices and maintaining adequate levels of capital and reserves.

Our vision is to remain independent, expanding our presence with organic growth and the addition of new strategically important locations. We will pursue attractive opportunities to enter related lines of business and to acquire financial institutions with complementary lines of business when it is beneficial to do so. During 2018 our organic growth in average assets totaled \$90.6 million or 8%.

Our long-term success rests on the shoulders of the leadership team and its ability to effectively enhance the performance of the Company. As a financial services company, we are in the business of taking and managing risks. Whether we are successful depends largely upon whether we take the right risks and are rewarded appropriately for those risks. Our governance structure enables us to manage all major aspects of our business effectively through an integrated process that includes financial, strategic, risk and leadership planning.

We define risks to include not only credit, market and liquidity risk, the traditional concerns for financial institutions, but also operational risks, including risks related to systems, processes or external events, as well as legal, regulatory and reputation risks. Our management processes, structures, and policies help to ensure compliance with laws and regulations and provide clear lines for decision-making and accountability. Results are important, but equally important is how we achieve those results. Our core values and commitment to high ethical standards are essential to maintaining and to sustaining public trust and confidence in our Company.

SOURCES OF INCOME

We derive our income primarily from net interest income, which is the difference between the interest income we receive on interest-earning assets and the interest expense we pay on interest-bearing liabilities. Net interest income is impacted by many factors that are beyond our control, including general economic conditions and the policies of various governmental and regulatory agencies, the Federal Reserve Board in particular. In recent years, we originated higher volumes of longer term

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

fixed rate loans. These loans, combined with the structure of our investment portfolio, the use of floors in the pricing of our variable rate loans and funding mix caused the Company to become neutral to slightly to moderately liability sensitive, which could negatively impact earnings in a rapidly rising interest rate environment.

Net interest income reflects both the amount of earning assets we hold and our net interest margin, which is the difference between the yields we receive on our earning assets and the interest rates we pay to fund those assets. As a result, changes in either our net interest margin or the amount of earning assets we hold will affect our net interest income and earnings.

Increases or decreases in interest rates could adversely affect our net interest margin. Although our asset yields and funding costs tend to move in the same direction in response to changes in interest rates, one can rise or fall faster than the other, and cause our net interest margin to expand or contract. Many of our assets are tied to indexes, which adjust in response to changes in interest rates.

Changes in the slope of the yield curve, and the spread between short-term and long-term interest rates could also reduce our net interest margin. Normally, the yield curve is upward sloping, which means that short-term rates are lower than long-term rates. Because our liabilities tend to be shorter in duration than our assets, when the yield curve flattens or even inverts, we could experience pressure on our net interest margin as our cost of funds increases relative to the yield we can earn on our assets.

We assess our interest rate risk by estimating the effect of interest rate changes on our earnings under various simulated scenarios. The scenarios differ based on assumptions including the direction, magnitude and speed of interest rate changes, and the slope of the yield curve.

There is always the risk that changes in interest rates could reduce our net interest income and earnings in material amounts, especially if actual conditions turn out to be materially different than simulated scenarios. For example, if interest rates rise or fall faster than we assumed or the slope of the yield curve changes, we may incur significant losses on debt securities we hold as investments. To reduce our interest rate risk, we may rebalance our investment and loan portfolios, refinance our debt and take other strategic actions, which may result in losses or expenses.

The following table summarizes as of December 31, 2018 when loans are projected to reprice by year and by rate index.

<i>(Amounts in thousands)</i>	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6 Through Year 10	Beyond Year 10	Total
Rate Index:								
Fixed	\$ 45,584	\$ 36,111	\$ 57,493	\$ 35,954	\$ 60,277	\$ 136,951	\$ 14,546	\$ 386,916
Prime	102,971	6,468	5,050	7,154	5,484	5,287	—	132,414
5 Year Treasury	40,138	27,910	65,426	74,377	66,077	43,898	—	317,826
7 Year Treasury	884	923	7,098	9,343	523	19,414	—	38,185
1 Year LIBOR	24,345	—	—	—	—	—	—	24,345
Other Indexes	4,975	5,372	4,839	2,181	5,853	18,622	2,504	44,346
Nonaccrual	1,791	314	276	255	247	830	433	4,146
Total	<u>\$ 220,688</u>	<u>\$ 77,098</u>	<u>\$ 140,182</u>	<u>\$ 129,264</u>	<u>\$ 138,461</u>	<u>\$ 225,002</u>	<u>\$ 17,483</u>	<u>\$ 948,178</u>

We also earn noninterest income. Sources of noninterest income include fees earned on deposit related services, ATM and point of sale fees, payroll and benefit processing fees, earnings on bank-owned life insurance, gains on sale of available-for-sale securities, and dividends on Federal Home Loan Bank of San Francisco stock.

RESULTS OF OPERATIONS

The following discussion and analysis provides a comparison of the results of operations for the three years ended December 31, 2018. This discussion should be read in conjunction with the Consolidated Financial Statements and related notes.

Overview

The Year Ended December 31, 2018 Compared to the Year Ended December 31, 2017

Net income was \$15.7 million for the year ended December 31, 2018, compared to \$7.3 million for the year ended December 31, 2017. For 2018, increases in net interest income, a decrease in the provision for loan and lease losses and a decreased provision for income taxes were partially offset by decreased noninterest income and increased noninterest expenses.

Diluted earnings per share were \$0.96 for the year ended December 31, 2018 compared with \$0.48 for the same period a year previous.

We declared cash dividends of \$0.15 per share in 2018 and \$0.12 per share in 2017. In determining the amount of dividend to be paid, we give consideration to capital preservation objectives, expected asset growth, projected earnings, the overall dividend pay-out ratio and the dividend yield.

The Year Ended December 31, 2017 Compared to the Year Ended December 31, 2016

Net income was \$7.3 million for the year ended December 31, 2017, compared to \$5.3 million for the year ended December 31, 2016. For 2017, increases in net interest income, noninterest income and decreases in noninterest expense were offset by an increased provision for loan and lease losses and an increased provision for income taxes.

Diluted earnings per share were \$0.48 for the year ended December 31, 2017 compared with \$0.39 for the same period a year previous. Changes in earnings per share are the result of changes in net income and the issuance of 2,738,096 shares common stock during 2017.

We declared cash dividends of \$0.12 per share in both 2017 and 2016.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Return on Average Assets and Return on Average Equity

The following table presents the return on average assets and return on average equity for the years ended December 31, 2018, 2017 and 2016. For each of the periods presented, the table includes the calculated ratios based on reported net income as shown in the Consolidated Statements of Income incorporated in this document.

	2018	2017	2016
Return on average assets	1.22 %	0.61 %	0.49 %
Return on average equity	12.08 %	6.34 %	5.68 %

Net Interest Income and Net Interest Margin

Net interest income is our largest source of operating income. Net interest income for the years ended December 31, 2018, 2017 and 2016 was \$47.5 million, \$41.4 million and \$36.2 million, respectively.

The Year Ended December 31, 2018 Compared to the Year Ended December 31, 2017

Interest income for the year ended December 31, 2018 was \$52.7 million, an increase of \$6.8 million or 15% compared to a year previous. The increase in interest income was derived primarily from our loan portfolio (\$5.8 million) and our investment securities portfolio (\$729 thousand). Both portfolios benefited from increases in both volume and yield.

Interest expense for the year ended December 31, 2018 was \$5.2 million, an increase of \$568 thousand or 12% compared to a year previous.

- Interest on interest-bearing deposits increased \$126 thousand during 2018. Average interest-bearing core deposit balances increased \$52.0 million while average time deposit balances decreased \$37.5 million. The cost of all interest-bearing deposits was 0.43% for 2018 compared with 0.42% for 2017.
- Interest on senior and subordinated term debt decreased \$88 thousand during 2018 and reflects principal repayments made on senior debt during the year.
- Interest on FHLB term debt increased \$432 thousand during 2018. FHLB term debt averaged \$22.5 million in 2018, but only \$302 thousand in 2017. In addition, the cost of FHLB term debt was 1.94% in 2018 compared with .99% in 2017.
- Interest on junior subordinated debentures increased \$98 thousand during 2018.

The net interest margin for the year ended December 31, 2018 was 3.90% an increase of 22 basis points as compared to 2017. Our net interest margin was enhanced during 2018 by our efforts to deploy liquidity from strong core deposit growth into loan originations, the purchase of intermediate term available for sale securities and the accelerated repayment of our senior debt.

The benefit of our actions resulted in a 23 basis point increase in the yield on average interest-earning assets. The net interest margin on a fully tax-equivalent basis was 3.93% for the year ended December 31, 2018, an increase of 16 basis points as compared to the same period a year previous. The tax equivalent yields for 2018 were calculated using a 21% tax rate while the tax equivalent yields for 2017 were calculated using a 34% tax rate.

Maintaining our net interest margin in the future will continue to be challenging as market pressures increase on deposit rates.

The Year Ended December 31, 2017 Compared to the Year Ended December 31, 2016

Interest income for the year ended December 31, 2017 was \$45.9 million, an increase of \$4.9 million or 12% compared to a year previous. The increase in interest income was derived primarily from our loan portfolio (\$3.7 million) and our investment securities portfolio (\$823 thousand). Both portfolios benefited from increased volume. The loan portfolio also benefited from increases in yield however, yields decreased for the investment portfolio.

Interest expense for the year ended December 31, 2017 was \$4.6 million, a decrease of \$191 thousand or 4% compared to the prior year.

- Interest on interest-bearing deposits increased \$256 thousand during 2017. Average interest-bearing core deposit balances increased \$67.1 million while average time deposit balances decreased \$15.4 million. The cost of all deposits decreased by one basis point to 0.30% for 2017 compared to the prior year.
- Interest on senior and subordinated term debt decreased \$9 thousand during 2017 and reflects principal repayments made on senior debt during the year.
- Interest on FHLB term debt decreased \$482 thousand during 2017. FHLB term debt averaged \$302 thousand in 2017 compared to \$17.9 million in 2016. For 2016, interest on Federal Home Loan Bank of San Francisco borrowings includes the effect of hedge losses reclassified out other comprehensive income. During March of 2016, we terminated all of our interest rate swaps (active and forward starting, the “hedging” instrument) and simultaneously paid off the \$75.0 million Federal Home Loan Bank of San Francisco borrowing (the “hedged instrument”).
- Interest on junior subordinated debentures increased \$52 thousand during 2017.

The net interest margin on a fully tax-equivalent basis was 3.78% for the year ended December 31, 2017, an increase of seven basis points as compared to the same period a year previous. The increase in our net interest margin resulted mostly from a decrease in the cost of funding average earning assets. These lower funding costs are the result of reductions in term debt and the termination of an interest rate hedge in 2016.

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The following table presents condensed average balance sheet information, together with interest income and yields earned on average interest-earning assets, and interest expense and rates paid on average interest-bearing liabilities for the years ended December 31, 2018, 2017 and 2016.

Average Balances, Interest Income/Expense and Yields Earned/Rates Paid

	Years Ended December 31,								
	2018			2017			2016		
(Amounts in thousands)	Average Balance	Interest ⁽¹⁾	Yield/Rate ⁽⁵⁾	Average Balance	Interest ⁽¹⁾	Yield/Rate ⁽⁵⁾	Average Balance	Interest ⁽¹⁾	Yield/Rate ⁽⁵⁾
Interest-earning assets:									
Net loans ⁽²⁾	\$ 915,360	\$ 44,955	4.91 %	\$ 818,119	\$ 39,112	4.78 %	\$ 752,938	\$ 35,435	4.71 %
Taxable securities	207,407	5,165	2.49 %	165,333	3,921	2.37 %	120,884	2,986	2.47 %
Tax-exempt securities	50,330	1,629	3.24 %	74,231	2,144	2.89 %	75,303	2,256	3.00 %
Interest-bearing deposits in other banks	47,038	952	2.02 %	66,872	772	1.15 %	58,668	332	0.57 %
Average interest-earning assets	1,220,135	52,701	4.32 %	1,124,555	45,949	4.09 %	1,007,793	41,009	4.07 %
Cash and due from banks	20,468			18,301			15,831		
Premises and equipment, net	13,952			15,567			15,078		
Goodwill and core deposit intangible, net	1,917			2,136			1,888		
Other assets	32,369			37,692			39,160		
Average total assets	\$ 1,288,841			\$ 1,198,251			\$ 1,079,750		
Interest-bearing liabilities:									
Demand - interest-bearing	\$ 238,328	\$414	0.17 %	\$ 209,792	274	0.13 %	\$ 172,011	201	0.12 %
Money market accounts	\$ 250,685	646	0.26 %	\$ 224,913	470	0.21 %	\$ 202,159	322	0.16 %
Savings accounts	109,025	288	0.26 %	111,376	200	0.18 %	104,771	174	0.17 %
Certificates of deposit	168,183	1,910	1.14 %	205,648	2,188	1.06 %	221,074	2,179	0.99 %
Federal Home Loan Bank of San Francisco borrowings	22,466	435	1.94 %	302	3	0.99 %	17,856	484	2.71 %
Other borrowings	15,143	1,077	7.11 %	17,981	1,165	6.48 %	19,430	1,183	6.09 %
Junior subordinated debentures	10,310	385	3.73 %	10,310	287	2.78 %	10,310	235	2.28 %
Average interest-bearing liabilities	814,140	5,155	0.63 %	780,322	4,587	0.59 %	747,611	4,778	0.64 %
Noninterest-bearing demand	332,197			289,735			226,368		
Other liabilities	12,286			12,293			13,217		
Shareholders' equity	130,218			115,901			92,554		
Average liabilities and shareholders' equity	\$ 1,288,841			\$ 1,198,251			\$ 1,079,750		
Net interest income and net interest margin ⁽⁴⁾		\$ 47,546	3.90 %		\$ 41,362	3.68 %		\$ 36,231	3.60 %
Tax equivalent net interest margin ⁽³⁾			3.93 %			3.78 %			3.71 %

(1) Interest income on loans includes deferred fees and costs of approximately \$465 thousand, \$546 thousand, and \$1.1 million for the years ended December 31, 2018, 2017 and 2016 respectively.

(2) Net loans includes average nonaccrual loans of \$4.2 million, \$8.9 million and \$10.6 million for the years 2018, 2017, and 2016, respectively.

(3) Tax-exempt income has been adjusted to tax equivalent basis at a 21% for 2018 and at a 34% tax rate for 2017 and 2016. The amount of such adjustments was an addition to recorded income of approximately \$433 thousand, \$1.1 million and \$1.2 million for the years 2018, 2017 and 2016, respectively.

(4) Net interest margin is net interest income expressed as a percentage of average interest-earning assets.

(5) Yields and rates are calculated by dividing income or expense by the average balance of the respective assets or liabilities.

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The following table sets forth a summary of the changes in tax equivalent net interest income due to changes in average asset and liability balances (volume variance) and changes in average rates (rate variance) for 2018 compared to 2017 and 2017 compared to 2016. Changes in tax equivalent interest income and expense, which are not specifically attributable to either volume or rate, are allocated proportionately between both variances.

Analysis of Changes in Net Interest Income

(Amounts in thousands)	Years Ended December 31,					
	2018 over 2017			2017 over 2016		
	Volume	Rate	Net Change	Volume	Rate	Net Change
Increase (decrease) in interest income:						
Net loans	\$ 4,752	\$ 1,091	\$ 5,843	\$ 3,109	\$ 568	\$ 3,677
Taxable securities	1,040	204	1,244	1,049	(114)	935
Tax-exempt securities ⁽¹⁾	(990)	(196)	(1,186)	(48)	(122)	(170)
Interest-bearing deposits in other banks	(117)	297	180	52	388	440
Total increase (decrease)	4,685	1,396	6,081	4,162	720	4,882
Increase (decrease) in interest expense:						
Interest-bearing demand and money market	101	215	316	93	128	221
Savings accounts	(4)	92	88	11	15	26
Certificates of deposit	(441)	163	(278)	(65)	74	9
Federal Home Loan Bank of San Francisco borrowings	426	6	432	(482)	1	(481)
Other borrowings	(231)	143	(88)	(129)	111	(18)
Junior subordinated debentures	—	98	98	—	52	52
Total increase	(149)	717	568	(572)	381	(191)
Net increase (decrease)	\$ 4,834	\$ 679	\$ 5,513	\$ 4,734	\$ 339	\$ 5,073

⁽¹⁾ Tax-exempt income has been adjusted to tax equivalent basis at a 21% for 2018 and at a 34% tax rate for 2017 and 2016.

Noninterest Income

The following table presents the key components of noninterest income for the years ended December 31, 2018, 2017 and 2016.

(Amounts in thousands)	Years Ended December 31,							
	2018 Compared to 2017				2017 Compared to 2016			
	2018	2017	Change Amount	Change Percent	2017	2016	Change Amount	Change Percent
Noninterest income:								
Service charges on deposit accounts	\$ 682	\$ 542	\$ 140	26 %	\$ 542	\$ 413	\$ 129	31 %
ATM and point of sale fees	1,131	1,093	38	3 %	1,093	995	98	10 %
Payroll and benefit processing fees	652	658	(6)	(1) %	658	593	65	11 %
Life insurance	512	1,050	(538)	(51) %	1,050	613	437	71 %
Gains on sales of investment securities, net	44	137	(93)	(68) %	137	244	(107)	(44) %
Other-than-temporary impairment on investment securities	—	—	—	— %	—	(546)	546	100 %
Federal Home Loan Bank of San Francisco dividends	480	318	162	51 %	318	644	(326)	(51) %
Gain (loss) on sale of OREO	73	368	(295)	(80) %	368	(109)	477	438 %
Insured cash sweep fees	—	197	(197)	(100) %	197	3	194	6,467 %
Other	445	461	(16)	(3) %	461	636	(175)	(28) %
Total noninterest income	\$ 4,019	\$ 4,824	\$ (805)	(17) %	\$ 4,824	\$ 3,486	\$ 1,338	38 %

The Year Ended December 31, 2018 Compared to the Year Ended December 31, 2017

Noninterest income in 2018 was \$4.0 million, a decrease of \$805 thousand or 17% compared to 2017. During 2017 we recognized income from life insurance death benefit proceeds, gains on sale of OREO and fees from ICS one-way sales totaling \$894 thousand that did not recur in 2018. These decreases were partially offset by increased service charges on deposit accounts of \$140 thousand and a \$96 thousand special dividend on Federal Home Loan Bank of San Francisco stock.

The Year Ended December 31, 2017 Compared to the Year Ended December 31, 2016

Noninterest income in 2017 was \$4.8 million, an increase of \$1.3 million or 38% compared to 2016.

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- Our branch and offsite ATM acquisition completed late in the first quarter of 2016, enhanced 2017 point of sale and ATM fees by \$98 thousand and enhanced service charges on deposit accounts by \$129 thousand.
- During 2017 we received life insurance death benefit proceeds of \$502 thousand.
- During 2016, we recorded a \$546 thousand other-than-temporary impairment on an investment security.
- During 2016 we received a special dividend on Federal Home Loan Bank of San Francisco of \$152 thousand.
- During 2017 gains on sale of OREO properties were \$368 thousand, compared to a loss of \$109 thousand in 2016. Net gains on sale of OREO property in 2017 were primarily derived from one nonfarm nonresidential property.
- During 2017 we received fees totaling \$197 thousand from ICS one-way sales, which were nominal in 2016.
- The major components of other noninterest income are fees earned on merchant bankcard processing, check orders, safe deposit box rental and wire transfers. However during 2016 we also recorded a \$176 thousand gain on payoff of an impaired loan.

Noninterest Expense

The following table presents the key components of noninterest expense for the years ended December 31, 2018, 2017 and 2016.

(Amounts in thousands)	Years Ended December 31,							
	2018 Compared to 2017				2017 Compared to 2016			
	2018	2017	Change Amount	Change Percent	2017	2016	Change Amount	Change Percent
Noninterest expense:								
Salaries & related benefits	\$ 18,709	\$ 17,819	\$ 890	5 %	\$ 17,819	\$ 16,425	\$ 1,394	8 %
Premises & equipment	4,047	4,242	(195)	(5) %	4,242	3,869	373	10 %
Federal Deposit Insurance Corporation insurance premium	376	318	58	18 %	318	615	(297)	(48) %
Data processing fees	1,933	1,749	184	11 %	1,749	1,675	74	4 %
Professional service fees	1,431	1,398	33	2 %	1,398	1,690	(292)	(17) %
Telecommunications	594	879	(285)	(32) %	879	751	128	17 %
Acquisition costs	844	—	844	100 %	—	580	(580)	(100) %
Loss on cancellation of interest rate swap	—	—	—	— %	—	2,325	(2,325)	(100) %
Other	4,272	4,559	(287)	(6) %	4,559	4,570	(11)	(0) %
Total noninterest expense	<u>\$ 32,206</u>	<u>\$ 30,964</u>	<u>\$ 1,242</u>	<u>4 %</u>	<u>\$ 30,964</u>	<u>\$ 32,500</u>	<u>\$ (1,536)</u>	<u>(5) %</u>

The Year Ended December 31, 2018 Compared with the Year Ended December 31, 2017

Noninterest expense for the year ended December 31, 2017 was \$32.2 million, an increase of \$1.2 million or 4% compared to 2017.

For the year ended December 31, 2018 compared to the prior year:

- Salaries and related benefit costs increased \$890 thousand primarily as a result of additional employees hired in our Sacramento market.
- Acquisition costs in 2018 totaled \$844 thousand while there were none in 2017.

The Year Ended December 31, 2017 Compared with the Year Ended December 31, 2016

Noninterest expense for the year ended December 31, 2017 was \$31.0 million, a decrease of \$1.5 million or 5% compared to 2016.

For the year ended December 31, 2017 compared to the prior year:

- Expenses associated with our branch acquisition (\$580 thousand) in 2016 and cancellation of our interest rate swap (\$2.3 million) in 2016 did not recur.
- Salaries and occupancy costs increased \$1.8 million including \$438 thousand directly related to the branch and offsite ATM locations acquired late in the first quarter of 2016.
- During 2017 a \$208 thousand software development project was terminated and written off.

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Income Taxes

Our provision for income taxes includes both federal and state income taxes and reflects the application of federal and state statutory rates to our income before taxes. The following table reflects our tax provision and the related effective tax rate for the periods indicated.

(Amounts in thousands)	Years Ended December 31,		
	2018	2017	2016
Income before provision for income taxes	\$ 19,359	\$ 14,272	\$ 7,217
Provision for income taxes	\$ 3,629	\$ 6,928	\$ 1,958
Effective tax rate	18.7 %	48.5 %	27.1 %

The following table presents a reconciliation of income taxes computed at the federal statutory rate to the actual effective rate for the years ended December 31, 2018, 2017, and 2016.

	2018	2017	2016
Income tax at the federal statutory rate	21.0 %	34.0 %	34.0 %
Deferred tax asset write-down	— %	17.5 %	5.0 %
State franchise tax, net of federal tax benefit	8.3 %	6.5 %	6.1 %
Amortization of affordable housing credit partnerships	2.7 %	4.8 %	8.1 %
Officer life insurance	(0.6) %	(2.5) %	(2.9) %
Tax-exempt interest	(1.8) %	(5.2) %	(10.9) %
Affordable housing credits and benefits	(3.8) %	(5.7) %	(11.7) %
Accelerated depreciation - cost segregation study	(2.5) %	— %	— %
Reversal of uncertain tax position	(5.1) %	— %	— %
Other	0.5 %	(0.8) %	(0.7) %
Effective Tax Rate	18.7 %	48.5 %	27.1 %

Cost Segregation Study and Tangible Property Review

We completed a cost segregation study and a tangible property review during 2018, which shortened the depreciable lives of certain assets and accelerate the tax depreciation deduction on our 2017 federal income tax return. We recorded an expense of \$293 thousand in other noninterest expense and a benefit to our 2018 book provision for income taxes of \$484 thousand in the fourth quarter of 2018 upon completion of these projects.

Amended Tax Returns

In September of 2016, we filed amended federal and state tax returns for tax years 2011, 2012, 2013, and 2014. The amendments were filed to properly recognize tax events in years 2011 and 2013 that were improperly recognized in years 2011 through 2014. The IRS rejected the 2011 amended tax return citing the statute for assessment had expired. Accordingly, in early 2017, \$988 thousand of taxes due to the taxing authorities pursuant to the 2011 amended federal tax return was returned to us. We maintained the liability for the taxes due on the rejected 2011 tax return which created an uncertain tax position. During 2018, the statute of limitations on the 2014 amended federal tax return passed, we reversed the reserve for our uncertain tax position and recognized the \$988 thousand in our provision for income taxes which reduced our effective tax rate.

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FINANCIAL CONDITION

Consolidated Balance Sheets

As of December 31, 2018, we had total consolidated assets of \$1.307 billion, gross loans of \$946.3 million, allowance for loan and lease losses (“ALLL”) of \$12.3 million, total deposits of \$1.132 billion, and shareholders’ equity of \$138.3 million.

We continued to maintain a strong liquidity position during the reporting period. As of December 31, 2018, we maintained noninterest-bearing cash positions at the Federal Reserve Bank and correspondent banks in the amount of \$23.7 million. We also held interest-bearing deposits in the amount of \$23.7 million.

Available-for-sale investment securities totaled \$257.0 million at December 31, 2018, compared with \$266.9 million at December 31, 2017. Our available-for-sale investment portfolio provides a secondary source of liquidity to fund other higher yielding asset opportunities, such as loan originations and wholesale loan purchases.

During 2018, we purchased 37 securities with a par value of \$57.1 million and weighted average yield of 3.40% and sold 45 securities with a par value of \$29.7 million and weighted average yield of 2.51%. The sales and call activity on securities resulted in \$43.7 thousand in net realized gains for the year ended December 31, 2018. During 2018 we also received \$31.5 million in proceeds from principal payments, calls and maturities within the portfolio.

At December 31, 2018, our net unrealized losses on available-for-sale securities were \$4.3 million compared with \$452 thousand net unrealized losses at December 31, 2017. The changes in the net unrealized losses on the investment securities portfolio are primarily due to changes in market interest rates.

We recorded gross loan balances of \$946.3 million at December 31, 2018, compared with \$879.8 million at December 31, 2017, an increase of \$66.4 million. The increase in gross loans occurred primarily in the Bank’s Sacramento marketplace and is the result of past investments in our SBA division and in our expanded Sacramento commercial banking group.

The ALLL at December 31, 2018 increased \$367 thousand to \$12.3 million compared to \$11.9 million at December 31, 2017. As a result of continued improved asset quality, and net loan loss recoveries, no provision for loan and lease losses was necessary during the year ended December 31, 2018. A provision for loan and lease losses of \$950 thousand was recorded during the year ended December 31, 2017. Net loan loss recoveries were \$367 thousand during the year ended December 31, 2018, compared with net loan charge-offs of \$569 thousand during the prior year. At December 31, 2018, relying on our ALLL methodology, which uses criteria such as risk factors and historical loss rates, and given the ongoing improvements in asset quality, we believe the ALLL is adequate. There is, however, no assurance that future loan and lease losses will not exceed the levels provided for in the ALLL and could possibly result in additional charges to the provision for loan and lease losses.

Nonperforming loans, which include nonaccrual loans and accruing loans past due over 90 days, decreased by \$1.7 million to \$4.1 million, or 0.44% of gross loans, as of December 31, 2018, compared to \$5.8 million, or 0.66% of gross loans as of December 31, 2017. The decrease in nonperforming loans was primarily due to repayments totaling \$1.2 million from one commercial loan and one commercial real estate loan.

Past due loans as of December 31, 2018 increased to \$13.9 million, compared to \$2.3 million as of December 31, 2017. The increase in past due loans was primarily due to three commercial real estate loans totaling \$12.1 million. We believe that risk grading for past due and nonperforming loans appropriately reflects the risk associated with the past due loans. See Note 5 *Loans* in the *Notes to Consolidated Financial Statements* in this document for further detail on the ALLL and the loan portfolio.

Premises and equipment totaled \$13.1 million at December 31, 2018, a decrease of \$1.6 million compared to \$14.7 million at December 31, 2017. The decrease was primarily due to provision for depreciation and amortization recognized during the current year.

Our OREO balance at December 31, 2018 was \$31 thousand compared to \$35 thousand at December 31, 2017. For the year ended December 31, 2018, we transferred five foreclosed properties in the amount of \$140 thousand to OREO. During 2018, we sold five properties with balances of \$144 thousand for a net gain of \$73 thousand. See Note 8, *Other Real Estate Owned* in the *Notes to Consolidated Financial Statements* in this document, for further details relating to our OREO portfolio.

Bank-owned life insurance increased \$512 thousand during the year ended December 31, 2018 to \$22.4 million compared to \$21.9 million at December 31, 2017.

Our net deferred tax assets were \$7.0 million at December 31, 2018 compared to \$6.5 million at December 31, 2017.

Other assets which include the Bank’s investment in qualified zone academy bonds, Federal Home Loan Bank of San Francisco stock and low income housing tax credit partnerships totaled \$22.5 million at December 31, 2018 compared to \$21.3 million at December 31, 2017.

Total deposits at December 31, 2018, increased \$29 million or 3% to \$1.132 billion compared to December 31, 2017.

- Total non-maturing deposits increased \$65.9 million or 7% compared to the same date a year ago.
- Certificates of deposit decreased \$36.9 million or 19% compared to the same date a year ago.

Other liabilities which include the Bank’s supplemental executive retirement plan and funding obligation for investments in qualified affordable housing partnerships increased \$563 thousand to \$13.4 million as of December 31, 2018 compared to \$12.8 million at December 31, 2017.

Investment Securities

The composition of our investment securities portfolio reflects management’s investment strategy of maintaining an appropriate level of liquidity while providing a relatively stable source of interest income.

The investment securities portfolio also:

- Partially mitigates interest rate risk;
- Diversifies the credit risk inherent in the loan portfolio;
- Provides a vehicle for the investment of excess liquidity;
- Provides a source of liquidity when pledged as collateral for lines of credit;
- Is used as collateral for certain public funds.

Our available-for-sale investment securities totaled \$257.0 million at December 31, 2018, compared to \$266.9 million at December 31, 2017. During the year ended December 31, 2018, we deployed liquidity provided by strong core deposit growth into organic loan originations, interest-bearing deposits at other banks and purchases of available for sale securities.

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During the fourth quarter of 2017, we reclassified the entire HTM securities portfolio to AFS. At the date of the reclassification the HTM securities portfolio was carried at an amortized cost of \$30.3 million. The reclassification of securities between categories was accounted for at fair value. At the date of the reclassification, the securities had a fair value of \$31.4 million and unrealized holding gains of \$1.2 million which were recorded in other comprehensive income. We reclassified the held-to-maturity securities portfolio to available-for-sale to provide increased flexibility to support the loan pipeline and take advantage of opportunities to improve the overall structure and yield of the investment portfolio. As a result of this transfer we are precluded from classifying any investment securities as held-to-maturity for two years from the date of the transfer. The following table presents the carrying value of the investment securities portfolio by classification and major type as of December 31, for each of the last three years.

<i>(Amounts in thousands)</i>	2018	2017	2016
Available-for-sale securities: ⁽¹⁾			
U.S. government & agencies	\$ 40,087	\$ 40,369	\$ 10,354
Obligations of state and political subdivisions	50,530	78,844	59,428
Residential mortgage-backed securities and collateralized mortgage obligations	138,503	114,592	69,604
Corporate securities	2,922	4,992	16,116
Commercial mortgage-backed securities	24,762	26,641	15,514
Other asset-backed securities	124	1,505	3,158
Total	\$ 256,928	\$ 266,943	\$ 174,174
Held-to-maturity securities: ⁽¹⁾			
Obligations of state and political subdivisions	\$ —	\$ —	\$ 31,187

(1) Available-for-sale securities are reported at fair value, and held-to-maturity securities are reported at amortized cost.

The following table presents information regarding the amortized cost, and maturity structure of the investment portfolio at December 31, 2018.

<i>(Amounts in thousands)</i>	Maturities		Maturities		Maturities		Maturities		Total	
	Within One Year		Over One Through Five Years		Over Five Through Ten Years		Over Ten Years			
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available-for-sale securities:										
U.S. government & agencies	\$ —	—%	\$ 3,940	2.83 %	\$ 7,235	3.43 %	\$ 29,040	2.81 %	\$ 40,215	2.93 %
Obligations of state and political subdivisions	34	5.52 %	11,276	3.42 %	21,345	3.38 %	17,382	3.05 %	50,037	3.27 %
Residential mortgage-backed securities and collateralized mortgage obligations	20	3.66 %	63,558	2.87 %	74,434	2.96 %	4,343	3.83 %	142,355	2.95 %
Corporate securities	—	—%	2,022	3.75 %	1,000	2.30 %	—	—%	3,022	3.27 %
Commercial mortgage-backed securities	—	—%	—	—%	4,237	2.22 %	21,209	2.71 %	25,446	2.63 %
Other asset-backed securities	—	—%	—	—%	—	—%	123	4.40 %	123	4.40 %
Total	\$ 54	5.56 %	\$ 80,796	2.97 %	\$ 108,251	3.04 %	\$ 72,097	2.90 %	\$ 261,198	2.98 %

Loan Portfolio

Loan Concentrations

Historically, we have concentrated our loan origination activities primarily within El Dorado, Placer, Sacramento, and Shasta counties in California. In recent years, our loan origination activity has expanded to include other portions of California and northern Nevada. We manage our credit risk through various diversifications of our loan portfolio, the application of sound underwriting policies and procedures, and ongoing credit monitoring practices. Generally, the loans are secured by real estate or other assets located in California. Repayment is expected from the borrower's cash flows or cash flows from real estate investments.

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The following table presents the composition of the loan portfolio as of December 31 for each of the last five years.

(Amounts in thousands)

Loan Portfolio	As of December 31,									
	2018	%	2017	%	2016	%	2015	%	2014	%
Commercial	\$ 135,543	14 %	\$ 142,405	16 %	\$ 146,881	18 %	\$ 125,394	17 %	\$ 150,253	23 %
Commercial real estate:										
Real estate – construction and land development	22,563	2 %	15,902	2 %	36,792	5 %	28,319	4 %	30,099	5 %
Real estate – commercial non-owner occupied	433,708	46 %	377,668	43 %	292,615	36 %	228,174	32 %	195,563	30 %
Real estate – commercial owner occupied	204,622	22 %	192,023	22 %	174,298	22 %	178,910	25 %	138,644	20 %
Residential real estate:										
Real estate – residential - ITIN	37,446	4 %	41,188	5 %	45,566	6 %	49,106	7 %	52,830	8 %
Real estate – residential - 1-4 family mortgage	34,366	4 %	30,377	3 %	20,425	3 %	17,268	2 %	14,183	2 %
Real estate – residential - equity lines	26,958	3 %	30,347	3 %	35,953	4 %	39,595	6 %	43,954	7 %
Consumer and other	51,045	5 %	49,925	6 %	51,681	6 %	49,873	7 %	35,372	5 %
Gross loans	946,251	100 %	879,835	100 %	804,211	100 %	716,639	100 %	660,898	100 %
Deferred fees and costs	1,927		1,710		1,324		870		157	
Loans, net of deferred fees and costs	948,178		881,545		805,535		717,509		661,055	
Allowance for loan and lease losses	(12,292)		(11,925)		(11,544)		(11,180)		(10,820)	
Net loans	<u>\$ 935,886</u>		<u>\$ 869,620</u>		<u>\$ 793,991</u>		<u>\$ 706,329</u>		<u>\$ 650,235</u>	

The following table sets forth the maturity and fixed or variable rate distribution of our loan portfolio as of December 31, 2018.

(Amounts in thousands)	Within One Year	After One Through Five Years	After Five Years	Total
Commercial	\$ 43,879	\$ 51,101	\$ 41,451	\$ 136,431
Commercial real estate:				
Real estate - construction and land development	3,967	4,422	14,124	22,513
Real estate - commercial non-owner occupied	8,540	101,646	322,991	433,177
Real estate - commercial owner occupied	7,992	23,759	174,047	205,798
Residential real estate:				
Real estate - residential - ITIN	—	—	37,446	37,446
Real estate - residential - 1-4 family mortgage	25	2,583	31,847	34,455
Real estate - residential - equity lines	51	2,387	24,843	27,281
Consumer and other	504	49,342	1,231	51,077
Gross loans	<u>\$ 64,958</u>	<u>\$ 235,240</u>	<u>\$ 647,980</u>	<u>\$ 948,178</u>
Loans due after one year with:				
Fixed rates	45,584	\$ 189,835	151,496	386,915
Variable rates	19,374	45,405	496,484	561,263
Total	<u>64,958</u>	<u>\$ 235,240</u>	<u>\$ 647,980</u>	<u>\$ 948,178</u>

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Loans with unique credit characteristics

We own a pool of Individual Tax Identification Number (“ITIN”) residential mortgage loans. The ITIN loans are geographically disbursed throughout the United States and are made to legal United States residents who do not possess a social security number. The ITIN loan portfolio is serviced by a third party. The majority of the ITIN loans are variable rate loans and may have an increased default risk in a rising rate environment. Worsening economic conditions in the United States may cause us to suffer higher default rates on our ITIN loans and reduce the value of the assets that we hold as collateral. In addition, if we become responsible for servicing of these ITIN loans, then we may realize additional monitoring, servicing and appraisal costs due to the geographic disbursement of the portfolio which will adversely affect our noninterest expense.

Purchased Loans

In addition to loans we have originated, the loan portfolio includes purchased loan pools and purchased participations. Purchased loans are recorded at their fair value at the acquisition date. Additional information regarding the individual purchased loan pools can be found in Note 6 *Purchase of Financial Assets* in the *Notes to Consolidated Financial Statements* in this document.

The following table presents the recorded investment in purchased loans at December 31, 2018 and 2017.

Loan Type	For The Years Ended			
	December 31,			
	2018		2017	
	Balance	% of Gross Loan Portfolio	Balance	% of Gross Loan Portfolio
Commercial	\$ 66	—%	\$ 108	— %
Commercial real estate	29,096	3 %	30,195	3 %
Residential real estate	51,164	5 %	56,735	6 %
Consumer and other	46,049	5 %	47,836	5 %
Total purchased loans	\$ 126,375	13 %	\$ 134,874	14 %

During the second quarter of 2018 we terminated an agreement to purchase a maximum par value of \$50.0 million in unsecured consumer home improvement loans from a third party originator.

Asset Quality

Nonperforming Assets

Our loan portfolio is heavily concentrated in real estate, and a significant portion of our borrowers’ ability to repay their loans is dependent upon the professional services, commercial real estate market and the residential real estate development industry sectors. Loans secured by real estate or other assets primarily located in California are expected to be repaid from cash flows of the borrower or proceeds from the sale of collateral. As such, our dependence on real estate secured loans could increase the risk of loss in our loan portfolio in a market of declining real estate values. Furthermore, declining real estate values would negatively impact holdings of OREO.

We manage asset quality and mitigate credit risk through the application of policies designed to promote sound underwriting and loan monitoring practices. Our Loan Committee is charged with monitoring asset quality, establishing credit policies and procedures and enforcing the consistent application of these policies and procedures across the Bank. The provision for loan and lease losses charged to earnings is based upon management’s judgment of the amount necessary to maintain the allowance at a level adequate to absorb probable incurred losses. The amount of provision charge is dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management’s assessment of loan portfolio quality, general economic conditions that can impact the value of collateral, and other trends. The evaluation of these factors is performed through an analysis of the adequacy of the ALLL. Reviews of nonperforming, past due loans and larger credits, designed to identify potential charges to the ALLL, and to determine the adequacy of the allowance, are conducted on a monthly basis. These reviews consider such factors as the financial strength of borrowers, the value of the applicable collateral, loan and lease loss experience, estimated loan and lease losses, growth in the loan portfolio, prevailing economic conditions and other factors.

A loan is considered impaired when, based on current information and events, we determine it is probable that we will not be able to collect all amounts due according to the loan contract, including scheduled interest payments. Generally, when we identify a loan as impaired, we measure the loan for potential impairment using discount cash flows, except when the sole remaining source of the repayment for the loan is the liquidation of the collateral. In these cases, we use the current fair value of collateral, less selling costs. The starting point for determining the fair value of collateral is through obtaining external appraisals. Generally, external appraisals are updated every twelve months. We obtain appraisals from a pre-approved list of independent, third party, local appraisal firms. Approval and addition to the list is based on experience, reputation, character, consistency and knowledge of the respective real estate market. At a minimum, it is ascertained that the appraiser is: (1) currently licensed in the state in which the property is located, (2) is experienced in the appraisal of properties similar to the property being appraised, (3) is actively engaged in the appraisal work, (4) has knowledge of current real estate market conditions and financing trends, (5) is reputable, and (6) is not on Freddie Mac’s nor our Exclusionary List of appraisers and brokers. In most cases, appraisals will be reviewed by another independent third party to ensure the quality of the appraisal and the expertise and independence of the appraiser. Upon receipt and review, an external appraisal is utilized to measure a loan for potential impairment.

Our impairment analysis documents the date of the appraisal used in the analysis, whether the officer preparing the report deems it current, and, if not, allows for internal valuation adjustments with justification. Typical justified adjustments might include discounts for continued market deterioration subsequent to appraisal date, adjustments for the release of collateral contemplated in the appraisal, or the value of other collateral or consideration not contemplated in the appraisal. An appraisal over one year old in most cases will be considered stale dated and an updated or new appraisal will be required. Any adjustments from appraised value to net realizable value are detailed and justified in the impairment analysis, which is reviewed and approved by our Chief Credit Officer. Although an external appraisal is the primary source to value collateral dependent loans, we may also utilize values obtained through purchase and sale agreements, negotiated short sales, broker price opinions, or the sales price of the note. These alternative sources of value are used only if deemed to be more representative of value based on updated information regarding

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collateral resolution. Impairment analyses are updated, reviewed and approved on a quarterly basis at or near the end of each reporting period. Based on these processes, we do not believe there are significant time lapses for the recognition of additional provision for loan and lease loss or charge-offs from the date they become known.

Loans are classified as nonaccrual when collection of principal or interest is doubtful; generally these are loans that are past due as to maturity or payment of principal or interest by 90 days or more, unless such loans are well-secured and in the process of collection. Additionally, all loans that are impaired are considered for nonaccrual status. Loans placed on nonaccrual will typically remain on nonaccrual status until all principal and interest payments are brought current and the prospects for future payments in accordance with the loan agreement appear certain.

Upon acquisition of real estate collateral, typically through the foreclosure process, we promptly begin to market the property for sale. If we do not receive offers or indications of interest within a reasonable timeframe, we will review market conditions to assess the pricing level that would enable us to sell the property. At the time of foreclosure, OREO is recorded at fair value less costs to sell ("cost"), which becomes the property's new basis. Unless a current appraisal is available, an appraisal will be ordered prior to a loan migrating to OREO. Any write-downs based on the asset's fair value at the date of acquisition are charged to the ALLL. After foreclosure, management periodically performs valuations and the property is carried at the lower of the cost or fair value less expected selling costs. We obtain updated appraisals on OREO property every six to twelve months. Valuation adjustments recorded in a period are primarily based on (1) updated appraisals received during the period, or (2) management's authorization to reduce the selling price of the property during the period.

The following table summarizes our nonperforming assets as of December 31 for each of the last five years.

(Amounts in thousands)

	As of December 31,				
Nonperforming Assets	2018	2017	2016	2015	2014
Commercial	\$ 959	\$ 1,603	\$ 2,749	\$ 1,994	\$ 5,112
Commercial real estate:					
Real estate - commercial non-owner occupied	548	—	1,196	5,488	6,909
Real estate - commercial owner occupied	—	600	784	1,071	2,787
Total commercial real estate	548	600	1,980	6,559	9,696
Residential real estate:					
Real estate - residential - ITIN	2,388	2,909	3,576	3,649	4,647
Real estate - residential - 1-4 family mortgage	185	606	1,914	1,775	2,135
Real estate - residential - equity lines	43	45	917	—	24
Total residential real estate	2,616	3,560	6,407	5,424	6,806
Consumer and other	23	36	250	32	35
Total nonaccrual loans	4,146	5,799	11,386	14,009	21,649
90 days past due and still accruing	—	—	—	88	23
Total nonperforming loans	4,146	5,799	11,386	14,097	21,672
Other real estate owned	31	35	759	1,423	502
Total nonperforming assets	\$ 4,177	\$ 5,834	\$ 12,145	\$ 15,520	\$ 22,174
Nonperforming loans to gross loans	0.44 %	0.66 %	1.42 %	1.97 %	3.28 %
Nonperforming assets to total assets	0.32 %	0.46 %	1.06 %	1.53 %	2.22 %

We regularly perform thorough reviews of the commercial real estate portfolio, including semi-annual stress testing. These reviews are performed on both our non-owner and owner occupied credits. These reviews are completed to verify leasing status, to ensure the accuracy of risk ratings, and to develop proactive action plans with borrowers on projects. Stress testing is performed to determine the effect of rising cap rates, interest rates, and vacancy rates on the portfolio. Based on our analysis, we believe we are effectively managing the risks in this portfolio. There can be no assurance that declines in economic conditions, such as potential increases in retail or office vacancy rates, will not exceed the projected assumptions utilized in stress testing resulting in additional nonperforming loans in the future.

Loans are reported as troubled debt restructurings when we grant a concession(s) to a borrower experiencing financial difficulties that we would not otherwise consider. Examples of such concessions include a reduction in the loan rate, forgiveness of principal or accrued interest, extending the maturity date(s) significantly, or providing a lower interest rate than would be normally available for a transaction of similar risk. As a result of these concessions, restructured loans are impaired as we will not collect all amounts due, either principal or interest, in accordance with the terms of the original loan agreement. Impairment reserves on non-collateral dependent troubled debt restructured loans are measured by comparing the present value of expected future cash flows of the restructured loans, discounted at the effective interest rate of the original loan agreement to the loans carrying value. These impairment reserves are recognized as a specific component to be provided for in the ALLL.

As of December 31, 2018, we had \$9.6 million in troubled debt restructurings compared to \$10.9 million as of December 31, 2017. As of December 31, 2018, we had 106 restructured loans that qualified as troubled debt restructurings, of which all loans were performing according to their restructured terms. Troubled debt restructurings represented 1.01% of gross loans as of December 31, 2018, compared with 1.24% at December 31, 2017.

Impaired loans of \$6.9 million and \$7.3 million were classified as accruing troubled debt restructurings at December 31, 2018 and December 31, 2017, respectively. For a restructured loan to be on accrual status, the loan's collateral coverage must generally be greater than or equal to 100% of the loan balance, the loan payments must be current, and the borrower must demonstrate the ability to make payments from a verified source of cash flow. As of December 31, 2018 and December 31, 2017, we had one restructured commercial line of credit in nonaccrual status that had \$313 thousand and \$33 thousand in available credit, respectively.

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The following table sets forth a summary of our restructured loans that qualify as troubled debt restructurings for each of the last five years.

(Amounts in thousands)

Troubled Debt Restructurings	As of December 31,				
	2018	2017	2016	2015	2014
Accruing troubled debt restructurings					
Commercial	\$ 1,224	\$ 1,551	\$ 776	\$ 49	\$ 1,485
Commercial real estate:					
Real estate - commercial non-owner occupied	795	803	808	824	840
Real estate - commercial owner occupied	—	—	—	—	858
Residential real estate:					
Real estate - residential - ITIN	4,484	4,614	5,033	5,458	5,462
Real estate - residential - equity lines	363	380	454	558	579
Total accruing troubled debt restructurings	<u>6,866</u>	<u>7,348</u>	<u>7,071</u>	<u>6,889</u>	<u>9,224</u>
Nonaccruing troubled debt restructurings					
Commercial	877	863	1,940	863	2,136
Commercial real estate:					
Real estate - commercial non-owner occupied	—	—	—	4,292	6,909
Real estate - commercial owner occupied	—	—	—	1,071	2,488
Residential real estate:					
Real estate - residential - ITIN	1,793	2,396	2,691	2,538	2,420
Real estate - residential - 1-4 family mortgage	—	296	335	219	242
Consumer and other	23	26	29	32	35
Total nonaccruing troubled debt restructurings	<u>2,693</u>	<u>3,581</u>	<u>4,995</u>	<u>9,015</u>	<u>14,230</u>
Total troubled debt restructurings					
Commercial	2,101	2,414	2,716	912	3,621
Commercial real estate:					
Real estate - commercial non-owner occupied	795	803	808	5,116	7,749
Real estate - commercial owner occupied	—	—	—	1,071	3,346
Residential real estate:					
Real estate - residential - ITIN	6,277	7,010	7,724	7,996	7,882
Real estate - residential - 1-4 family mortgage	—	296	335	219	242
Real estate - residential - equity lines	363	380	454	558	579
Consumer and other	23	26	29	32	35
Total troubled debt restructurings	<u>\$ 9,559</u>	<u>\$ 10,929</u>	<u>\$ 12,066</u>	<u>\$ 15,904</u>	<u>\$ 23,454</u>
Total troubled debt restructuring to gross loans outstanding at period end					
	1.01 %	1.24 %	1.50 %	2.22 %	3.55 %

Allowance for Loan and Lease Losses and Reserve for Unfunded Commitments

The ALLL at December 31, 2018 increased \$367 thousand to \$12.3 million compared to \$11.9 million at December 31, 2017. As a result of continued improved asset quality, no provision for loan and lease losses was necessary during the year ended December 31, 2018. A provision for loan and lease losses of \$950 thousand was recorded during the year ended December 31, 2017.

We recorded net loan loss recoveries of \$367 thousand for the year ended December 31, 2018 compared to net loan charge-offs of \$569 thousand for the year ended December 31, 2017. Recoveries of \$1.6 million during the year ended December 31, 2018 occurred primarily from two commercial loans partially offset by charge-offs occurred primarily from purchased consumer loans for \$837 thousand. Our ALLL as a percentage of gross loans outstanding was 1.30% and 1.36% as of December 31, 2018, and December 31, 2017, respectively.

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The following table summarizes the ALLL roll forward for each of the five years ended December 31. This table also includes impaired loan information for each of the five years as of December 31.

<i>(Amounts in thousands)</i>	For the Years Ended December 31,				
	2018	2017	2016	2015	2014
Beginning balance ALLL	\$ 11,925	\$ 11,544	\$ 11,180	\$ 10,820	\$ 14,172
Provision for loan and lease loss charged to expense	—	950	—	—	3,175
Loans charged off	(1,248)	(1,502)	(2,784)	(2,376)	(7,319)
Loan and lease loss recoveries	1,615	933	3,148	2,736	792
Ending balance ALLL	<u>12,292</u>	<u>11,925</u>	<u>11,544</u>	<u>11,180</u>	<u>10,820</u>
At December 31,					
	2018	2017	2016	2015	2014
Nonaccrual loans:					
Commercial	959	1,603	2,749	1,994	5,112
Real estate - commercial non-owner occupied	548	—	1,196	5,488	6,909
Real estate - commercial owner occupied	—	600	784	1,071	2,787
Real estate - residential - ITIN	2,388	2,909	3,576	3,649	4,647
Real estate - residential - 1-4 family mortgage	185	606	1,914	1,775	2,135
Real estate - residential - equity lines	43	45	917	—	24
Consumer and other	23	36	250	32	35
Total nonaccrual loans	<u>4,146</u>	<u>5,799</u>	<u>11,386</u>	<u>14,009</u>	<u>21,649</u>
Accruing troubled-debt restructured loans					
Commercial	1,224	1,551	776	49	1,485
Real estate - commercial non-owner occupied	795	803	808	824	840
Real estate - commercial owner occupied	—	—	—	—	858
Real estate - residential - ITIN	4,484	4,614	5,033	5,458	5,462
Real estate - residential - equity lines	363	380	454	558	579
Total accruing restructured loans	<u>6,866</u>	<u>7,348</u>	<u>7,071</u>	<u>6,889</u>	<u>9,224</u>
All other accruing impaired loans	—	—	337	492	535
Total impaired loans	<u>11,012</u>	<u>13,147</u>	<u>18,794</u>	<u>21,390</u>	<u>31,408</u>
Gross loans outstanding	<u>\$ 946,251</u>	<u>\$ 879,835</u>	<u>\$ 804,211</u>	<u>\$ 716,639</u>	<u>\$ 660,898</u>
Ratio of ALLL to gross loans outstanding	1.30 %	1.36 %	1.44 %	1.56 %	1.64 %
Nonaccrual loans to gross loans outstanding	0.44 %	0.66 %	1.42 %	1.95 %	3.28 %

As of December 31, 2018, impaired loans totaled \$11.0 million, of which \$4.1 million were in nonaccrual status. Of the total impaired loans, \$6.9 million or 105 were ITIN loans with an average balance of approximately \$65 thousand per loan. The remaining impaired loans consist of seven commercial loans, two commercial real estate loans, one residential mortgage, one consumer loan and eight home equity loans.

At December 31, 2018, impaired loans had a corresponding specific allowance of \$1.2 million. The specific allowance on impaired loans represents the impairment reserves on performing restructured loans, other accruing loans, and nonaccrual loans.

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The following table sets forth the allocation of the ALLL for each of the five years as of December 31.

(Amounts in thousands)	At December 31,									
	2018		2017		2016		2015		2014	
ALLL	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial	\$ 2,205	18 %	\$ 2,397	20 %	\$ 2,748	24 %	\$ 2,373	21 %	\$ 3,503	33 %
Commercial real estate:										
Real estate - construction and land development	107	1 %	82	1 %	177	2 %	246	2 %	388	4 %
Real estate - commercial non-owner occupied	5,169	42 %	4,698	40 %	3,637	32 %	3,014	27 %	2,139	19 %
Real estate - commercial owner occupied	1,840	15 %	1,734	15 %	1,865	16 %	2,643	24 %	2,348	22 %
Residential real estate:										
Real estate - residential - ITIN	660	5 %	602	5 %	973	8 %	998	9 %	836	8 %
Real estate - residential - 1-4 family mortgage	162	1 %	151	1 %	106	1 %	111	1 %	155	1 %
Real estate - residential - equity lines	351	3 %	416	3 %	637	5 %	469	4 %	679	6 %
Consumer and other	1,356	11 %	1,435	12 %	955	8 %	770	7 %	450	4 %
Unallocated	442	4 %	410	3 %	446	4 %	556	5 %	322	3 %
Total ALLL	\$ 12,292	100 %	\$ 11,925	100 %	\$ 11,544	100 %	\$ 11,180	100 %	\$ 10,820	100 %

The unallocated portion of ALLL provides for coverage of credit losses inherent in the loan portfolio but not captured in the credit loss factors that are utilized in the risk grading-based component, or in the specific reserve component of the ALLL, and acknowledges the inherent imprecision of all loss prediction models. As of December 31, 2018, the unallocated allowance amount represented 4% of the ALLL, compared to 3% at December 31, 2017. While the ALLL composition is an indication of specific amounts or loan categories in which future charge-offs may occur, actual amounts may differ.

Natural Disasters

Wildfires

We have extended credit to borrowers in California where devastating fires have recently caused widespread destruction, especially in the Redding area. A thorough review has been performed on the Bank's loan portfolio and we have determined that the Bank does not have heightened exposure to losses due to the fires, and no adjustment to the ALLL for the fires was required.

Hurricanes

Many of the loans that we have acquired from third party originators were made to borrowers who are located throughout the United States, other than in California. Some of those borrowers reside in portions of North Carolina, South Carolina, Missouri, Texas, Florida, Georgia and Puerto Rico where hurricanes caused severe damage during the third quarters of 2018 and 2017. The loans that were affected are primarily ITIN loans which are secured by 1st deeds of trust and consumer home improvement loans which are unsecured. These loans are not serviced by us and we are dependent on third party servicers for collection efforts, processing payment deferral requests and obtaining loss information. We have not seen any significant increase in losses as a result of the hurricanes.

Reserve for Unfunded Commitments

The reserve for unfunded commitments, which is included in *Other Liabilities* on the *Consolidated Balance Sheets*, was \$695 thousand at December 31, 2018 and 2017. The adequacy of the reserve for unfunded commitments is reviewed on a quarterly basis, based upon changes in the amount of commitments, loss experience, and economic conditions. When necessary, the provision expense is recorded in other noninterest expense in the *Consolidated Statements of Income*.

Deposits

Total deposits as of December 31, 2018 were \$1.132 billion compared to \$1.103 billion at December 31, 2017, an increase of \$29 million or 3%. The following table presents the deposit balances by major category as of December 31 for the last two years.

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(Amounts in thousands)

	2018		2017	
	Amount	Percentage	Amount	Percentage
Deposits				
Noninterest-bearing demand	\$ 347,199	31 %	\$ 305,650	28 %
Interest-bearing demand	252,202	22 %	260,221	24 %
Money market accounts	265,093	23 %	236,769	21 %
Savings accounts	114,840	10 %	110,837	10 %
Certificates of deposit, \$100,000 or greater	119,376	11 %	148,438	13 %
Certificates of deposit, less than \$100,000	33,006	3 %	40,817	4 %
Total	\$ 1,131,716	100 %	\$ 1,102,732	100 %

The following table sets forth the distribution of our year-to-date average daily balances and their respective rates for the periods indicated.

	Years Ended December 31,					
	2018		2017		2016	
(Amounts in thousands)	Average Balance	Rate	Average Balance	Rate	Average Balance	Rate
Interest-bearing demand	\$ 238,328	0.17 %	\$ 209,792	0.13 %	\$ 172,011	0.12 %
Money market accounts	250,685	0.26 %	224,913	0.21 %	202,159	0.16 %
Savings accounts	109,025	0.26 %	111,376	0.18 %	104,771	0.17 %
Certificates of deposit	168,183	1.14 %	205,648	1.06 %	221,074	0.99 %
Interest-bearing deposits	766,221	0.43 %	751,729	0.42 %	700,015	0.41 %
Noninterest-bearing demand	332,197		289,735		226,368	
Total deposits	1,098,418	0.24 %	1,041,464	0.26 %	926,383	0.28 %

Federal Home Loan Bank of San Francisco borrowings ⁽¹⁾	22,466	1.94 %	302	0.99 %	17,856	2.71 %
Other borrowings, net	15,143	7.11 %	17,981	6.48 %	19,430	6.08 %
Junior subordinated debentures	10,310	3.73 %	10,310	2.78 %	10,310	2.28 %
Total borrowings	\$ 47,919	3.96 %	\$ 28,593	5.09 %	\$ 47,596	4.00 %

⁽¹⁾ For 2016, the Bank's effective weighted average interest rate on Federal Home Loan Bank of San Francisco borrowings includes the effect of hedge losses reclassified out other comprehensive income. During March of 2016, we terminated all of our interest rate swaps (active and forward starting, the "hedging" instrument) and simultaneously paid off the \$75.0 million Federal Home Loan Bank of San Francisco borrowing (the "hedged instrument")

Deposit Maturity Schedule

The following table sets forth the maturities of certificates of deposit in the amounts of \$100,000 or more as of December 31, 2018.

(Amounts in thousands)

Maturing in:	2018
Three months or less	\$ 35,494
Three through six months	13,836
Six through twelve months	13,556
Over twelve months	56,490
Total	\$ 119,376

We have an agreement with Promontory Interfinancial Network LLC ("Promontory") allowing provision of FDIC deposit insurance to balances in excess of current FDIC deposit insurance limits. Promontory's Certificate of Deposit Account Registry Service ("CDARS") and Insured Cash Sweep ("ICS") use a deposit-matching program to exchange Bank deposits in excess of the current deposit insurance limits for excess balances at other participating banks, on a dollar-for-dollar basis, that would be fully insured at the Bank. These products are designed to enhance our ability to attract and retain customers and increase deposits, by providing additional FDIC coverage to customers. CDARS and ICS deposits can be reciprocal or one-way.

For calendar quarters prior to April 1, 2018, CDARS/ ICS reciprocal deposits were considered to be brokered deposits by regulatory authorities and were reported as such on quarterly Call Reports. With passage of The Economic Growth, Regulatory Relief and Consumer Protection Act in May 2018, this is no longer so.

Included in our certificate of deposit balances are \$22.0 million of subscription time deposits obtained in years past through online deposit listing services. We no longer utilize online deposit listing services. As they mature, these legacy deposits are not being renewed.

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Borrowings

Term Debt

At December 31, 2018, we had term debt outstanding with a carrying value of \$13.4 million compared to \$17.0 million at December 31, 2017. Term debt consisted of the following:

Federal Home Loan Bank of San Francisco Borrowings

As of December 31, 2018 and 2017, the Bank had no Federal Home Loan Bank of San Francisco advances outstanding. The average balances outstanding on Federal Home Loan Bank of San Francisco term advances during 2018 and 2017 were \$22.5 million and \$302 thousand, respectively. See Note 12 *Term Debt* in the *Notes to Consolidated Financial Statements* for information on our Federal Home Loan Bank of San Francisco borrowings.

Senior Debt

In December of 2015, we entered into a senior debt loan agreement to borrow \$10.0 million. The debt is secured by a pledge from the Holding Company of all of the outstanding stock of Redding Bank of Commerce, matures in 2020, and at December 31, 2018 had a balance of \$3.5 million net of unamortized debt issuance costs. Interest on the senior debt is paid at a variable rate equal to three month LIBOR plus 400 basis points, resetting monthly. The effective interest rate at December 31, 2018, was 6.51%.

Subordinated Debt

In December of 2015, we issued \$10.0 million of fixed to floating rate Subordinated Notes. The subordinated debt initially bears interest at 6.88% per annum for a five-year term. Thereafter, interest on the subordinated debt will be paid at a variable rate equal to three month LIBOR plus 526 basis points, resetting quarterly. At December 31, 2018, the subordinated debt had a balance of \$9.9 million net of unamortized debt issuance costs. The notes are due in 2025.

Junior Subordinated Debentures

Bank of Commerce Holdings Trust II

During July of 2005, we participated in a \$10.0 million private placement of fixed rate trust-preferred securities (the "Trust-Preferred Securities") through a wholly owned Delaware trust affiliate, Bank of Commerce Holdings Trust II (the "Trust II"). Trust II simultaneously issued \$310 thousand common securities to the Holding Company. Rates paid on the Trust-Preferred Securities have transitioned from fixed to floating and are now paid on a quarterly basis at a rate equal to three month LIBOR plus 158 basis points (4.37% at December 31, 2018).

The Trust-Preferred Securities mature on September 15, 2035, and the covenants allow for redemption of the securities at our option during any quarter prior to maturity.

The proceeds from the sale of the Trust-Preferred Securities were used by Trust II to purchase from the Holding Company the aggregate principal amount of \$10.3 million of the Holding Company's junior subordinate debentures (the "Notes"). The net proceeds to the Holding Company from the sale of the Notes to Trust II were partially distributed to the Bank. The proceeds from the Notes qualify as Tier 1 capital under Federal Reserve Board guidelines.

LIQUIDITY AND CASH FLOW

Redding Bank of Commerce

On January 31, 2019 we completed the acquisition of Merchants Holding Company located in Sacramento California. The transaction was attractive to us because it expanded our presence in the Sacramento market, provided a new source of low cost core deposits and a quality loan portfolio. The acquisition provided approximately \$104.5 million of additional liquidity (\$119.8 cash and investment securities less \$15.3 million paid to Merchants shareholders).

The principal objective of our liquidity management program is to maintain our ability to meet the day-to-day cash flow requirements of our customers who either wish to withdraw funds on deposit or to draw upon their credit facilities.

We monitor the sources and uses of funds on a daily basis to maintain an acceptable liquidity position. One source of funds includes public deposits. We may be required to collateralize a portion of public deposits that exceed FDIC insurance limitations based on the state of California's risk assessment of the Bank. Public deposits represent 2% of total deposits at December 31, 2018 and December 31, 2017.

In addition to liquidity provided by core deposits, loan repayments and cash flows from securities, the Bank can borrow on established conditional federal funds lines of credit, sell securities, borrow on a secured basis from the Federal Home Loan Bank of San Francisco, borrow on a secured basis from the Federal Reserve Bank, or issue subscription / brokered certificates of deposit.

At December 31, 2018, the Bank had the following credit arrangements:

- We have an available line of credit with the Federal Home Loan Bank of San Francisco of \$395.5 million; credit availability is subject to certain collateral requirements, namely the amount of pledged loans and investment securities.
- We have an available line of credit with the Federal Reserve Bank of \$17.3 million subject to collateral requirements, namely the amount of pledged loans.
- We have entered into nonbinding federal funds line of credit agreements with three financial institutions. The available credit on these lines totaled \$35.0 million at December 31, 2018 and had interest rates ranging from 2.64% to 3.28%. Advances under the lines are subject to funds availability, continued borrower eligibility, and may have consecutive day usage restrictions.

Bank of Commerce Holdings

The Holding Company is a separate entity from the Bank and must provide for its own liquidity. At December 31, 2018 we held \$19.4 million from our May 2017 public offering. In January of 2019, we paid \$15.3 million of that cash for the Merchants acquisition. Our principal source of cash is dividends received from the Bank. During 2018, the Bank paid a dividend of \$4.0 million to the Holding Company. There are statutory and regulatory provisions that could limit the ability of the Bank to pay dividends to the Holding Company in the future.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Consolidated Statements of Cash Flows

As disclosed in the *Consolidated Statements of Cash Flows*, net cash of \$20.7 million was provided by operating activities for the year ended December 31, 2018. The primary difference between net income and cash provided by operating activities are non-cash items including depreciation and amortization of \$3.9 million and a decrease in deferred income tax expense of \$595 thousand.

Net cash of \$63.6 million used by investing activities consisted principally of \$57.6 million in purchases of available-for-sale investment securities and \$66.2 million in net loan purchases and originations partially offset by \$30.2 million in proceeds from sale of available-for-sale investment securities and \$31.5 million in proceeds from maturities and payments of available-for-sale securities.

Net cash of \$23.2 million provided by financing activities consisted principally of a \$65.9 million increase in demand and savings deposits partially offset by a decrease in certificates of deposit of \$36.9 million and \$3.6 million in net repayment of term debt.

CAPITAL RESOURCES

We use equity capital to support growth and pay dividends. The objective of effective capital management is to produce above market long-term returns for our shareholders. Our sources of capital include retained earnings, common and preferred stock issuance, and issuance of subordinated debt or trust notes.

REGULATORY CAPITAL GUIDELINES

Federal bank regulatory agencies use capital adequacy guidelines in the examination and regulation of bank holding companies and banks. The guidelines are “risk-based,” meaning that they are designed to make capital requirements more sensitive to differences in risk profiles among banks and bank holding companies. On July 2, 2013, the federal banking agencies approved the final rules (the “Final Rules”) implementing the Basel Committee's December 2010 final capital framework (commonly known as Basel III). The Final Rules substantially amended the regulatory risk-based capital rules applicable to the Holding Company and the Bank. The phase-in period for the Final Rules ended January 1, 2019.

Generally speaking, the Final Rules did the following:

- Created “Common Equity Tier 1 Capital Ratio,” which is a measure of regulatory capital closer to pure tangible common equity than the previous Tier 1 definition;
- Established a required minimum risk-based capital ratio for “Common Equity Tier 1 Capital Ratio” at 4.5%;
- Increased the required minimum risk-based “Tier 1 Capital Ratio” to 6.0%;
- Increased the required minimum risk-based “Total Capital Ratio” to 8.0%;
- Increased the required minimum “Tier 1 Leverage Ratio” to 4.0%;
- Added a 2.50% capital conservation buffer to the minimum “Common Equity Tier 1 Capital Ratio”, “Tier 1 Capital Ratio” and “Total Capital Ratio”; and
- Allowed for permanent grandfathering of non-qualifying instruments, such as our trust-preferred securities, subject to a limit of 25% of Tier 1 capital.

The Final Rules require the Bank and the Company to meet the capital conservation buffer requirement in order to avoid constraints on capital distributions, such as dividends and equity repurchases, and certain bonus compensation for executive officers. The capital conservation buffer of 2.50% is added to the minimum capital ratios. And was phased in between 2016 and 2019. For 2018, the partially phased in buffer is 1.875%.

These capital rules also change the risk-weights of certain assets for purposes of the risk-based capital ratios and phase out certain instruments as qualifying capital. The Final Rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, if their capital levels begin to show signs of weakness.

Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are required to meet the following increased capital level requirements in order to qualify as “well-capitalized:”

- a “Common Equity Tier 1 Capital Ratio” of at least 6.5%;
- a “Tier 1 Capital Ratio” of at least 8%;
- a “Total Capital Ratio” of at least 10%;
- a “Tier 1 Leverage Ratio” of at least 5%; and
- not be subject to any order or written directive requiring a specific capital level.

The FDIC's rules (as amended by the Final Rules) also contain other capital classification categories, such as “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized,” which are based on an institution's specific capital ratios.

As instructed by the Crapo Bill, the FDIC recently published a proposed Community Bank Leverage Ratio of 9%. Any qualifying depository institution or its holding company that exceeds the Community Bank Leverage Ratio will be considered to have met generally applicable leverage and risk-based regulatory capital requirements and considered to be “well capitalized” under the prompt corrective action rules discussed above. It is difficult at this time to predict when or how the new standards under the Crapo Bill will ultimately be applied to us or what specific impact the Crapo Bill (and any implementing rules and regulations) will have on community banks.

CAPITAL ADEQUACY

Overall capital adequacy is monitored on a day-to-day basis by management and reported to our Board of Directors on a monthly basis. Our regulators measure capital adequacy by using a risk-based capital framework and by monitoring compliance with minimum leverage ratio guidelines. Based on management's review and analysis of Basel III, management believes that the Holding Company and the Bank will exceed the standards under these new rules.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

As of December 31, 2018, the most recent notification from the FDIC categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. There are no conditions or events since the notification that management believes have changed the Bank’s risk category. The Holding Company and the Bank’s capital amounts and ratios as of December 31, 2018, are presented in the following table.

(Amounts in thousands)	December 31, 2018					
	Capital	Actual Ratio	Well Capitalized Requirement	Minimum Capital Requirement	Applicable 2018 Capital Conservation Buffer	Minimum Capital Ratio plus Capital Conservation Buffer
Holding Company:						
Common equity tier 1 capital ratio	\$ 139,488	12.79 %	n/a	4.500 %	1.875 %	6.375 %
Tier 1 capital ratio	\$ 149,488	13.71 %	n/a	6.000 %	1.875 %	7.875 %
Total capital ratio	\$ 172,475	15.82 %	n/a	8.000 %	1.875 %	9.875 %
Tier 1 leverage ratio	\$ 149,488	11.21 %	n/a	4.000 %	n/a	4.000 %
Bank:						
Common equity tier 1 capital ratio	\$ 144,245	13.23 %	6.500 %	4.500 %	1.875 %	6.375 %
Tier 1 capital ratio	\$ 144,245	13.23 %	8.000 %	6.000 %	1.875 %	7.875 %
Total capital ratio	\$ 157,232	14.42 %	10.000 %	8.000 %	1.875 %	9.875 %
Tier 1 leverage ratio	\$ 144,245	10.81 %	5.000 %	4.000 %	n/a	4.000 %

On December 10, 2015, the Holding Company issued \$10.0 million in aggregate principal amount of Subordinated Notes to certain institutional investors. The Subordinated Notes qualify as Tier 2 Capital under the Final Rules. See Item 1a - *Risk Factors*, in our Annual Report on Form 10-K for the year ended December 31, 2018 for further detail on potential risks relating to the Subordinated Notes.

During 2016, as part of a branch acquisition, we recorded a core deposit intangible of \$1.8 million and goodwill of \$665 thousand. When calculating capital ratios, goodwill and a portion of the core deposit intangibles are subtracted from Tier 1 capital. The deduction for core deposit intangibles is subject to a phase in period under the Basel III risk based capital rules. During 2017, 80% of the core deposit intangible was deducted from Tier 1 capital and 100% will be deducted thereafter. Both of these intangible assets are subtracted from tangible equity as part of the calculation of tangible book value per share.

Capital ratios for the Holding Company include the benefit of \$26.8 million net proceeds from the sale of 2,738,096 shares of common stock in the second quarter of 2017.

CASH DIVIDENDS AND PAYOUT RATIOS PER COMMON SHARE

During the quarters ended June 30, 2018, September 30, 2018 and December 31, 2018, we declared quarterly dividends of \$0.04 per common share. During the quarter ended March 31, 2018 and the years ended December 31, 2017 and 2016, we declared quarterly cash dividends of \$0.03 per common share.

These dividends were made pursuant to our existing dividend policy and in consideration of, among other things, earnings, regulatory capital levels, capital preservation and expected growth. The dividend rate is reassessed periodically by the Board of Directors in accordance with the Company’s dividend policy. There is no assurance that future cash dividends on common shares will be declared or increased.

The following table presents cash dividends declared and dividend pay-out ratios (dividends declared per common share divided by basic earnings per common share) for the years ended December 31.

	2018	2017	2016
Dividends declared per common share	\$ 0.15	\$ 0.12	\$ 0.12
Dividend payout ratio	15 %	25 %	31 %

OFF-BALANCE SHEET ARRANGEMENTS

Information regarding Off-Balance Sheet Arrangements is included in Note 15, *Commitments and Contingencies* in the *Notes to Consolidated Financial Statements* in this document.

CONCENTRATION OF CREDIT RISK

Information regarding Concentration of Credit Risk is included in Note 15, *Commitments and Contingencies*, in the *Notes to Consolidated Financial Statements* incorporated in this document.

LENDING TRANSACTIONS WITH RELATED PARTIES

The business we conduct with directors, officers, significant shareholders and other related parties (collectively, “Related Parties”) is restricted and governed by various laws and regulations, including 12 CFR Part 215 (Regulation O). Furthermore, it is our policy to conduct business with Related Parties on an arm’s length basis at current market prices with terms and conditions no more favorable than we provide in the normal course of business. See Note 25, *Related Party Transactions* in the *Notes to Consolidated Financial Statements* in this document for additional detail on lending transactions with related parties.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

IMPACT OF INFLATION

Inflation affects our financial position as well as operating results. It is our opinion that the effects of inflation for the three years ended December 31, 2018 on the financial statements have not been material.

CONTRACTUAL OBLIGATIONS AS OF DECEMBER 31, 2018:

The following table presents a summary of significant contractual obligations as of December 31, 2018, which mature as indicated.

<i>(Amounts in thousands)</i>	Less Than One Year	1 - 3 Years	3 - 5 Years	More Than 5 Years	Indeterminate Maturity	Total
Deposits ⁽¹⁾	\$ 83,928	\$ 55,331	\$ 13,098	\$ 25	\$ 979,334	\$ 1,131,716
Term debt ⁽²⁾	1,000	2,496	—	10,000	—	13,496
Junior subordinated debentures ⁽³⁾	—	—	—	10,310	—	10,310
Operating lease obligations	866	1,783	1,142	1,032	—	4,823
Total	\$ 85,794	\$ 59,610	\$ 14,240	\$ 21,367	\$ 979,334	\$ 1,160,345

⁽¹⁾ Represents interest-bearing and noninterest-bearing checking, money market, savings and certificate of deposit accounts.

⁽²⁾ Represents senior debt and subordinated debt.

⁽³⁾ Represents the issued amount of all junior subordinated debentures.

RISK MANAGEMENT

Overview

Through our corporate governance structure, risk and return are evaluated to produce sustainable revenues, reduce risk of earnings volatility and increase shareholder value. The financial services industry is exposed to four major categories or types of risks; liquidity, credit, market and operational. Liquidity risk is the inability to meet liability maturities and withdrawals, fund asset growth and otherwise meet contractual obligations at reasonable market rates. Credit risk is the inability of a customer to meet their repayment obligations or the inability of a bond issuer to meet their contractual repayment obligations. Market risk is the fluctuation in asset and liability values caused by changes in market prices and yields, and operational risk is the potential for losses resulting from events involving people, processes, technology, legal issues, external events, regulation, or reputation.

Board Committees

Our corporate governance structure begins with our Board of Directors. The Board of Directors evaluates risk through the Chief Risk Officer and our Enterprise Risk Management reporting and monitoring process (ERM). Our ERM is updated quarterly and compares our risk appetite and key risk indicators to actual results and to peer data. The Board of Directors also evaluates risk through a number of Board Committees including the following:

- Audit and Qualified Legal Compliance Committee reviews the scope and coverage of internal and external audit activities.
- Loan Committee reviews credit risks in the loan portfolio and the adequacy of the Allowance for Loan and Lease Losses (“ALLL”).
- Asset/Liability Management Committee (“ALCO”) reviews liquidity risk, credit risk in the investment bond portfolio and market risk.
- Nominating and Corporate Governance Committee evaluates corporate governance structure, committee performance and evaluates recommendations for the appointment of director nominees.
- Technology Committee provides oversight with respect to technology and innovation and the related risk assessment and risk management process.

These committees review reports from management, our auditors, and other outside sources. On the basis of materials that are available to them and on which they rely, the committees review the performance of our management and personnel, and establish policies, but neither the committees nor their individual members (in their capacities as members of the Board of Directors) is responsible for daily operations of the Company.

Management Committees

To ensure that our risk management goals and objectives are accomplished, oversight of our risk taking and risk management activities are conducted through a number of management committees comprised of members of management including the following.

- The Senior Management Committee establishes short and long-term strategies and operating plans. The committee establishes performance measures and reviews performance to plan on a monthly basis. The committee is also responsible for evaluating operational risk assessments and approving and implementing mitigating action plans.
- The Asset Liability Roundtable establishes and monitors liquidity ranges, pricing, maturities, investment goals, and interest spread on balance sheet accounts.
- The SOX 404 Compliance Committee has established the master plan for full documentation of our internal controls and compliance with Section 404 of the Sarbanes-Oxley Act of 2002.

Risk Management Controls

We use various controls and our ERM to manage risk exposure within the Company. Budgeting and variance analyses and key performance indicators provide an early indication of unfavorable results or heightened risk levels. Models are used to estimate market risk and net interest income sensitivity. Segmentation analysis is an important tool used to estimate expected and unexpected credit losses. Compliance with regulatory guidelines plays a significant role in risk management as well as corporate culture and the actions of management. Our code of ethics provides guidelines for all employees to use to ensure that they conduct themselves with the highest integrity in the delivery of service to our clients.

Liquidity Risk Management

Liquidity Risk

Liquidity risk is the inability to meet liability maturities, deposit withdrawals, fund asset growth or otherwise meet contractual obligations at reasonable market rates. Liquidity management involves maintaining ample and diverse funding capacity, liquid assets and other sources of cash to accommodate fluctuations in asset and liability levels due to business shocks or unanticipated events. ALCO is responsible for establishing our liquidity policy and the Bank's internal ALCO Roundtable group is responsible for planning and executing the funding activities and strategies.

The Bank's liquid assets consist of cash and amounts due from banks, cash from repayments and maturities of loans, short-term money market investments, sales of available-for-sale securities and cash flows from principal repayment and maturities of investments. Liquidity is generated from liabilities through deposit growth and term debt borrowings. Deposit marketing strategies are reviewed for consistency with liquidity policy objectives.

The Bank has secondary sources of liquidity available from correspondent banking lines of credit, a secured line of credit with the Federal Reserve Bank and a secured borrowing line with the Federal Home Loan Bank of San Francisco. While these sources are expected to continue to provide significant amounts of secondary liquidity in the future, their availability, as well as the possible use of other sources, is dependent on future economic and market conditions, pledging of acceptable collateral and maintenance of required minimum capital ratios.

At December 31, 2018 the Holding Company held \$19.4 million from our May 2017 public offering. In January of 2019, we paid \$15.3 million of that cash for the Merchants acquisition. The Holding Company's principal source of cash is dividends received from the Bank, which it has consistently received for many years. See Item 1A *Risk Factors* and Note 18 *Regulatory Capital* in the *Notes to Consolidated Financial Statements* in this document for a discussion of the restrictions on the Bank's ability to pay dividends.

To accommodate future growth and business needs, we develop an annual capital expenditure budget during strategic planning sessions. Based on our budgets and forecasts, we believe that our earnings, acquisition of core deposits and wholesale borrowing arrangements will be sufficient to support liquidity needs in 2018.

Term Debt

Federal Home Loan Bank of San Francisco borrowings

We periodically utilize Federal Home Loan Bank of San Francisco advances as a source of wholesale funding to provide temporary liquidity. As of December 31, 2018 and 2017, the Bank had no Federal Home Loan Bank of San Francisco advances outstanding. See Note 12 *Term Debt* in the *Notes to Consolidated Financial Statements* for information on our Federal Home Loan Bank of San Francisco borrowings and our remaining line of credit.

During the fourth quarter of 2015, the Holding Company redeemed \$20.0 million of preferred stock by entering into a senior debt loan agreement to borrow \$10.0 million from another financial institution and issuing \$10.0 million of Subordinated Notes. The details are as follows:

Senior Debt

In December of 2015, the Holding Company, entered into a senior debt loan agreement to borrow \$10.0 million. The original loan terms required monthly principal installments of \$83 thousand, plus accrued and unpaid interest, commencing on January 1, 2016 and continuing to and including December 10, 2020. A final scheduled payment of \$5.0 million is due on the maturity date of December 10, 2020. The loan may be prepaid in whole or in part at any time without any prepayment premium or penalty. The principal amount of the loan bears interest at a variable rate, resetting monthly that is equal to the sum of the current three month LIBOR plus 400 basis points. The Holding Company incurred senior debt issuance costs of \$15 thousand which are being amortized over the life of the loan as additional interest expense. We have elected to accelerate repayment of this debt.

Subordinated Debt

In December of 2015, the Holding Company issued \$10.0 million in aggregate principal amount of fixed to floating rate Subordinated Notes due December 10, 2025. The Subordinated Debt initially bears interest at 6.88% per annum for a five-year term, payable semi-annually. Thereafter, interest on the Subordinated Debt will be paid at a variable rate equal to three month LIBOR plus 526 basis points, payable quarterly until the maturity date. The notes qualify as Tier 2 capital under the capital adequacy rules and regulations issued by the Federal Reserve. The Holding Company incurred subordinated debt issuance costs of \$210 thousand which are being amortized over the initial five year term as additional interest expense.

Term debt at December 31, 2018, 2017 and 2016 consisted of the following:

<i>(Amounts in thousands)</i>	2018	2017	2016
Senior debt	\$ 3,496	\$ 7,096	\$ 8,917
Less unamortized debt issuance cost	(2)	(6)	(12)
Subordinated debt	10,000	10,000	10,000
Less unamortized debt issuance cost	(89)	(132)	(172)
Total term debt at December 31,	\$ 13,405	\$ 16,958	\$ 18,733

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

The following table presents the weighted average contractual interest rates on outstanding borrowings during the years ended December 31, 2018, 2017 and 2016.

	2018	2017	2016
Federal Home Loan Bank of San Francisco borrowings	1.94 %	0.88 %	0.51 %
Senior debt	6.18 %	5.21 %	4.68 %
Subordinated debt	6.88 %	6.88 %	6.88 %

The following table presents the maximum outstanding balance at any month end, average balance during the year and effective weighted average interest rate during the year on outstanding term debt for the years ended December 31, 2018, 2017 and 2016.

<i>(Amounts in thousands)</i>	2018	2017	2016
Federal Home Loan Bank of San Francisco borrowings:			
Maximum outstanding at any month end	\$ 70,000	\$ 10,000	\$ 80,000
Average balance during the year	\$ 22,466	\$ 302	\$ 17,856
Effective weighted average interest rate during year ⁽¹⁾	1.94 %	0.99 %	2.71 %
Senior debt net of unamortized debt issuance costs:			
Maximum outstanding at any month end	\$ 6,890	\$ 8,822	\$ 9,819
Average balance during the year	\$ 5,239	\$ 8,132	\$ 9,400
Effective weighted average interest rate during year	6.51 %	5.34 %	4.79 %
Subordinated debt net of unamortized debt issuance costs:			
Maximum outstanding at any month end	\$ 9,911	\$ 9,868	\$ 9,829
Average balance during the year	\$ 9,890	\$ 9,849	\$ 9,811
Effective weighted average interest rate during year	7.38 %	7.38 %	7.38 %

⁽¹⁾ For 2016, the Bank's effective weighted average interest rate on Federal Home Loan Bank of San Francisco borrowings includes the effect of hedge losses reclassified out other comprehensive income. During March of 2016, we terminated all of our interest rate swaps (active and forward starting, the "hedging" instrument) and simultaneously paid off the \$75.0 million Federal Home Loan Bank of San Francisco borrowing (the "hedged instrument")

Credit Risk Management

Credit risk arises from the inability of a loan customer to meet their repayment obligations or the inability of a bond issuer to meet their contractual repayment obligations. Credit risk exists in our outstanding loans, letters of credit, Federal Home Loan Bank of San Francisco affordable housing grant sponsorships, unfunded loan commitments, deposits with other institutions and investment bond portfolio. In all of these areas we manage credit risk based on the risk profile of the borrower/grantee/issuer, repayment sources and the nature of the underlying collateral given current events and conditions. We rely on various controls including our underwriting standards, loan policies, internal loan monitoring, ALLL methodology and credit reviews to manage credit risk.

Concentrations of credit risk

We grant real estate construction, commercial, and installment loans to customers throughout northern California. In our judgment, a concentration exists in real estate related loans, which represented approximately 81% and 77% of our gross loan portfolio at December 31, 2018 and December 31, 2017.

Commercial real estate concentrations are managed to assure wide geographic and business diversity. Although management believes such concentrations have no more than the normal risk of collectability, a substantial decline in the economy in general, material increases in interest rates, changes in tax policies, tightening credit or refinancing markets, or a decline in real estate values in our principal market areas in particular, could have an adverse impact on the repayment of these loans. Personal and business incomes, proceeds from the sale of real property, or proceeds from refinancing, represent the primary sources of repayment for a majority of these loans.

We recognize the credit risks inherent in dealing with other depository institutions. Accordingly, to prevent excessive exposure to other depository institutions in aggregate or to any single correspondent, we have established general standards for selecting correspondent banks as well as internal limits for allowable exposure to other depository institutions in aggregate or to any single correspondent. In addition, we have an investment policy that sets forth limitations that apply to all investments with respect to credit rating and concentrations with an issuer.

Loan portfolio

Credit risk management for the loan portfolio begins with an assessment of the credit risk profile of each individual borrower based on an analysis of the borrower's financial position in light of current industry, economic or geopolitical trends. As part of the overall credit risk assessment of a borrower, each credit is assigned a risk grade and is subject to approval based on our existing credit approval standards. Risk grading is a significant factor in determining the adequacy of the ALLL.

Credit decisions are made by our Credit Administration subject to certain limitations and, when those limitations are encountered, the approvals are made by the Board Loan Committee. Credit risk is continuously monitored by Credit Administration for possible adjustment of a loan risk grade if there has been a change in the borrower's ability to perform under the terms of their obligation. Additionally, we may manage the size of our credit exposure through loan sales and loan participation agreements.

Our specific underwriting standards and methods for each principal line of lending include industry-accepted analysis and modeling and certain proprietary techniques. Our underwriting criteria are designed to comply with applicable regulatory guidelines, including required loan-to-value ratios. Our credit administration policies contain mandatory lien position and debt service coverage requirements, and we generally require a guarantee from individuals owning 20% or more of the borrowing entity. Our evaluations of our borrowers' are facilitated by management's knowledge of local market conditions and periodic reviews by a consultant of our credit administration policies.

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Allowance for loan and lease losses

The ALLL represents management's best estimate of probable losses in the loan portfolio. Within the allowance, reserves are allocated to segments of the portfolio based on specific formula components. Changes to the ALLL are reported in the *Consolidated Statements of Income* in the line item provision for loan and lease losses.

We perform periodic and systematic detailed evaluations of our lending portfolio to identify and estimate the inherent risks and assess the overall collectability. We evaluate the following:

- General conditions such as the portfolio composition, size and maturities of various segmented portions of the portfolio such as secured, unsecured, construction, and Small Business Administration.
- Concentrations of borrowers, industries, geographical sectors, loan product, loan classes and collateral types.
- Volume and trends in the aggregate of loan delinquencies, nonaccruals, and watch, criticized and classified loans

Our ALLL is the accumulation of various components that are calculated based upon independent methodologies. All components of the ALLL represent an estimation based on certain observable data that management believes most reflects the underlying credit losses being estimated. Changes in the amount of each component of the ALLL are directionally consistent with changes in the observable data, taking into account the interaction of the components over time.

An essential element of the methodology for determining the ALLL is our credit risk evaluation process, which includes credit risk grading of individual, commercial, construction, commercial real estate, and consumer loans. Loans are assigned credit risk grades based on our assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrower's current financial information, historical payment experience, credit documentation, public information, and other information specific to each individual borrower. Loans are reviewed on an annual or rotational basis or as management becomes aware of information affecting the borrower's ability to fulfill its obligations. Credit risk grades carry a dollar weighted risk percentage.

For individually impaired loans, we measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of future cash flows for a loan, we consider all available information reflecting past events and current conditions, including the effect of existing environmental factors. In addition to the ALLL, an allowance for unfunded loan commitments and letters of credit is determined using estimates of the probability of funding and the associated inherent credit risk. This reserve is carried as a liability on the *Consolidated Balance Sheets*.

We make provisions to the ALLL as necessary through charges to operations that are reflected in our *Consolidated Statements of Income* as provision for loan and lease loss expense. When a loan is deemed uncollectible, it is charged against the allowance. Any recoveries of previously charged off loans and leases are credited back to the allowance. There is no precise method of predicting specific losses or amounts that ultimately may be charged off on particular categories of the loan and lease portfolio.

Various regulatory agencies periodically review our ALLL as an integral part of their examination process. Such agencies may require us to provide additions to the allowance based on their judgment of information available to them at the time of their examination. There is uncertainty concerning future economic trends. Accordingly, it is not possible to predict the effect future economic trends may have on the level of the provisions for loan and lease losses in future periods. The ALLL should not be interpreted as an indication that charge-offs in future periods will occur in the stated amounts or proportions.

Federal Home Loan Bank of San Francisco Affordable Housing Grant Sponsorships

As part of satisfying our CRA responsibilities, we are a sponsor for various nonprofit organizations which receive cash grants from the Federal Home Loan Bank of San Francisco. Those grants require the nonprofit organization to comply with stipulated conditions of the grant over specified periods of time which typically vary from 10 to 15 years. If the nonprofit organization fails to comply, Federal Home Loan Bank of San Francisco can require us to refund the amount of the grant to Federal Home Loan Bank of San Francisco. To mitigate this contingent credit risk, Credit Administration underwrites the financial strength of the nonprofit organization and reviews their systems of internal control to determine, as best as is possible, that they will not fail to comply with the conditions of the grant.

Securities Portfolio

To manage credit risk in the securities portfolio, we have an investment policy that sets forth limitations that apply to all investments with respect to credit rating and concentrations with an issuer. We perform a pre-purchase analysis on all bonds not secured by the U.S. Government or Agency of the U.S. Government to ensure that the investment meets our credit risk requirements and repayment expectations. We perform annual and quarterly credit reviews to ensure our investments continue to meet our credit risk requirements and repayment expectations.

Deposits With Other Institutions

We recognize the credit risks inherent in dealing with other depository institutions. Accordingly, to prevent excessive exposure to other depository institutions in aggregate or to any single correspondent, we have established general standards for selecting correspondent banks as well as internal limits for allowable exposure to other depository institutions in aggregate or to any single correspondent.

Market Risk Management

General

Market risk is the potential loss due to adverse changes in market prices and interest rates. Market risk is inherent in our operating positions and activities including customers' loans, deposit accounts, securities and long-term debt. Loans and deposits generate income and expense, respectively, and the value of cash flows changes based on general economic levels, and most importantly, the level of interest rates.

The goal for managing our assets and liabilities is to maximize shareholder value and earnings while maintaining a high quality balance sheet without exposing the Company to undue interest rate risk. The absolute level and volatility of interest rates can have a significant impact on our profitability. Market risk arises from exposure to changes in interest rates, exchange rates, commodity prices, and other relevant market rate or price risk. We do not operate a trading account, and do not hold a position with exposure to foreign currency exchange.

We face market risk through interest rate volatility. Net interest income, or margin risk, is measured based on rate shocks over varying time horizons versus a current stable interest rate environment. Assumptions used in these calculations are similar to those used in the planning and budgeting model. The overall interest rate risk position and strategies are reviewed on an ongoing basis with ALCO.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Securities Portfolio

The securities portfolio is central to our asset liability management strategies. The decision to purchase or sell securities is based upon our assessment of current and projected economic and financial conditions, including the interest rate environment, liquidity, changes in a security's credit rating, the risk weighting of a security and other regulatory requirements. We classify our securities as "available-for-sale" or "held-to-maturity" at the time of purchase. We do not engage in trading activities. Securities *held-to-maturity* are carried at amortized cost. Securities *available-for-sale* may be sold to implement our asset liability management strategies and in response to changes in interest rates, prepayment rates, and similar factors. Securities *available-for-sale* are recorded at fair value and unrealized gains or losses, net of income taxes, are reported as a component of accumulated other comprehensive income (loss), in a separate component of shareholders' equity. Gain or loss on sale of securities is calculated on the specific identification method.

Operational Risk Management

Operational risk is the potential for loss resulting from events involving people, processes, technology, legal or regulatory issues, external events, and reputation. In keeping with the corporate governance structure, the Senior Leadership committee is responsible for operational risk controls. Operational risks are managed through specific policies and procedures, controls and monitoring tools. Examples of these include reconciliation processes, transaction monitoring and analysis and system audits. Operational risks fall into two major categories, business specific and company-wide. The Senior Leadership committee works to ensure consistency in policies, processes and assessments. With respect to company-wide risks, the Senior Leadership committee works directly with members of our Board of Directors to develop policies and procedures for information security, business resumption plans, compliance and legal issues.

SUMMARY OF CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are described in Note 2 *Summary of Significant Accounting Policies* in the *Notes to Consolidated Financial Statements* in this document. Some of these significant accounting policies are considered critical and require management to make difficult, subjective or complex judgments or estimates. Management believes that the following policies would be considered critical under the SEC's definition.

Valuation of Investments and Impairment of Securities

At the time of purchase, we designate a security as held-to-maturity or available-for-sale, based on our investment objectives, operational needs and intent to hold. We do not engage in trading activity. Securities designated as held-to-maturity are carried at amortized cost. We have the ability and intent to hold these securities to maturity. Securities designated as available-for-sale may be sold to implement our asset/liability management strategies and in response to changes in interest rates, prepayment rates and similar factors. Securities designated as available-for-sale are recorded at fair value and unrealized gains or losses, net of income taxes, are reported as part of accumulated other comprehensive income (loss), a separate component of shareholders' equity. Gains or losses on sale of securities are based on the specific identification method. The market value and underlying rating of the security is monitored to identify changes in quality.

Securities may be adjusted to reflect changes in valuation as a result of other-than-temporary declines in value. Investments with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed rate investments, from changes in interest rates. At each financial statement date, management assesses each investment to determine if impaired investments are temporarily impaired or if the impairment is other-than-temporary based upon the positive and negative evidence available. Evidence evaluated includes, but is not limited to, industry analyst reports, credit market conditions, and interest rate trends.

When an investment is other-than-temporarily impaired, we assess whether we intend to sell the security, or it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses. If we intend to sell the security or if it is more likely than not that we will be required to sell security before recovery of the amortized cost basis, the entire amount of other-than-temporary impairment is recognized in earnings.

For debt securities that are considered other-than-temporarily impaired and that we do not intend to sell and will not be required to sell prior to recovery of our amortized cost basis, we separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is calculated as the difference between the investment's amortized cost basis and the present value of its expected future cash flows.

The remaining differences between the investment's fair value and the present value of future expected cash flows is deemed to be due to factors that are not credit related and is recognized in other comprehensive income. Significant judgment is required in the determination of whether other-than-temporary impairment has occurred for an investment. We follow a consistent and systematic process for determining other-than-temporary impairment loss. We have designated the ALCO responsible for the other-than-temporary evaluation process.

The ALCO's assessment of whether other-than-temporary impairment loss should be recognized incorporates both quantitative and qualitative information including, but not limited to: (1) the length of time and the extent of which the fair value has been less than amortized cost, (2) the financial condition and near term prospects of the issuer, (3) our intent and ability to retain the investment for a period of time sufficient to allow for an anticipated recovery in value, (4) whether the debtor is current on interest and principal payments, and (5) general market conditions and industry or sector specific outlook. See Note 4 *Securities* in the *Notes to Consolidated Financial Statements* in this document for further detail on other-than-temporary impairment and the securities portfolio.

Allowance for Loan and Lease Losses

The ALLL is based upon estimates of loan and lease losses and is maintained at a level considered adequate to provide for probable losses inherent in the outstanding loan portfolio. The allowance is increased by provisions charged to expense and reduced by net charge-offs. In periodic evaluations of the adequacy of the allowance balance, management considers our past loan and lease loss experience by type of credit, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, current economic conditions and other factors.

Management reviews the ALLL on a monthly basis and conducts a formal assessment of the adequacy of the ALLL on a quarterly basis. These assessments include the periodic re-grading of classified loans based on changes in their individual credit characteristics including delinquency, seasoning, recent financial performance of the borrower, economic factors, changes in the interest rate environment and other factors as warranted. Loans are initially graded when originated. Loans are reviewed as they are renewed, when there is a new loan to the same borrower and/or when identified facts demonstrate heightened risk of default. Confirmation of the quality of our grading process is obtained by independent reviews conducted by outside consultants specifically hired for this purpose and by periodic examination by various bank regulatory agencies. Management monitors delinquent loans continuously and identifies problem loans to be evaluated individually for impairment testing. For loans that are determined impaired, formal impairment measurement is performed at least quarterly on a loan-by-loan basis.

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Our method for assessing the appropriateness of the allowance includes specific allowances for identified problem loans, an allowance factor for categories of credits and allowances for changing environmental factors (e.g., portfolio trends, concentration of credit, growth, economic factors). Allowances for identified problem loans are based on specific analysis of individual credits. Loss estimation factors for unimpaired loan categories are based on analysis of historical losses adjusted for changing environmental factors applicable to each loan category. Allowances for changing environmental factors are management's best estimate of the probable impact these changes would have on the loan portfolio as a whole. See Note 5 *Loans* in the *Notes to Consolidated Financial Statements* in this document for further detail on the ALLL and the loan portfolio.

Income Taxes

Income taxes reported in the consolidated financial statements are computed based on an asset and liability approach. We recognize the amount of taxes payable or refundable for the current year, and deferred tax assets and liabilities for the expected future tax consequences that have been recognized in the consolidated financial statements. Under this method, deferred tax assets and liabilities are determined based on the differences between the consolidated financial statements and the tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. We record net deferred tax assets to the extent it is more likely than not that they will be realized. In evaluating our ability to recover the deferred tax assets, management considers all available positive and negative evidence, including projected future taxable income, tax planning strategies and recent financial operations.

In projecting future taxable income, management develops assumptions including the amount of future state and federal pre-tax operating income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates being used to manage the underlying business. We file consolidated federal and state income tax returns.

ASC 740-10-55 *Income Taxes* requires a two-step process that separates recognition from measurement of tax positions. We recognize the financial statement effect of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination by a taxing authority. The measurement process is applied only after satisfying the recognition requirement and determines what amount of a tax position will be sustainable upon a potential examination or settlement. If upon measuring, the tax position produces a range of potential tax benefits, we may claim the highest tax benefit from that range as long as it is over 50% likely to be realized using a probability analysis.

We believe that all of the tax positions we have taken, meet the more likely than not recognition threshold. To the extent tax authorities disagree with these tax positions, our effective tax rates could be materially affected in the period of settlement with the taxing authorities. See Note 21 *Income Taxes* in the *Notes to Consolidated Financial Statements* in this document for further detail on our income taxes.

Fair Value Measurements

We use fair value measurements to record fair value adjustments to certain assets and liabilities, and to determine fair value disclosures. We base our fair values on 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. Securities available-for-sale and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record certain assets at fair value on a nonrecurring basis, such as certain impaired loans held for investment, ("OREO"), core deposit intangible and goodwill. These nonrecurring fair value adjustments typically involve write-downs of individual assets due to application of lower of cost or market accounting.

We have established and documented a process for determining fair value. We maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. Whenever there is no readily available market data, we use our best estimate and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these consolidated financial statements. Additional information on our use of fair value measurements and our related valuation methodologies is provided in Note 20 *Fair Values* in the *Notes to Consolidated Financial Statements* incorporated in this document.

Item 7a - Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk that values of assets and liabilities or revenues will be adversely affected by changes in market conditions such as interest rates. The risk is inherent in the financial instruments associated with our operations and activities including loans, deposits, securities, short-term borrowings and long-term debt. We do not operate a securities trading account and do not hold a position with exposure to foreign currency exchange or commodities. Market-sensitive assets and liabilities are generated through loans and deposits associated with our banking business, our asset liability management process, and credit risk mitigation activities. Traditional loan and deposit products are reported at amortized cost for assets or the amount owed for liabilities. These positions are subject to changes in economic value based on varying market conditions. Interest rate risk is the effect of changes in economic value of our loans and deposits, as well as our other interest rate sensitive instruments and is reflected in the levels of future income and expense produced by these positions versus levels that would be generated by current levels of interest rates. We seek to mitigate interest rate risk as part of the asset liability management process.

The Board of Directors has overall responsibility for our interest rate risk management policies. We have an Asset/Liability Management Committee ("ALCO") which establishes and monitors guidelines to control our sensitivity of earnings to changes in interest rates. Our internal ALCO Roundtable group forecasts net interest income using different rate scenarios via a simulation model. This group updates the net interest income forecast for changing assumptions and differing outlooks based on economic and market conditions.

The simulation model includes expected re-pricing characteristics of our rate sensitive assets and liabilities. These re-pricing characteristics recognize the relative sensitivity of assets and liabilities to changes in market interest rates, as demonstrated through current and historical experience and recognizing the timing differences of rate changes. In the simulation of net interest margin and net interest income the forecast balance sheet is processed against nine possible rate scenarios. These nine rate scenarios include a flat rate environment, which assumes interest rates are unchanged in the future and eight additional rate ramp scenarios ranging from +400 to -400 basis points in 100 basis point increments. The model does not simulate for rates below zero.

The formal policies and practices we have adopted to monitor and manage interest rate risk exposure rely on measuring risk in two ways: (1) the impact of changes in rates on net interest income, and (2) the impact of changes in rates on the fair value of equity. In moderately rising interest rate scenarios the model indicates that the company is slightly liability sensitive. In more rapidly rising interest rate scenarios however, the model indicates that the company is somewhat more liability sensitive.

The Federal Reserve currently has the federal funds rate targeted between 225 and 250 basis points. Accordingly, we are focused on the effects of increasing interest rate shocks on our net interest income during a rising rate environment. The most recent model results as of December 31, 2018, indicate the estimated annualized decrease in net interest income attributable to a 100 or 200 basis point increase in the federal funds rate was \$627 thousand and \$2.5 million respectively. The model also shows an annualized decrease in net interest income attributable to a 300 or 400 basis point increase in the fed funds rate of \$5.1 million and \$7.0 million,

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respectively. In a declining rate environment, the most recent model results as of December 31, 2018, indicate the estimated annualized reduction in net interest income attributable to a 100 or 200 basis point decline in the federal funds rate was \$291 thousand and \$1.4 million, respectively. Given that the model assumes a static balance sheet, relies on historic betas and assumes immediate parallel rate changes, no assurance can be given that future performance will mirror the model.

We believe that the short duration of our rate-sensitive assets and liabilities contributes to our ability to re-price a significant amount of our rate-sensitive assets and liabilities and mitigate the impact of rate changes in excess of 100, 200, 300, or 400 basis points. The model's primary benefit to management is its assistance in evaluating the impact that future strategies with respect to our mix and level of rate-sensitive assets and liabilities will have on our net interest income.

Our approach to managing interest rate risk may include the use of derivatives, including interest rate swaps, caps and floors. This helps to minimize significant, unplanned fluctuations in earnings, fair values of assets and liabilities and cash flows caused by interest rate volatility. This approach involves a financial instrument with the same characteristics of certain assets and liabilities so that changes in interest rates do not have a significant adverse effect on the net interest margin and cash flows. As a result of interest rate fluctuations, hedged assets and liabilities will gain or lose market value. In a fair value hedging strategy, the effect of this unrealized gain or loss will generally be offset by income or loss on the derivatives linked to the hedged assets and liabilities. For a cash flow hedge, the change in the fair value of the derivative to the extent that it is effective is recorded through other comprehensive income.

At inception, the relationship between hedging instruments and hedged items is formally documented with our risk management objective, strategy and our evaluation of effectiveness of the hedge transactions. This includes linking all derivatives designated as fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific transactions. Periodically, as required, we formally assess whether the derivative we designated in the hedging relationship is expected to be and has been highly effective in offsetting changes in fair values or cash flows of the hedged item.

The following table sets forth as of December 31, 2018 the distribution of re-pricing opportunities for our earning assets and interest-bearing liabilities. It also reports the GAP (different volumes of rate sensitive assets and liabilities) re-pricing interest-earning assets and interest-bearing liabilities at different time intervals, the cumulative GAP, the ratio of rate sensitive assets to rate sensitive liabilities for each re-pricing interval, and the cumulative GAP to total assets.

	Gap Analysis				
	Within 3 Months	3 Months To One Year	One Year To Five Years	Over Five Years	Total
<i>(Amounts in thousands)</i>					
Interest-earning assets					
AFS securities	\$ 42,558	\$ 22,482	\$ 86,813	\$ 105,075	\$ 256,928
Other investments	23,673	—	—	—	23,673
Loans, net of deferred fees and costs	90,325	130,363	485,005	242,485	948,178
Total earning assets	156,556	152,845	571,818	347,560	\$ 1,228,779
Interest-bearing liabilities					
Demand - interest-bearing	252,202	—	—	—	\$ 252,202
Money market accounts	265,093	—	—	—	265,093
Savings accounts	114,840	—	—	—	114,840
Certificates of deposit	45,373	38,725	68,259	25	152,382
Term debt and junior subordinated debentures, net	11,198	2,560	9,957	—	23,715
Total interest-bearing deposits and borrowings	\$ 688,706	\$ 41,285	\$ 78,216	\$ 25	\$ 808,232
Re-pricing GAP	\$ (532,150)	\$ 111,560	\$ 493,602	\$ 347,535	\$ 420,547
Cumulative re-pricing GAP	\$ (532,150)	\$ (420,590)	\$ 73,012	\$ 420,547	\$ —
Gap ratio	0.23	3.70	7.31	13,902.40	1.52
Cumulative gap ratio	0.23	0.42	1.09	1.52	—
Gap as % of earning assets	(43) %	9 %	40 %	28 %	34 %
Cumulative GAP as % of earning assets	(43) %	(34) %	6 %	34 %	— %

Item 8 - Financial Statements and Supplementary Data

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BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Bank of Commerce Holdings

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Bank of Commerce Holdings and subsidiaries (the “Company”) as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, shareholders’ equity, and cash flows for each of the three years in the period ended December 31, 2018, and the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control–Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2018 and 2017, and the consolidated 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. Also 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 (2013)* issued by COSO.

Basis for Opinions

The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the

Company’s consolidated financial statements and an opinion on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the 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 consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated 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 consolidated financial statements. Our audit of internal control over financial reporting 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 audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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/ Moss Adams LLP

Sacramento, California
March 12, 2019

We have served as the Company’s auditor since 2004.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

To the Shareholders:

Management's Report on Internal Control over Financial Reporting

Management of Bank of Commerce Holdings and its subsidiaries ("the Company") is responsible for establishing and maintaining internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Company's internal control system is designed to provide reasonable assurance to our management and Board of Directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that:

- Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company's assets;
- 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 the authorizations of management and directors of the Company; and
- 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.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2018. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control - Integrated Framework (2013)*. Based on our assessment and those criteria, we believe that, as of December 31, 2018, the Company maintained effective internal control over financial reporting.

The Company's independent registered public accounting firm has audited the Company's consolidated financial statements that are included in this annual report and the effectiveness of our internal control over financial reporting as of December 31, 2018 and issued their Report of Independent Registered Public Accounting Firm, which appears on the previous page. The audit report expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2018.

/s/ Randall S. Eslick

Randall S. Eslick, President and Chief Executive Officer

/s/ James A. Sundquist

James A. Sundquist, EVP and Chief Financial Officer

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Consolidated Balance Sheets
December 31, 2018 and 2017

(Amounts in thousands, except share information)

	2018	2017
Assets:		
Cash and due from banks	\$ 23,692	\$ 17,979
Interest-bearing deposits in other banks	23,673	48,991
Total cash and cash equivalents	47,365	66,970
Securities available-for-sale, at fair value	256,928	266,943
Loans, net of deferred fees and costs	948,178	881,545
Allowance for loan and lease losses	(12,292)	(11,925)
Net loans	935,886	869,620
Premises and equipment, net	13,119	14,748
Other real estate owned	31	35
Life insurance	22,410	21,898
Deferred tax asset, net	7,039	6,505
Goodwill and core deposit intangible, net	1,841	2,030
Other assets	22,485	20,672
Total assets	\$ 1,307,104	\$ 1,269,421
Liabilities and shareholders' equity:		
Liabilities:		
Demand - noninterest-bearing	\$ 347,199	\$ 305,650
Demand - interest-bearing	252,202	260,221
Money market accounts	265,093	236,769
Savings accounts	114,840	110,837
Certificates of deposit	152,382	189,255
Total deposits	1,131,716	1,102,732
Term debt:		
Other borrowings	13,496	17,096
Less unamortized debt issuance costs	(91)	(138)
Net term debt	13,405	16,958
Junior subordinated debentures	10,310	10,310
Other liabilities	13,352	12,157
Total liabilities	1,168,783	1,142,157
Commitments and contingencies (Note 15)		
Shareholders' equity:		
Common stock, no par value, 50,000,000 shares authorized; issued and outstanding – 16,333,502 as of December 31, 2018 and 16,271,563 as of December 31, 2017	52,284	51,830
Retained earnings	89,045	75,700
Accumulated other comprehensive loss, net of tax	(3,008)	(266)
Total shareholders' equity	138,321	127,264
Total liabilities and shareholders' equity	\$ 1,307,104	\$ 1,269,421

See accompanying Notes to Consolidated Financial Statements.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Consolidated Statements of Income
For the years ended December 31, 2018, 2017 and 2016

(Amounts in thousands, except per share information)

	2018	2017	2016
Interest income:			
Interest and fees on loans	\$ 44,955	\$ 39,112	\$ 35,435
Interest on taxable securities	5,165	3,921	2,986
Interest on tax-exempt securities	1,629	2,144	2,256
Interest on interest-bearing deposits in other banks	952	772	332
Total interest income	52,701	45,949	41,009
Interest expense:			
Interest on demand - interest-bearing	414	274	201
Interest on money market accounts	646	470	322
Interest on savings accounts	288	200	174
Interest on certificates of deposit	1,910	2,188	2,179
Interest on Federal Home Loan Bank of San Francisco borrowings	435	3	484
Interest on other borrowings	1,077	1,165	1,183
Interest on junior subordinated debentures	385	287	235
Total interest expense	5,155	4,587	4,778
Net interest income	47,546	41,362	36,231
Provision for loan and lease losses	—	950	—
Net interest income after provision for loan and lease losses	47,546	40,412	36,231
Noninterest income:			
Service charges on deposit accounts	682	542	413
ATM and point of sale fees	1,131	1,093	995
Fees on payroll and benefit processing	652	658	593
Life insurance	512	1,050	613
Gains on sale of investment securities, net	44	137	244
Impairment losses on investment securities	—	—	(546)
Federal Home Loan Bank of San Francisco dividends	480	318	644
Gain (loss) on sale of OREO	73	368	(109)
Insured cash sweep fees	—	197	3
Other income	445	461	636
Total noninterest income	4,019	4,824	3,486
Noninterest expense:			
Salaries and related benefits	18,709	17,819	16,425
Premises and equipment	4,047	4,242	3,869
Federal Deposit Insurance Corporation insurance premium	376	318	615
Data processing fees	1,933	1,749	1,675
Professional service fees	1,431	1,398	1,690
Telecommunications	594	879	751
Acquisition costs	844	—	580
Loss on cancellation of interest rate swap	—	—	2,325
Other expenses	4,272	4,559	4,570
Total noninterest expense	32,206	30,964	32,500
Income before provision for income taxes	19,359	14,272	7,217
Provision for income taxes	3,629	6,928	1,958
Net income	\$ 15,730	\$ 7,344	\$ 5,259
Earnings per share - basic	\$ 0.97	\$ 0.48	\$ 0.39
Weighted average shares - basic	16,248	15,207	13,367
Earnings per share - diluted	\$ 0.96	\$ 0.48	\$ 0.39
Weighted average shares - diluted	16,332	15,310	13,425

See accompanying Notes to Consolidated Financial Statements.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Consolidated Statements of Comprehensive Income
For the years ended December 31, 2018 2017 and 2016

(Amounts in thousands)

	2018	2017	2016
Net income	\$ 15,730	\$ 7,344	\$ 5,259
Available-for-sale securities:			
Unrealized losses arising during the period	(3,774)	(179)	(3,286)
Unrealized gains from securities transferred from held-to-maturity to available-for-sale	—	1,208	—
Income taxes	1,115	(423)	1,353
Change in unrealized (losses) gains, net of tax	(2,659)	606	(1,933)
Reclassification adjustment for realized gains included in net income	(44)	(137)	(224)
Income taxes	13	55	92
Realized gains, net of tax	(31)	(82)	(132)
Reclassification adjustment for other-than-temporary impairment included in net income	—	—	546
Income taxes	—	—	(225)
Realized impairment, net of tax	—	—	321
Net change in unrealized (losses) gains on available-for-sale securities	(2,690)	524	(1,744)
Held-to-maturity securities:			
Accretion of held-to-maturity fair value adjustment from other comprehensive income to interest income	—	(56)	(97)
Income taxes	—	23	40
Net accretion of held-to-maturity fair value adjustment from other comprehensive income to interest income	—	(33)	(57)
Fair value adjustment for held-to-maturity securities transferred to available-for-sale	—	(167)	—
Income taxes	—	69	—
Fair value adjustment for held-to-maturity securities transferred to available-for-sale	—	(98)	—
Net change in fair value adjustment on held-to-maturity securities	—	(131)	(57)
Derivatives:			
Unrealized losses arising during the period	—	—	(348)
Income taxes	—	—	143
Change in unrealized losses, net of tax	—	—	(205)
Reclassification adjustment for net losses on derivatives included in net income	—	—	2,721
Income taxes	—	—	(1,120)
Reclassification adjustment for net losses on derivatives included in net income, net of tax	—	—	1,601
Net change in unrealized losses on derivatives	—	—	1,396
Other comprehensive (loss) income	(2,690)	393	(405)
Comprehensive income – Bank of Commerce Holdings	\$ 13,040	\$ 7,737	\$ 4,854

See accompanying Notes to Consolidated Financial Statements.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Consolidated Statements of Shareholders' Equity
For the years ended December 31, 2016, 2017 and 2018

	Common Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss) Net of Tax	Total
<i>(Amounts in thousands except per share information)</i>					
Balance at December 31, 2015	13,385	\$ 24,214	\$ 66,562	\$ (254)	\$ 90,522
2016					
Net income	—	—	5,259	—	5,259
Other comprehensive loss, net of tax	—	—	—	(405)	(405)
Comprehensive income	—	—	—	—	4,854
Dividends declared on common stock (\$0.12 per share)	—	—	(1,603)	—	(1,603)
Restricted stock granted, net	53	84	—	—	84
Stock options exercised	2	10	—	—	10
Compensation expense associated with stock options	—	24	—	—	24
Compensation expense associated with restricted stock, net of cash paid for shares surrendered for tax withholding purposes	—	215	—	—	215
Balance at December 31, 2016	13,440	\$ 24,547	\$ 70,218	\$ (659)	\$ 94,106
2017					
Net income	—	—	7,344	—	7,344
Other comprehensive loss, net of tax	—	—	—	393	393
Comprehensive income	—	—	—	—	7,737
Dividends declared on common stock (\$0.12 per share)	—	—	(1,862)	—	(1,862)
Stock issued pursuant to public offering, net of underwriting discounts and expenses of \$1.7 million	2,738	26,778	—	—	26,778
Stock compensation grants	5	41	—	—	41
Restricted stock granted, net	37	—	—	—	—
Stock options exercised	52	245	—	—	245
Compensation expense associated with stock options	—	23	—	—	23
Compensation expense associated with restricted stock, net of cash paid for shares surrendered for tax withholding purposes	—	196	—	—	196
Balance at December 31, 2017	16,272	\$ 51,830	\$ 75,700	\$ (266)	\$ 127,264
2018					
Net income	—	—	15,730	—	15,730
Reclassification of accumulated other comprehensive income due to tax rate change	—	—	52	(52)	—
Other comprehensive loss, net of tax	—	—	—	(2,690)	(2,690)
Comprehensive income	—	—	—	—	13,040
Dividends declared on common stock (\$0.15 per share)	—	—	(2,437)	—	(2,437)
Stock compensation grants	5	45	—	—	45
Restricted stock granted, net	20	—	—	—	—
Stock options exercised	37	216	—	—	216
Compensation expense associated with stock options	—	8	—	—	8
Compensation expense associated with restricted stock, net of cash paid for shares surrendered for tax withholding purposes	—	185	—	—	185
Balance at December 31, 2018	16,334	\$ 52,284	\$ 89,045	\$ (3,008)	\$ 138,321

See accompanying Notes to Consolidated Financial Statements.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Consolidated Statements of Cash Flows
For the years ended December 31, 2018, 2017 and 2016

(Amounts in thousands)

	2018	2017	2016
Cash flows from operating activities:			
Net income	\$ 15,730	\$ 7,344	\$ 5,259
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan and lease losses	—	950	—
Provision for depreciation and amortization	1,738	2,061	1,908
Amortization of core deposit intangible	221	221	185
Amortization of debt issuance costs	48	45	40
Compensation expense associated with stock options	8	23	24
Compensation expense associated with restricted stock	288	273	215
Tax benefits from vesting of restricted stock	(46)	(53)	—
Net gains on sale or call of securities	(44)	(137)	(244)
Other-than-temporary impairment on investment securities	—	—	546
Amortization of investment premiums and accretion of discounts, net	1,845	2,031	1,715
Accretion of held-to-maturity fair value adjustments	—	(56)	(97)
Loss on cancellation of interest rate swap	—	—	2,325
Write-down of other real estate owned	—	52	66
(Gain) loss on sale of other real estate owned	(73)	(368)	109
Increase in cash surrender value of life insurance	(512)	(548)	(613)
Life insurance death benefit	—	(502)	—
Increase (decrease) in deferred compensation and salary continuation plans	67	18	(19)
Increase in deferred loan fees and costs	(217)	(386)	(454)
Decrease in deferred income taxes	595	271	132
Deferred tax asset write-down	—	2,490	363
(Increase) decrease in other assets	(10)	863	118
Increase (decrease) in other liabilities	1,094	(961)	306
Net cash provided by operating activities	20,732	13,631	11,884
Cash flows from investing activities:			
Proceeds from maturities and payments of available-for-sale securities	31,538	23,551	31,685
Proceeds from sale of available-for-sale securities	30,235	64,349	51,025
Purchases of available-for-sale securities	(57,616)	(150,888)	(104,134)
Proceeds from maturities and payments of held-to-maturity securities	—	1,098	4,963
Investment in Qualified Zone Academy Bonds	—	(1,000)	(2,000)
Investment in qualified affordable housing partnerships	(38)	(124)	(697)
Net purchase of Federal Home Loan Bank of San Francisco stock	(1,355)	(72)	—
Loan originations, net of principal repayments	(57,690)	(76,016)	(105,892)
Net (purchase of) repayment on purchased loans	(8,499)	(1,158)	18,666
Purchase of premises and equipment	(351)	(584)	(2,873)
Proceeds from the sale of other real estate owned	217	2,111	636
Proceeds from life insurance policy	—	2,249	—
Payments to derivative counterparties for the termination of interest rate swaps	—	—	(2,578)
Acquisition of branches, net of cash paid	—	—	142,411
Net cash (used) provided by investing activities	(63,559)	(136,484)	31,212

See accompanying Notes to Consolidated Financial Statements.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Consolidated Statements of Cash Flows (Continued)

(Amounts in thousands)

	2018	2017	2016
Cash flows from financing activities:			
Net increase in demand deposits, money market accounts and savings accounts	\$ 65,857	\$ 124,201	\$ 84,722
Net decrease in certificates of deposit	(36,873)	(26,135)	(32,838)
Advances on term debt	230,160	30,260	55,000
Repayment of term debt	(233,761)	(32,080)	(131,172)
Proceeds from stock options exercised	216	245	10
Net proceeds from issuance of common stock	—	26,778	—
Cash paid for shares surrendered for tax-withholding purposes	(103)	(77)	—
Cash dividends paid on common stock	(2,274)	(1,776)	(1,603)
Net cash provided by (used in) financing activities	23,222	121,416	(25,881)
Net (decrease) increase cash and cash equivalents	(19,605)	(1,437)	17,215
Cash and cash equivalents at the beginning of year	66,970	68,407	51,192
Cash and cash equivalents at the end of year	<u>\$ 47,365</u>	<u>\$ 66,970</u>	<u>\$ 68,407</u>

See accompanying Notes to Consolidated Financial Statements.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Consolidated Statements of Cash Flows (Continued)

(Amounts in thousands)

	2018	2017	2016
Supplemental disclosures of cash flow activity:			
Cash paid during the period for:			
Income taxes	\$ 2,727	\$ 3,846	\$ 2,705
Interest	\$ 5,171	\$ 4,581	\$ 5,142
Supplemental disclosures of non cash investing activities:			
Transfer of loans to other real estate owned	\$ 140	\$ 981	\$ 147
Changes in unrealized (loss) gain on investment securities available-for-sale	\$ (3,818)	\$ 892	\$ (2,964)
Changes in net deferred tax asset related to changes in unrealized loss (gain) on investment securities available-for-sale	1,128	(368)	1,220
Changes in accumulated other comprehensive (loss) income due to changes in unrealized (loss) gain on investment securities available-for-sale	\$ (2,690)	\$ 524	\$ (1,744)
Accretion of held-to-maturity fair value adjustment from other comprehensive income to interest income	\$ —	\$ (56)	\$ (97)
Changes in deferred tax related to accretion of held-to-maturity investment securities	—	23	—
Changes in accumulated other comprehensive income (loss) due to accretion of held-to-maturity investment securities	—	(33)	(97)
Fair value adjustment for held to maturities securities transferred to available-for-sale	—	(167)	—
Changes in deferred tax related to transfer of held-to-maturity investment securities to available-for-sale	—	69	—
Net fair value adjustment for held-to-maturity securities transferred to available-for-sale	—	(98)	—
Changes in accumulated other comprehensive income (loss) related held-to-maturity investment securities	\$ —	\$ (131)	\$ (97)
Reclassification of accumulated other comprehensive income due to tax rate change	\$ 52	\$ —	\$ —
Changes in unrealized loss on derivatives	\$ —	\$ —	\$ (348)
Changes in net deferred tax asset related to changes in unrealized loss on derivatives	—	—	143
Changes in accumulated other comprehensive income (loss) due to changes in unrealized loss on derivatives	\$ —	\$ —	\$ (205)
Reclassification of losses on derivatives	\$ —	\$ —	\$ 2,721
Changes in net deferred tax asset related to reclassification of losses on derivatives	—	—	(1,120)
Changes in accumulated other comprehensive income (loss) due to reclassification of losses on derivatives	\$ —	\$ —	\$ 1,601
Supplemental disclosures of non cash financing activities:			
Vested and granted restricted stock issued under employee plans	\$ —	\$ —	\$ 84
Stock issued under employee plans	\$ 45	\$ 41	\$ —
Transfer of investment securities from HTM to AFS	\$ —	\$ 30,330	\$ —
Cash dividend declared on common stock and payable after period-end	\$ 651	\$ 486	\$ 401
Transactions Related to Acquisition:			
Assets acquired - fair value	\$ —	\$ —	\$ 155,230
Goodwill	\$ —	\$ —	\$ 665
Liabilities assumed - fair value	\$ —	\$ —	\$ 149,239

See accompanying Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

NOTE 1. THE BUSINESS OF THE COMPANY

Bank of Commerce Holdings (“Company,” “Holding Company,” “we,” or “us”), is a corporation organized under the laws of California and a bank holding company (“BHC”) registered under the Bank Holding Company Act of 1956, as amended (“BHC Act”) with its principal offices in Sacramento, California. The Holding Company’s principal business is to serve as a holding company for Redding Bank of Commerce (the “Bank” and together with the Holding Company, the “Company”) which operates under three separate names (Redding Bank of Commerce, Sacramento Bank of Commerce, a division of Redding Bank of Commerce and The Merchants Bank of Sacramento, a division of Redding Bank of Commerce) and for Bank of Commerce Mortgage (inactive). The Company has an unconsolidated subsidiary in Bank of Commerce Holdings Trust II. The Bank is principally supervised and regulated by the California Department of Business Oversight (“CDBO”) and the Federal Deposit Insurance Corporation (“FDIC”). Substantially all of the Company’s activities are carried out through the Bank. The Bank was incorporated as a California banking corporation on November 25, 1981 and opened for business on October 22, 1982.

We operate ten full service offices and one limited service office and consider northern California to be our major market. We also operate a “cyber office” as identified in our summary of deposits reporting filed with the FDIC. The services offered by the Bank include those traditionally offered by banks of similar size and character in California. Our principal deposit products include the following types of accounts; checking, interest-bearing checking, savings, money market deposits and certificates of deposit. We also offer sweep arrangements, commercial loans, construction loans, consumer loans, safe deposit boxes, collection services and electronic banking services. The primary focus of the Bank is to provide banking services to the communities in our major market area, including Small Business Administration loans and payroll processing. The Bank does not offer trust services or international banking services. Our customers are mostly retail customers and small to medium sized businesses.

On January 31, 2019, we completed the acquisition of Merchants Holding Company (“Merchants”), to extend our presence in the Sacramento marketplace. Merchants, headquartered in Sacramento, California, was the parent company of The Merchants National Bank of Sacramento (“Merchants Bank”), a 97-year-old bank with approximately \$211.7 million in assets as of January 31, 2019. Merchants Bank operated one full service branch and one limited service branch in the Sacramento metropolitan area. See Note 23 *Acquisition* in these *Notes to Consolidated Financial Statements* for additional information on the acquisition.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Financial Statement Presentation

The Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) and with prevailing practices within the banking and securities industries. In preparing such financial statements, management is required to make certain estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the balance sheet and the reported amounts of revenues and expenses for the reporting periods. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change relate to the valuation of investments and impairments of securities, the determination of the allowance for loan and lease losses (“ALL”), income taxes, the valuation of other real estate owned (“OREO”), and fair value measurements. Certain amounts for prior periods have been reclassified to conform to the current financial statement presentation. The results of reclassifications are not considered material and have no effect on previously reported equity or net income.

Principles of Consolidation

The accompanying Consolidated Financial Statements include the accounts of the Holding Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. As of December 31, 2018 and 2017, the Company had one wholly-owned trust formed in 2005 to issue trust preferred securities and related common securities. We have not consolidated the accounts of the Trust in our Consolidated Financial Statements in accordance with Financial Accounting Standards Board Accounting Standards Codification (“FASB”) ASC 810, *Consolidation* (“ASC 810”). We are not considered the primary beneficiary of the Trust (variable interest entity). As a result, the junior subordinated debentures issued by the Holding Company to the Trust are reflected on the Company’s *Consolidated Balance Sheets*.

Application of new accounting guidance

ASU No. 2014-09

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. This ASU will replace most existing revenue recognition guidance in GAAP when it becomes effective. ASU 2014-09 was initially effective for the Company’s reporting period beginning on January 1, 2017. However, in August of 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers - Deferral of the Effective Date*, which defers the effective date by one year. For financial reporting purposes, the standard allows for either a full retrospective or modified retrospective adoption. The FASB has also issued additional updates to provide further clarification to specific implementation issues associated with ASU 2014-09. These updates include ASU 2016-08, *Principal versus Agent Considerations*, ASU 2016-10, *Identifying Performance Obligations and Licensing*, ASU 2016-12, *Narrow-Scope Improvements and Practical Expedients*, and ASU 2016-20, *Technical Corrections and Improvements to Topic 606*. We adopted the standard on January 1, 2018, using the modified retrospective method, which resulted in no cumulative effect and no other adjustment or significant impact to the timing of revenue recognition.

Under Topic 606, we must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) we satisfy the performance obligations.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Consolidated Financial Statements

Our primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. We have evaluated the nature of our contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. For revenue sources that are within the scope of Topic 606, we fully satisfy our performance obligations and recognize revenue in the period it is earned as services are rendered. Transaction prices are typically fixed; charged on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with our customers.

All of our revenue from contracts with customers in the scope of ASC 606 is recognized in Non-Interest Income. Sources of revenue from contracts with customers that are in the scope of ASC 606 include the following:

- Service Charges on Deposit accounts - We earn monthly account fees and transaction-based fees from our customers for services rendered on deposit accounts. Fees charged to deposit accounts on a monthly basis are recognized as the performance obligation is satisfied at the end of the service period.
- Transaction-based fees are based on specific services provided to our customer. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.
- ATM and Point of Sale fees – We earn fees when debit cards we issued are used in transactions through card processing networks. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the cardholders' account. The fees are recognized monthly.
- Fees on Payroll and benefit processing – We earn fees by processing payroll and benefit payments for our business customers. The performance obligation is satisfied and the fees are recognized as each transaction is processed charged to the customer account.

ASU No. 2016-01

In January of 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. The new guidance is intended to improve the recognition and measurement of financial instruments. This ASU requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. In addition, the amendment requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. This ASU also eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The amendment also requires a 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 (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. We adopted the standard on January 1, 2018. Adoption of the standard resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 20 – *Fair Values* for further information regarding the valuation of these loans.

ASU No. 2018-02

In February of 2018, FASB issued ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220)*. The amendments in this update allow a reclassification from retained earnings to accumulated other comprehensive income for stranded tax effects resulting from the Tax Cuts and Jobs Act. However, because the amendments only relate to the reclassification of the income tax effects of the Tax Cuts and Jobs Act, the underlying guidance that requires that the effect of a change in tax laws or rates be included in income from continuing operations is not affected. The amendments in this update are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption of the amendments in this update is permitted, including adoption in any interim period. The amendments in this update should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. We elected the early adoption of ASU 2018-02 as of January 1, 2018 and reclassified \$52 thousand from accumulated other comprehensive income to retained earnings.

Subsequent Events

We have evaluated events and transactions subsequent to December 31, 2018 for potential recognition or disclosure. See Note 23 *Acquisition* in these *Notes to Consolidated Financial Statements* in this document for further details on the acquisition of Merchants Holding Company completed on January 31, 2019.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include amounts due from correspondent banks including interest-bearing deposits in correspondent banks and the Federal Reserve Bank.

Investment Securities

Securities are classified as held-to-maturity if we have both the intent and ability to hold those securities to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost adjusted for amortization of premium and accretion of discount, computed by the effective interest method over their contractual lives. Unrealized holding gains or losses are excluded from other comprehensive income (loss). Realized gains or losses, determined on the basis of the cost of specific securities sold or called, are included in earnings. Dividend and interest income are recognized when earned.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Consolidated Financial Statements

Securities are classified as available-for-sale if we intend and have the ability to hold those securities for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Securities available-for-sale are carried at fair value. Unrealized holding gains or losses are included in other comprehensive income (loss) as a separate component of shareholders' equity, net of tax. Realized gains or losses, determined on the basis of the cost of specific securities sold, are included in earnings. Premiums and discounts are amortized or accreted over the estimated life of the related investment security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized when earned.

Transfers of securities from available-for-sale to held-to-maturity are accounted for at fair value as of the date of the transfer. The difference between the fair value and the amortized cost at the date of transfer is considered a premium or discount and is accounted for accordingly. Any unrealized gain or loss at the date of the transfer is reported in other comprehensive income (loss), and is amortized over the estimated remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount, and will offset or mitigate the effect on interest income of the amortization of the premium or discount for that held-to-maturity security. Transfers of securities from held-to-maturity to available-for-sale are accounted for at fair value at the date of the reclassification. Any remaining unamortized fair value adjustments are reclassified from other comprehensive income (loss) and the unrealized holding gain (loss) at the date of transfer is recorded in other comprehensive income net of tax.

We review investment securities on an ongoing basis for the presence of other-than-temporary impairment or permanent impairment, taking into consideration current market conditions, fair value in relationship to cost, extent and nature of the change in fair value, issuer rating changes and trends, whether we intend to sell a security or if it is more likely than not that we will be required to sell the security before recovery of our amortized cost basis of the investment, which may be maturity, and other factors. For debt securities, if we intend to sell the security or it is more likely than not we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an other-than-temporary impairment. If we do not intend to sell the security and it is more likely than not we will not be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential other-than-temporary impairment. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income (loss). Impairment losses related to all other factors are presented as separate categories within other comprehensive income (loss). For investment securities held-to-maturity, this amount is accreted over the remaining life of the debt security prospectively based on the amount and timing of future estimated cash flows. The accretion of the other-than-temporary impairment amount recorded in other comprehensive income (loss) will increase the carrying value of the investment, and would not affect earnings. If there is an indication of additional credit losses the security is re-evaluated according to the procedures described above.

Loans

Loans are stated at the principal amounts outstanding, net of deferred loan fees, deferred loan costs, and the ALLL. Interest on loans is accrued daily based on the principal outstanding. Loan origination and commitment fees and certain origination costs are deferred and the net amount is amortized or accreted over the contractual life of the loans as an adjustment of their yield.

A loan is impaired when, based on current information and events, management believes it is probable that we will not be able to collect all amounts due according to the original contractual terms of the loan agreement. Impairment is measured based upon the present value of expected future cash flows discounted at the loan's effective rate, the loan's observable market price, or the fair value of collateral if the loan is collateral dependent. Interest on impaired loans is recognized on a cash basis, and only when the principal is not considered impaired. The CCO reviews and approves loans recommended for impaired status or their removal from impaired status.

Our practice is to place an asset on nonaccrual status when one of the following events occurs: (1) any installment of principal or interest is 90 days or more past due (unless in management's opinion the loan is well-secured and in the process of collection), (2) management determines the ultimate collection of the original principal or interest to be unlikely or, (3) the terms of the loan have been renegotiated due to a serious weakening of the borrower's financial condition. Accruals are resumed on loans only when they are brought fully current with respect to interest and principal and when the loan is estimated to be fully collectible. One exception to the 90 days past due policy for nonaccruals is our purchased pool of home equity loans and purchased consumer loans. For these specific loan pools, we will charge-off any loans that go more than 90 days past due. We believe that at the time these loans become 90 days past due, it is likely that we will not collect the remaining principal balance on the loan. In accordance with this policy, we do not expect to classify any of the loans from these pools as nonaccrual.

Nonperforming loans are loans which may be on nonaccrual, 90 days past due and still accruing, or have been restructured.

Restructured loans are those loans where concessions in terms have been granted because of the borrower's financial or legal difficulties. Interest is generally accrued on such loans in accordance with the new terms, after a period of sustained performance by the borrower.

Purchased Loans

Purchased loans are recorded at their fair value at the acquisition date. Credit discounts are included in the determination of fair value; therefore, an ALLL is not recorded at the acquisition date.

Allowance for Loan and Lease Losses

The adequacy of the ALLL is monitored on a regular basis and is based on management's evaluation of numerous factors. These factors include the quality of the current loan portfolio; the trend in the loan portfolio's risk ratings; current economic conditions; loan concentrations; loan growth rates; past-due and non-performing trends; evaluation of specific loss estimates for all impaired loans; historical charge-off and recovery experience; and other pertinent information.

We perform regular credit reviews of the loan portfolio to determine the credit quality of the portfolio and the adherence to underwriting standards. When loans are originated, they are assigned a risk rating that is reassessed periodically during the term of the loan through the credit review process. Our risk rating methodology assigns risk ratings ranging from 1 to 8, where a higher rating represents higher risk. The 8 risk rating categories are a primary factor in determining an appropriate

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Notes to Consolidated Financial Statements

amount for the ALLL. Our Chief Credit Officer (CCO) is responsible for regularly reviewing the ALLL methodology, including loss factors, and ensuring that it is designed and applied in accordance with generally accepted accounting principles. The Board of Directors reviews and approves the adequacy of the ALLL quarterly.

We have divided the loan portfolio into sub-categories of similar type loans. Each category is assigned an historical loss factor and additional qualitative factors. The sub-categories are also further segmented by risk rating. Each risk rating is assigned an additional loss factor to account for the additional risk in those loans with higher risk levels.

Regular credit reviews of the portfolio also identify loans that are considered potentially impaired. Potentially impaired loans are referred to the CCO who reviews and approves designated loans as impaired. A loan is considered impaired when, based on current information and events, we determine that it is probable that we will not be able to collect all amounts due according to the original loan contract, including scheduled interest payments. When we identify a loan as impaired, we measure the impairment using discounted cash flows, except when the sole remaining source of the repayment for the loan is the liquidation of the collateral. In these cases, we use the current fair value of the collateral, less selling costs, instead of discounted cash flows. If we determine that the value of the impaired loan is less than the recorded investment in the loan when using the cash flow method, we recognize this impairment reserve as a specific component to be provided for in the ALLL. If the value of the impaired loan is less than the recorded investment in the loan when using the collateral dependent method, we charge-off the impaired balance. The combination of the risk rating-based allowance component and the impairment reserve allowance component leads to an allocated ALLL.

We may also maintain an unallocated allowance amount to provide for other credit losses inherent in a loan and lease portfolio that may not have been contemplated in the credit loss factors. This unallocated amount generally comprises less than 4% of the allowance, but may be maintained at higher levels during times of economic conditions characterized by unstable real estate values. The unallocated amount is reviewed quarterly based on trends in credit losses, the results of credit reviews and overall economic trends.

As adjustments to the ALLL become necessary, they are reported in earnings in the periods in which they become known as a charge or credit to the provision for loan and lease losses. Loans, or portions thereof, deemed uncollectible are charged to the ALLL. Recoveries on loans previously charged-off, are added to the ALLL.

We believe that the ALLL was adequate as of December 31, 2018. There is, however, no assurance that future loan and lease losses will not exceed the levels provided for in the ALLL and could possibly result in additional charges to the provision for loan and lease losses. In addition, bank regulatory authorities, as part of their periodic examination of the Company, may require additional charges to the provision for loan and lease losses in future periods if warranted as a result of their review. Approximately 81% of our loan portfolio is secured by real estate, and a significant decline in real estate market values may require an increase in the ALLL.

Reserve for Unfunded Commitments

A reserve for unfunded commitments is maintained at a level that, in our opinion, is adequate to absorb probable losses associated with our commitment to lend funds under existing agreements such as letters or lines of credit. We determine the adequacy of the reserve for unfunded commitments based upon the category of loan, current economic conditions, the risk characteristics of the various categories of commitments and other relevant factors. The reserve is based on estimates, and ultimate losses may vary from the current estimates.

These estimates are evaluated on a regular basis and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. Draws on unfunded commitments that are considered uncollectible at the time funds are advanced are charged to the reserve for unfunded commitments. Provisions for unfunded commitment losses, and recoveries on loan and lease commitments previously charged off, are added to the reserve for unfunded commitments, which is included in the *Other Liabilities* line item of the *Consolidated Balance Sheets*. See Note 15, *Commitments and Contingencies* in these *Notes to Consolidated Financial Statements* for additional disclosures on the reserve for unfunded commitments.

Premises and Equipment

Premises and equipment are recorded at cost. Depreciation for equipment is provided over the estimated useful lives of the related assets, generally three to seven years, using the straight-line method for financial statement purposes. Depreciation for premises is provided over the estimated useful life up to 39 years, on a straight-line basis. We use other depreciation methods (generally accelerated depreciation methods) for tax purposes where appropriate. Amortization of leasehold improvements is computed using the straight-line method over the shorter of the remaining lease term or the estimated useful lives of the improvements. Repairs and maintenance are expensed as incurred. Expenditures that increase the value or productive capacity of assets are capitalized. When premises and equipment are retired, sold, or otherwise disposed of, the asset's carrying amount and related accumulated depreciation are removed from the accounts and any gain or loss is recorded in *other noninterest income* or *other noninterest expense* in the *Consolidated Statements of Income*, respectively.

Goodwill and Other Intangibles

Intangible assets are comprised of goodwill and other intangibles acquired in business combinations. Goodwill and intangible assets with indefinite useful lives are not amortized. Intangible assets with definite useful lives are amortized to their estimated residual values over their respective estimated useful lives, and also reviewed for impairment. Amortization of intangible assets is included in *non-interest expense* in the *Consolidated Statements of Income*. We perform a goodwill impairment analysis on an annual basis. Additionally, we perform a goodwill impairment evaluation on an interim basis when events or circumstances indicate impairment potentially exists.

Other Real Estate Owned

Represents real estate of which we have taken control in partial or full satisfaction of loans. At the time of foreclosure, OREO is recorded at fair value less costs to sell, plus costs for improvements that prepare the property for sale, which becomes the property's new basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the ALLL. After foreclosure, management periodically performs valuations and the property is carried at the lower of the cost or fair value less expected selling costs. Subsequent valuation adjustments are recognized under the line item *other expenses* in the *Consolidated Statements of Income*. Revenue and expenses incurred from OREO property are recorded in *noninterest income* or *noninterest expense*, in the *Consolidated Statements of Income*, respectively.

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Notes to Consolidated Financial Statements

Income Taxes

Income taxes reported in the *Consolidated Financial Statements* are computed based on an asset and liability approach. We recognize the amount of taxes payable or refundable for the current year, and deferred tax assets and liabilities for the expected future tax consequences. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. We record net deferred tax assets to the extent it is more likely than not that they will be realized. In evaluating our ability to recover the deferred tax assets, management considers all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies and recent financial operations.

In projecting future taxable income, management develops assumptions including the amount of future state and federal pre-tax operating income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates being used to manage the underlying business. We file consolidated federal and combined state income tax returns.

We recognize the financial statement effect of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. For tax positions that meet the more likely than not threshold, we may recognize only the largest amount of tax benefit that is greater than fifty percent likely to be realized upon ultimate settlement with the taxing authority. We believe that all of our tax positions taken meet the more likely than not recognition threshold. To the extent tax authorities disagree with these tax positions, our effective tax rates could be materially affected in the period of settlement with the taxing authorities. Interest and penalties related to unrecognized tax benefits are recorded in other noninterest expense. See Note 21, *Income Taxes* in these *Notes to Consolidated Financial Statements* for more information on income taxes.

Business Combinations

We record acquisitions of businesses using the acquisition method of accounting. Under the acquisition method, assets acquired and liabilities assumed are recorded at their estimated fair values at the date of acquisition. Management utilizes various valuation techniques and third party evaluations to determine these fair values. Any excess of the purchase price over amounts allocated to the acquired assets including identifiable intangible assets and liabilities assumed is recorded as goodwill.

Derivative Financial Instruments and Hedging Activities

Prior to March of 2016, we used derivatives to hedge the risk of changes in market interest rates to limit the impact on earnings and cash flows relating to specific groups of assets and liabilities. All of our derivative instruments were designated in qualifying hedge accounting relationships. In accordance with applicable accounting standards, all derivative financial instruments, whether designated for hedge accounting or not, are required to be recorded on the *Consolidated Balance Sheets* as assets or liabilities and measured at fair value. Additionally, we generally reported derivative financial instruments on a gross basis. However, in certain instances we reported our position on a net basis where we had asset and liability derivative positions with a single counterparty, we had a legally enforceable right of offset, and we intended to settle the position on a net basis. For additional detail on derivative instruments and hedging activities, refer to Note 19, *Derivatives* in these *Notes to Consolidated Financial Statements*.

At the inception of a hedging relationship, we designate each qualifying derivative financial instrument as either a hedge of the fair value of a specifically identified asset or liability (fair value hedge) or; as a hedge of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). We formally document all relationships between hedging instruments and hedged items and risk management objectives for undertaking various hedge transactions. Both at the hedge's inception and on an ongoing basis, we formally assess whether the derivatives that are used in hedging relationships are highly effective in offsetting changes in fair values or cash flows of hedged items.

Changes in the fair value of derivative financial instruments that are designated and qualify as fair value hedges along with the gain or loss on the hedged asset or liability attributable to the hedged risk, are recorded in the current period earnings. For qualifying cash flow hedges, the effective portion of the change in the fair value of the derivative financial instruments is recorded in accumulated other comprehensive income (loss), as a component of equity, and recognized in the *Consolidated Statements of Income* when the hedged cash flows affect earnings.

The hedge accounting treatment described herein is no longer applied if a derivative financial instrument is terminated or the hedge designation is removed or is assessed to be no longer highly effective. For these terminated fair value hedges, any changes to the hedged asset or liability remain as part of the basis of the asset or liability and are recognized into income over the remaining life of the asset or liability. For terminated cash flow hedges, unless it is probable that the forecasted cash flows will not occur within a specified period, any changes in fair value of the derivative financial instrument previously recognized remain in other comprehensive income, as a component of equity, and are reclassified into earnings in the same period that the hedged cash flows affect earnings.

Operating Segments

Public enterprises are required to report certain information about their operating segments in a complete set of financial statements to shareholders. They are also required to report certain enterprise-wide information about their products and services, their activities in different geographic areas, and their reliance on major customers. The basis for determining operating segments is the manner in which management operates the business. As of December 31, 2018, we operated under one primary business segment: Community Banking.

Share Based Payments

We have one active stock-based compensation plan that provides for equity awards including stock, stock options, restricted stock units and restricted stock to eligible employees and directors. The 2008 Stock Option Plan was approved by the Holding Company's shareholders on May 15, 2007 ("the Plan"). The Plan was amended and restated by the 2010 Equity Incentive Plan which was approved by the Holding Company's shareholders on May 18, 2010. A further amendment and restatement of the Plan was approved by the Holding Company's shareholders on May 15, 2012.

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In accordance with FASB ASC 718, *Stock Compensation*, we recognize in the *Consolidated Statements of Income* the grant-date fair value of stock, stock options, restricted stock and other equity-based forms of compensation issued to employees over the employees' requisite service period. We account for forfeitures as they occur.

The fair value of each option grant is estimated as of the grant date using the Black-Scholes option-pricing model using the following assumptions:

- Volatility represents the historical volatility in the Holding Company's common stock price, for a period consistent with the expected life of the option.
- Risk free rate was derived from the U.S. Treasury rate at the time of the grant, which coincides with the expected life of the option.
- Expected dividend yield is based on dividend trends and the market value of the Holding Company's common stock at the time of grant.
- Annual dividend rate is the ratio of the expected annual dividends to the Holding Company's common stock price on the grant date.
- Assumed forfeiture rate based on expected forfeiture rates.
- Expected life is estimated based on the history of the Holding Company's stock option holders and expectations regarding future forfeitures giving consideration to the contractual terms and vesting schedules, and represents the period of time that options granted are expected to be outstanding.

The fair value of stock grants and restricted stock grants are estimated as of the grant date using the fair value of the Company's stock at the date of the grant.

Earnings per Share

Earnings per share is an important measure of our performance for investors and other users of financial statements. Certain of our securities, such as stock options or restricted stock, permit the holders to become common shareholders or add to the number of shares of common stock already held. Because there is potential reduction, called *dilution*, of earnings per share figures inherent in our capital structure, we are required to present a dual presentation of earnings per share - basic earnings per share and diluted earnings per share.

Basic earnings per share excludes dilution and is computed by dividing income by the weighted-average number of common shares outstanding for the period, excluding unvested restricted stock awards which do not have voting rights or share in dividends. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Holding Company. The computation of diluted earnings per share does not assume conversion, exercise, or contingent issuance of securities that would have an anti-dilutive effect on earnings per share.

We present both basic and diluted earnings per share on the face of the *Consolidated Statements of Income*. In addition, a detailed presentation of the earnings per share calculation is provided in Note 24, *Earnings Per Common Share* in these *Notes to Consolidated Financial Statements*.

Advertising Costs

For the years ended December 31, 2018, 2017, and 2016, advertising costs were \$47 thousand, \$61 thousand, and \$171 thousand, respectively. Advertising costs are expensed as incurred.

Fair Value Measurements

FASB ASC 820, *Fair Value Measurements and Disclosures*, defines fair value 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. FASB ASC 820 establishes a three-level hierarchy for disclosure of assets and liabilities recorded at fair value. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used for measurement are observable or unobservable. Observable inputs reflect market-derived or market-based information obtained from independent sources, while unobservable inputs reflect our estimates about market data. In general, fair values determined by Level 1 inputs utilize quoted prices for identical assets or liabilities traded in active markets that we have the ability to access. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

Recent Accounting Pronouncements

ASU No. 2016-13

Description - In June of 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments are intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU 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 and other organizations will now use forward-looking information to better inform their credit loss estimates.

Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances.

The ASU requires enhanced disclosures to help investors and other financial statement users to better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting guidance for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration.

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Methods and timing of adoption – The amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.

Expected financial statement impact – We are currently evaluating the provisions of the ASU and have formed a committee for the purpose of developing a model that is compliant with the requirements under the ASU. The committee is also gathering pertinent data, consulting with outside professionals and evaluating our IT systems to create reasonable and supportable forecasts. The committee has determined that we do not currently own any securities that will be required to maintain an allowance as a result of implementing the ASU. Management expects to recognize a one-time cumulative effect adjustment to the allowance for loan and lease losses as of the first reporting period in which the new standard is effective. An estimate of the magnitude of the one-time adjustment or the overall impact of this standard has not yet been determined.

ASU No. 2016-02

Description - In February of 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. This Update was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leases. All leases create an asset and a liability for the lessee in accordance with FASB Concepts Statement No. 6, Elements of Financial Statements, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases.

Methods and timing of adoption – For public companies, the amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Expected financial statement impact – We have performed an analysis of our existing leases and expect to recognize a new lease asset and related lease liability of approximately \$4.8 million as we implement this ASU.

NOTE 3. RESTRICTIONS ON CASH AND DUE FROM BANKS

We have a Fed Funds line of credit with one correspondent bank which requires us to hold compensating cash balances of \$450 thousand. We maintained the required compensating balance of \$450 thousand at December 31, 2018 and December 31, 2017.

The Bank is required by federal regulations to set aside specified amounts of cash as reserves against transaction and time deposits. The cash reserve required as of December 31, 2018 and December 31, 2017 was \$1.4 million and \$1.7 million, respectively which was satisfied by vault cash balances.

NOTE 4. SECURITIES

The following tables present the amortized costs, unrealized gains, unrealized losses and estimated fair values of our investment securities as of December 31, 2018, and December 31, 2017.

	As of December 31, 2018			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<i>(Amounts in thousands)</i>				
Available-for-sale securities:				
U.S. government & agencies	\$ 40,215	\$ 202	\$ (330)	\$ 40,087
Obligations of state and political subdivisions	50,037	1,082	(589)	50,530
Residential mortgage-backed securities and collateralized mortgage obligations	142,355	129	(3,981)	138,503
Corporate securities	3,022	—	(100)	2,922
Commercial mortgage-backed securities	25,446	17	(701)	24,762
Other asset-backed securities	123	1	—	124
Total	\$ 261,198	\$ 1,431	\$ (5,701)	\$ 256,928

	As of December 31, 2017			
	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<i>(Amounts in thousands)</i>				
Available-for-sale securities:				
U.S. government & agencies	\$ 40,319	\$ 196	\$ (146)	\$ 40,369
Obligations of state and political subdivisions	77,412	1,910	(478)	78,844
Residential mortgage-backed securities and collateralized mortgage obligations	116,061	69	(1,538)	114,592
Corporate securities	5,079	18	(105)	4,992
Commercial mortgage-backed securities	26,995	24	(378)	26,641
Other asset-backed securities	1,529	4	(28)	1,505
Total	\$ 267,395	\$ 2,221	\$ (2,673)	\$ 266,943

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During the fourth quarter of 2017, we reclassified the held-to-maturity securities portfolio to available-for-sale. As a result of this transfer we are precluded from classifying any investment securities as held-to-maturity for two years from the date of the transfer. Management does not expect to designate acquired securities as held-to-maturity in the near future.

The following table presents the expected maturities of investment securities at December 31, 2018.

<i>(Amounts in thousands)</i>	Available-For-Sale	
	Amortized Cost	Fair Value
Amounts maturing in:		
One year or less	\$ 54	\$ 54
One year through five years	80,796	79,726
Five years through ten years	108,251	105,923
After ten years	72,097	71,225
Total	\$ 261,198	\$ 256,928

The amortized cost and fair value of residential mortgage-backed securities, collateralized mortgage obligations and commercial mortgage securities are presented by their expected average life, rather than contractual maturity, because the underlying loans may be repaid without prepayment penalties.

At December 31, 2018 and 2017, securities with a fair value of \$68.8 million and \$62.6 million, respectively, were pledged as collateral to secure public fund deposits, Federal Home Loan Bank of San Francisco borrowings and for other purposes as required by law.

The following table presents the cash proceeds from sales of investment securities and the associated gross realized gains and gross realized losses that have been included in earnings for the years ended December 31, 2018, 2017 and 2016.

<i>(Amounts in thousands)</i>	For Years Ended December 31,		
	2018	2017	2016
Proceeds from sales of investment securities	\$ 30,235	\$ 64,349	\$ 51,025
Gross realized gains on sales of investment securities:			
U.S. government & agencies	\$ —	\$ —	\$ 25
Obligations of state and political subdivisions	262	161	188
Residential mortgage-backed securities and collateralized mortgage obligations	—	52	17
Corporate securities	1	79	105
Commercial mortgage-backed securities	—	3	4
Other asset-backed securities	—	20	13
Total gross realized gains on sales of investment securities	263	315	352
Gross realized losses on sales of investment securities			
U.S. government & agencies	(43)	—	(13)
Obligations of state and political subdivisions	(71)	(102)	(3)
Residential mortgage-backed securities and collateralized mortgage obligations	(40)	(56)	(64)
Corporate securities	—	(3)	(27)
Commercial mortgage-backed securities	(19)	(17)	(1)
Other asset-backed securities	(46)	—	—
Total gross realized losses on sales of investment securities	(219)	(178)	(108)
Gains on investment securities, net	\$ 44	\$ 137	\$ 244

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Investment securities that were in an unrealized loss position as of December 31, 2018 and December 31, 2017 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position.

	As of December 31, 2018					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>(Amounts in thousands)</i>						
Available-for-sale securities:						
U.S. government & agencies	\$ 7,223	\$ (39)	\$ 12,274	\$ (291)	\$ 19,497	\$ (330)
Obligations of states and political subdivisions	5,545	(40)	16,320	(549)	21,865	(589)
Residential mortgage-backed securities and collateralized mortgage obligations	21,791	(183)	93,038	(3,798)	114,829	(3,981)
Corporate securities	—	—	2,922	(100)	2,922	(100)
Commercial mortgage-backed securities	1,548	(7)	20,176	(694)	21,724	(701)
Total temporarily impaired securities	<u>\$ 36,107</u>	<u>\$ (269)</u>	<u>\$ 144,730</u>	<u>\$ (5,432)</u>	<u>\$ 180,837</u>	<u>\$ (5,701)</u>

	As of December 31, 2017					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>(Amounts in thousands)</i>						
Available-for-sale securities:						
U.S. government & agencies	\$ 18,140	\$ (102)	\$ 2,131	\$ (44)	\$ 20,271	\$ (146)
Obligations of states and political subdivisions	15,030	(255)	8,368	(223)	23,398	(478)
Residential mortgage-backed securities and collateralized mortgage obligations	75,323	(827)	31,036	(711)	106,359	(1,538)
Corporate securities	—	—	2,934	(105)	2,934	(105)
Commercial mortgage-backed securities	11,162	(151)	10,026	(227)	21,188	(378)
Other asset-backed securities	1,157	(28)	—	—	1,157	(28)
Total temporarily impaired securities	<u>\$ 120,812</u>	<u>\$ (1,363)</u>	<u>\$ 54,495</u>	<u>\$ (1,310)</u>	<u>\$ 175,307</u>	<u>\$ (2,673)</u>

At December 31, 2018 and December 31, 2017, the number of securities in an unrealized loss position was 163 and 138, respectively. In the opinion of management, these securities are considered only temporarily impaired due to changes in market interest rates or widening of market spreads subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral. Our Investment Policy requires securities at the time of purchase to be rated A3/A- or higher by Moody's, S&P and Fitch rating agencies. Management monitors the published credit ratings of our investment portfolio for material rating or outlook changes. For all private-label securities collateralized by mortgages, management also monitors the credit characteristics of the underlying mortgages to identify potential credit losses, if any, in the portfolio. Because the decline in fair value is not due to credit quality concerns, and because we have no plans to sell the securities before the recovery of their amortized cost, and we believe the bank has the ability to hold the securities to maturity these investments are not considered other-than-temporarily impaired.

The following table presents the characteristics of our securities that are in unrealized loss positions at December 31, 2018 and December 31, 2017.

Characteristics of securities in unrealized loss positions at December 31, 2018 and December 31, 2017	
Available-for-sale securities:	
U.S. government & agencies	Direct obligations of the U.S. Government or obligations guaranteed by U.S. Government agencies.
Obligations of states and political subdivisions	General obligation issuances or revenue securities secured by revenues from specific sources issued by municipalities and political subdivisions located within the U.S.
Residential mortgage-backed securities and collateralized mortgage obligations	Obligations of U.S. government sponsored entities or non-governmental entities collateralized by high quality mortgages on residential properties. Issuances by non-governmental entities usually include good credit enhancements. Of the residential mortgage-backed securities and collateralized mortgage obligations that we owned at December 31, 2018 and December 31, 2017, 66% and 56% were issued or guaranteed by U.S. government sponsored entities, respectively.
Corporate securities	Debt obligations generally issued or guaranteed by large U.S. corporate institutions.
Commercial mortgage-backed securities	Obligations of U.S. government sponsored entities or non-governmental entities collateralized by high quality mortgages on commercial properties. Issuances by non-governmental entities usually include good credit enhancements. Of the commercial mortgage-backed securities that we owned at December 31, 2018 and December 31, 2017 90% were issued or guaranteed by U.S. government sponsored entities.
Other asset-backed securities	Obligations secured by high quality loans with good credit enhancements issued by non-governmental issuers.

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Other-Than-Temporary Impairment

For the years ended December 31, 2018 and 2017, we did not recognize any other-than-temporary impairment losses. We recognized one impairment loss of \$546 thousand during the year ended December 31, 2016.

NOTE 5. LOANS

Outstanding loan balances consist of the following at December 31, 2018, and December 31, 2017.

Loan Portfolio	As of December 31,	
	2018	2017
Commercial	\$ 135,543	\$ 142,405
Commercial real estate:		
Real estate – construction and land development	22,563	15,902
Real estate – commercial non-owner occupied	433,708	377,668
Real estate – commercial owner occupied	204,622	192,023
Residential real estate:		
Real estate – residential - Individual Tax Identification Number ("ITIN")	37,446	41,188
Real estate – residential - 1-4 family mortgage	34,366	30,377
Real estate – residential - equity lines	26,958	30,347
Consumer and other	51,045	49,925
Gross loans	946,251	879,835
Deferred fees and costs	1,927	1,710
Loans, net of deferred fees and costs	948,178	881,545
Allowance for loan and lease losses	(12,292)	(11,925)
Net loans	<u>\$ 935,886</u>	<u>\$ 869,620</u>

Certain loans are pledged as collateral with the Federal Home Loan Bank of San Francisco and the Federal Reserve Bank. Pledged loans totaled \$436.1 million and \$420.0 million at December 31, 2018 and December 31, 2017, respectively.

When we purchase loans they are typically purchased at a discount to enhance yield and compensate for credit risk. Gross loan balances in the table above include net purchase discounts of \$2.5 million and \$2.8 million as of December 31, 2018, and December 31, 2017, respectively.

Past Due Loans

Past due loans (gross), segregated by loan portfolio were as follows, as of December 31, 2018, and December 31, 2017.

Past Due Loans at December 31, 2018	Greater Than 90 Days Past Due			Total Past Due	Current	Total	Recorded Investment > 90 Days and Accruing
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due				
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 135,543	\$ 135,543	\$ —
Commercial real estate:							
Real estate - construction and land development	—	—	—	—	22,563	22,563	—
Real estate - commercial non-owner occupied	10,878	—	548	11,426	422,282	433,708	—
Real estate - commercial owner occupied	688	—	—	688	203,934	204,622	—
Residential real estate:							
Real estate - residential - ITIN	184	279	259	722	36,724	37,446	—
Real estate - residential - 1-4 family mortgage	—	—	185	185	34,181	34,366	—
Real estate - residential - equity lines	90	—	—	90	26,868	26,958	—
Consumer and other	534	263	—	797	50,248	51,045	—
Total	<u>\$ 12,374</u>	<u>\$ 542</u>	<u>\$ 992</u>	<u>\$ 13,908</u>	<u>\$ 932,343</u>	<u>\$ 946,251</u>	<u>\$ —</u>

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(Amounts in thousands)

Past Due Loans at December 31, 2017	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total	Recorded Investment > 90 Days and Accruing
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 142,405	\$ 142,405	\$ —
Commercial real estate:							
Real estate - construction and land development	—	—	—	—	15,902	15,902	—
Real estate - commercial non-owner occupied	—	—	—	—	377,668	377,668	—
Real estate - commercial owner occupied	142	—	—	142	191,881	192,023	—
Residential real estate:							
Real estate - residential - ITIN	555	122	462	1,139	40,049	41,188	—
Real estate - residential - 1-4 family mortgage	290	173	—	463	29,914	30,377	—
Real estate - residential - equity lines	141	—	—	141	30,206	30,347	—
Consumer and other	281	123	—	404	49,521	49,925	—
Total	\$ 1,409	\$ 418	\$ 462	\$ 2,289	\$ 877,546	\$ 879,835	\$ —

Nonaccrual Loans

Nonaccrual loans, segregated by loan portfolio, were as follows as of December 31, 2018, and December 31, 2017.

(Amounts in thousands)

Nonaccrual Loans	As of December 31,	
	2018	2017
Commercial	\$ 959	\$ 1,603
Commercial real estate:		
Real estate - commercial non-owner occupied	548	—
Real estate - commercial owner occupied	—	600
Residential real estate:		
Real estate - residential - ITIN	2,388	2,909
Real estate - residential - 1-4 family mortgage	185	606
Real estate - residential - equity lines	43	45
Consumer and other	23	36
Total	\$ 4,146	\$ 5,799

Had nonaccrual loans performed in accordance with their contractual terms, we would have recognized additional interest income, net of tax, of approximately \$166 thousand, \$226 thousand, and \$353 thousand for the years ended December 31, 2018, 2017, and 2016, respectively.

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Impaired Loans

A loan is considered impaired when, based on current information and events, we determine it is probable that we will not be able to collect all amounts due according to the loan contract, including scheduled interest payments. The following tables summarize impaired loans by loan portfolio as of December 31, 2018, and December 31, 2017.

<i>(Amounts in thousands)</i>	As of December 31, 2018		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
Impaired Loans			
With no related allowance recorded:			
Commercial	\$ 51	\$ 69	\$ —
Commercial real estate:			
Real estate - commercial non-owner occupied	548	548	—
Residential real estate:			
Real estate - residential - ITIN	6,138	7,676	—
Real estate - residential - 1-4 family mortgage	185	223	—
Real estate - residential - equity lines	43	48	—
Total with no related allowance recorded	<u>\$ 6,965</u>	<u>\$ 8,564</u>	<u>\$ —</u>
With an allowance recorded:			
Commercial	\$ 2,132	\$ 2,256	\$ 748
Commercial real estate:			
Real estate - commercial non-owner occupied	795	795	209
Residential real estate:			
Real estate - residential - ITIN	734	772	91
Real estate - residential - equity lines	363	363	182
Consumer and other	23	23	7
Total with an allowance recorded	<u>\$ 4,047</u>	<u>\$ 4,209</u>	<u>\$ 1,237</u>
By loan portfolio:			
Commercial	\$ 2,183	\$ 2,325	\$ 748
Commercial real estate	1,343	1,343	209
Residential real estate	7,463	9,082	273
Consumer and other	23	23	7
Total impaired loans	<u>\$ 11,012</u>	<u>\$ 12,773</u>	<u>\$ 1,237</u>

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	As of December 31, 2017		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
<i>(Amounts in thousands)</i>			
Impaired Loans			
With no related allowance recorded:			
Commercial	\$ 672	\$ 1,205	\$ —
Commercial real estate:			
Real estate - commercial owner-occupied	600	665	—
Residential real estate:			
Real estate - residential - ITIN	5,895	7,516	—
Real estate - residential - 1-4 family mortgage	414	897	—
Real estate - residential - equity lines	45	49	—
Total with no related allowance recorded	<u>\$ 7,626</u>	<u>\$ 10,332</u>	<u>\$ —</u>
With an allowance recorded:			
Commercial	\$ 2,482	\$ 2,540	\$ 690
Commercial real estate:			
Real estate - commercial non-owner occupied	803	803	77
Residential real estate:			
Real estate - residential - ITIN	1,628	1,678	199
Real estate - residential - 1-4 family mortgage	192	226	2
Real estate - residential - equity lines	380	380	190
Consumer and other	36	36	11
Total with an allowance recorded	<u>\$ 5,521</u>	<u>\$ 5,663</u>	<u>\$ 1,169</u>
By loan portfolio:			
Commercial	\$ 3,154	\$ 3,745	\$ 690
Commercial real estate	1,403	1,468	77
Residential real estate	8,554	10,746	391
Consumer and other	36	36	11
Total impaired loans	<u>\$ 13,147</u>	<u>\$ 15,995</u>	<u>\$ 1,169</u>

The following table summarizes average recorded investment and interest income recognized on impaired loans by loan portfolio for the years ended December 31, 2018, 2017 and 2016.

	2018		2017		2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<i>(Amounts in thousands)</i>						
Average Recorded Investment and Interest Income						
Commercial	\$ 2,455	\$ 78	\$ 3,211	\$ 46	\$ 2,605	\$ 23
Commercial real estate:						
Real estate - commercial non-owner occupied	890	46	1,548	46	2,013	47
Real estate - commercial owner- occupied	—	—	670	2	1,281	25
Residential real estate:						
Real estate - residential - ITIN	7,198	170	7,961	162	8,939	165
Real estate - residential - 1-4 family mortgage	218	—	1,019	—	1,788	—
Real estate - residential - equity lines	415	20	1,104	19	1,535	26
Consumer and other	31	—	72	—	162	—
Total	<u>\$ 11,207</u>	<u>\$ 314</u>	<u>\$ 15,585</u>	<u>\$ 275</u>	<u>\$ 18,323</u>	<u>\$ 286</u>

The impaired loans on which these interest income amounts were recognized are primarily accruing troubled debt restructured loans. Loans are reported as troubled debt restructurings when we grant a concession(s) to a borrower experiencing financial difficulties that we would not otherwise consider. Examples of such concessions

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include a reduction in the loan rate, forgiveness of principal or accrued interest, extending the maturity date(s) significantly, or providing a lower interest rate than would be normally available for a transaction of similar risk. As a result of these concessions, restructured loans are impaired as we will not collect all amounts due, either principal or interest, in accordance with the terms of the original loan agreement.

Troubled Debt Restructurings

At December 31, 2018 and December 31, 2017, impaired loans of \$6.9 million and \$7.3 million, respectively, were classified as performing restructured loans.

For a restructured loan to be on accrual status, the loan's collateral coverage must generally be greater than or equal to 100% of the loan balance, the loan payments must be current, and the borrower must demonstrate the ability to make payments from a verified source of cash flow. As of December 31, 2018 and 2017, we had one restructured commercial line of credit in nonaccrual status that had \$313 thousand and \$33 thousand in available credit.

As of December 31, 2018, we had \$9.6 million in troubled debt restructurings compared to \$10.9 million as of December 31, 2017. As of December 31, 2018, we had 106 loans that qualified as troubled debt restructurings, of which all loans were performing according to their restructured terms. Troubled debt restructurings represented 1.01% of gross loans as of December 31, 2018, compared with 1.24% at December 31, 2017.

The types of modifications offered can generally be described in the following categories:

Rate – A modification in which the interest rate is changed.

Maturity – A modification in which the maturity date is changed.

Payment deferral – A modification in which a portion of the principal is deferred.

Principal reduction – A modification in which a portion of the owing principal is decreased.

We do not have any newly restructured loans or modifications for the year ended December 31, 2018. The following tables present the period ended balances of newly restructured loans and the types of modifications that occurred during the years ended December 31, 2017 and 2016

For The Year Ended December 31, 2017						
(Amounts in thousands)	Rate & Maturity	Principal Reduction	Rate & Payment Deferral	Maturity	Payment Deferral	Total
Troubled Debt Restructuring Modification Types						
Residential real estate:						
Real estate - residential - ITIN	\$ —	\$ —	\$ 60	\$ —	\$ —	\$ 60
Total	\$ —	\$ —	\$ 60	\$ —	\$ —	\$ 60

For The Year Ended December 31, 2016						
(Amounts in thousands)	Rate & Maturity	Rate & Payment Deferral	Principal Reduction	Maturity	Payment Deferral	Total
Troubled Debt Restructuring Modification Types						
Commercial	\$ 905	\$ —	\$ —	\$ 1,120	\$ —	\$ 2,025
Residential real estate:						
Real estate - residential - ITIN	—	—	81	—	197	278
Real estate - residential - 1-4 family mortgage	144	—	—	—	—	144
Total	\$ 1,049	\$ —	\$ 81	\$ 1,120	\$ 197	\$ 2,447

For the years ended December 31, 2017, and 2016, the tables below provide information regarding the number of loans where the contractual terms have been restructured.

2017			
(Amounts in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Residential real estate:			
Real estate - residential - ITIN	1	\$ 81	\$ 61
Total	1	\$ 81	\$ 61

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	2016		
		Pre-Modification	Post-Modification
(Amounts in thousands)	Number of	Outstanding Recorded	Outstanding Recorded
Troubled Debt Restructurings	Contracts	Investment	Investment
Commercial	4	\$ 2,244	\$ 2,266
Residential real estate:			
Real estate - residential - ITIN	3	372	342
Real estate - residential - 1-4 family mortgage	1	144	144
Total	8	\$ 2,760	\$ 2,752

There were no loans modified as troubled debt restructuring during the 12 months ended December 31, 2018, 2017 and 2016, for which there was a subsequent payment default during the twelve months ended December 31, 2018, 2017 and 2016, respectively.

Performing and Nonperforming Loans

We define a performing loan as a loan where any installment of principal or interest is not 90 days or more past due, and management believes the ultimate collection of original contractual principal and interest is likely. We define a nonperforming loan as an impaired loan, which may be on nonaccrual, or is 90 days past due and still accruing, or has been restructured and does not comply with its modified terms, and our ultimate collection of original contractual principal and interest is uncertain.

Performing and nonperforming loans, segregated by loan portfolio, are as follows at December 31, 2018 and 2017.

	December 31, 2018		
	Performing	Nonperforming	Total
<i>(Amounts in thousands)</i>			
Performing and Nonperforming Loans			
Commercial	\$ 134,584	\$ 959	\$ 135,543
Commercial real estate:			
Real estate - construction and land development	22,563	—	22,563
Real estate - commercial non-owner occupied	433,160	548	433,708
Real estate - commercial owner occupied	204,622	—	204,622
Residential real estate:			
Real estate - residential - ITIN	35,058	2,388	37,446
Real estate - residential - 1-4 family mortgage	34,181	185	34,366
Real estate - residential - equity lines	26,915	43	26,958
Consumer and other	51,022	23	51,045
Total	\$ 942,105	\$ 4,146	\$ 946,251

	December 31, 2017		
	Performing	Nonperforming	Total
<i>(Amounts in thousands)</i>			
Performing and Nonperforming Loans			
Commercial	\$ 140,802	\$ 1,603	\$ 142,405
Commercial real estate:			
Real estate - construction and land development	15,902	—	15,902
Real estate - commercial non-owner occupied	377,668	—	377,668
Real estate - commercial owner occupied	191,423	600	192,023
Residential real estate:			
Real estate - residential - ITIN	38,279	2,909	41,188
Real estate - residential - 1-4 family mortgage	29,771	606	30,377
Real estate - residential - equity lines	30,302	45	30,347
Consumer and other	49,889	36	49,925
Total	\$ 874,036	\$ 5,799	\$ 879,835

Credit Quality Ratings

Management assigns a credit quality rating (risk grade) to each loan. The foundation or primary factor in determining the appropriate credit quality rating is the degree of a debtor's willingness and ability to perform as agreed. In conjunction with evaluating the performing versus nonperforming nature of our loan portfolio, management evaluates the following credit risk and other relevant factors in determining the appropriate credit quality indicator (rating) for each loan portfolio:

Pass Grade: A Pass loan is a strong credit with no existing or known weaknesses that may require management's close attention. Some pass loans require short-term enhanced monitoring to determine when the credit relationship would merit either an upgrade or a downgrade. Loans classified as Pass Grade specifically demonstrate:

- Strong Cash Flows – borrower's cash flows must meet or exceed our minimum debt service coverage ratio.
- Collateral Margin – generally, the borrower must have pledged an acceptable collateral class with an adequate collateral margin.

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- Qualitative Factors – in addition to meeting our minimum cash flow and collateral requirements, a number of other qualitative factors are also factored into assigning a Pass Grade including the borrower's level of leverage (debt to equity), prospects, history and experience in their industry, credit history, and any other relevant factors including a borrower's character.

Those borrowers who qualify for unsecured loans must fully demonstrate above average cash flows and strong secondary sources of repayment to mitigate the lack of unpledged collateral.

Watch Grade: The credit is acceptable but the borrower has experienced a temporary setback or adverse information has been received, and may exhibit one or more of the characteristics shown in the list below. This risk grade could apply to credits on a temporary basis pending a full review. Credits with this risk grade will require more handling time and increased management. The list below contains characteristics of this risk grade, but individually do not automatically cause the loan to be assigned a Watch Grade.

- The primary source of repayment may be weakening causing greater reliance on the secondary source of repayment or
- The primary source of repayment is adequate, but the secondary source of repayment is insufficient
- In-depth financial analysis would compare to the lower quartile in two or more of the major components of the Risk Management Association Annual Statement Studies
- Volatile or deteriorating collateral
- Management decisions may be called into question
- Delinquencies in bank credits or other financial/trade creditors
- Frequent overdrafts
- Significant change in management/ownership

Special Mention Grade: Credits in this grade are potentially weak and deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects of the credit. Special Mention credits are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification. The list below exhibits the characteristics of this grade, but individually do not automatically cause the borrower to be assigned a grade of Special Mention:

- Inadequate or incomplete loan documentation or perfection of collateral, or any other deviation from prudent lending practices
- Credit is structured in a manner in which the timing of the repayment source does not match the payment schedule or maturity, materially jeopardizing repayment
- Current economic or market conditions exist which may affect the borrower's ability to perform or affect the Bank's collateral position
- Adverse trends in the borrower's operations or continued deterioration in the borrower's financial condition that has not yet reached a point where the retirement of debt is jeopardized. A credit in this grade should have favorable prospects of the deteriorating financial trends reversing within a reasonable timeframe.
- The borrower is less than cooperative or unable to produce current and adequate financial information

Substandard Grade: A Substandard credit is inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard credits have a well-defined weakness or weaknesses that jeopardize the liquidation or timely collection of the debt. Substandard credits are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. However, a potential loss does not have to be recognizable in an individual credit for it to be considered a substandard credit. As such, substandard credits may or may not be graded as impaired.

The following represents, but is not limited to, the potential characteristics of a Substandard Grade and do not necessarily generate automatic reclassification into this loan grade:

- Sustained or substantial deteriorating financial trends,
- Unresolved management problems,
- Collateral is insufficient to repay debt; collateral is not sufficiently supported by independent sources, such as asset-based financial audits, appraisals, or equipment evaluations,
- Improper perfection of lien position, which is not readily correctable,
- Unanticipated and severe decline in market values,
- High reliance on secondary source of repayment,
- Legal proceedings, such as bankruptcy or a divorce, which has substantially decreased the borrower's capacity to repay the debt,
- Fraud committed by the borrower,
- IRS liens that take precedence,
- Forfeiture statutes for assets involved in criminal activities,
- Protracted repayment terms outside of policy that are for longer than the same type of credit in our portfolio,
- Any other relevant quantitative or qualitative factor that negatively affects the current net worth and paying capacity of the borrower or of the collateral pledged, if any.

Doubtful Grade: A Doubtful loan has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain pending factors that may work to the advantage and strengthening of the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include, but are not limited to:

- Proposed merger(s),
- Acquisition or liquidation procedures,
- Capital injection,
- Perfecting liens on additional collateral,
- Refinancing plans.

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Generally, a Doubtful Grade does not remain outstanding for a period greater than six months. Within six months, the pending events should have been resolved. Based on resolution of the pending events, the credit grade should have improved or the principal balance charged against the ALLL.

The following table summarizes loans by internal risk grades and by loan class as of December 31, 2018, and December 31, 2017.

December 31, 2018						
(Amounts in thousands)	Pass	Watch	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 118,643	\$ 15,247	\$ —	\$ 1,653	\$ —	\$ 135,543
Commercial real estate:						
Real estate - construction and land development	22,539	24	—	—	—	22,563
Real estate - commercial non-owner occupied	409,157	21,698	—	2,853	—	433,708
Real estate - commercial owner occupied	179,154	14,075	—	11,393	—	204,622
Residential real estate:						
Real estate - residential - ITIN	31,805	—	—	5,641	—	37,446
Real estate - residential - 1-4 family mortgage	33,388	793	—	185	—	34,366
Real estate - residential - equity lines	25,336	1,313	—	309	—	26,958
Consumer and other	51,016	—	—	29	—	51,045
Total	\$ 871,038	\$ 53,150	\$ —	\$ 22,063	\$ —	\$ 946,251

December 31, 2017						
(Amounts in thousands)	Pass	Watch	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 117,087	\$ 22,213	\$ 40	\$ 3,065	\$ —	\$ 142,405
Commercial real estate:						
Real estate - construction and land development	14,762	—	1,140	—	—	15,902
Real estate - commercial non-owner occupied	364,230	9,160	2,900	1,378	—	377,668
Real estate - commercial owner occupied	171,005	15,198	3,907	1,913	—	192,023
Residential real estate:						
Real estate - residential - ITIN	34,923	—	—	6,265	—	41,188
Real estate - residential - 1-4 family mortgage	28,981	791	—	605	—	30,377
Real estate - residential - equity lines	28,457	1,501	63	326	—	30,347
Consumer and other	49,887	—	2	36	—	49,925
Total	\$ 809,332	\$ 48,863	\$ 8,052	\$ 13,588	\$ —	\$ 879,835

The recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure was \$245 thousand at December 31, 2018.

Allowance for Loan and Lease Losses

The following tables below summarize the ALLL by portfolio for the years ended December 31, 2018, 2017 and 2016.

As of December 31, 2018						
(Amounts in thousands)	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
ALLL by Loan Portfolio						
Beginning balance	\$ 2,397	\$ 6,514	\$ 1,169	\$ 1,435	\$ 410	\$ 11,925
Charge-offs	(132)	—	(226)	(890)	—	(1,248)
Recoveries	865	—	435	315	—	1,615
Provision	(925)	602	(205)	496	32	—
Ending balance	\$ 2,205	\$ 7,116	\$ 1,173	\$ 1,356	\$ 442	\$ 12,292

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	As of December 31, 2017					
<i>(Amounts in thousands)</i>						
ALLL by Loan Portfolio	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Beginning balance	\$ 2,747	\$ 5,680	\$ 1,716	\$ 955	\$ 446	\$ 11,544
Charge-offs	(51)	—	(483)	(968)	—	(1,502)
Recoveries	512	27	178	216	—	933
Provision	(811)	807	(242)	1,232	(36)	950
Ending balance	\$ 2,397	\$ 6,514	\$ 1,169	\$ 1,435	\$ 410	\$ 11,925

	As of December 31, 2016					
<i>(Amounts in thousands)</i>						
ALLL by Loan Portfolio	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Beginning balance	\$ 2,493	\$ 5,784	\$ 1,577	\$ 770	\$ 556	\$ 11,180
Charge-offs	(1,106)	(37)	(829)	(812)	—	(2,784)
Recoveries	427	2,480	114	127	—	3,148
Provision	933	(2,547)	854	870	(110)	—
Ending balance	\$ 2,747	\$ 5,680	\$ 1,716	\$ 955	\$ 446	\$ 11,544

The following tables summarize the ALLL and the recorded investment in loans and leases as of December 31, 2018, 2017 and 2016.

	As of December 31, 2018					
<i>(Amounts in thousands)</i>						
ALLL:	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Individually evaluated for impairment	\$ 748	\$ 209	\$ 273	\$ 7	\$ —	\$ 1,237
Collectively evaluated for impairment	1,457	6,907	900	1,349	442	11,055
Total	2,205	7,116	1,173	1,356	442	12,292
Gross loans:						
Individually evaluated for impairment	\$ 2,183	\$ 1,343	\$ 7,463	\$ 23	\$ —	\$ 11,012
Collectively evaluated for impairment	133,360	659,550	91,307	51,022	—	935,239
Total gross loans	\$ 135,543	\$ 660,893	\$ 98,770	\$ 51,045	\$ —	\$ 946,251

	As of December 31, 2017					
<i>(Amounts in thousands)</i>						
ALLL:	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Individually evaluated for impairment	\$ 690	\$ 77	\$ 391	\$ 11	\$ —	\$ 1,169
Collectively evaluated for impairment	1,707	6,437	778	1,424	410	10,756
Total	2,397	6,514	1,169	1,435	410	11,925
Gross loans:						
Individually evaluated for impairment	\$ 3,154	\$ 1,403	\$ 8,554	\$ 36	\$ —	\$ 13,147
Collectively evaluated for impairment	139,251	584,190	93,358	49,889	—	866,688
Total gross loans	\$ 142,405	\$ 585,593	\$ 101,912	\$ 49,925	\$ —	\$ 879,835

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(Amounts in thousands)	As of December 31, 2016					
	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
ALLL:						
Individually evaluated for impairment	\$ 641	\$ 85	\$ 721	\$ 14	\$ —	\$ 1,461
Collectively evaluated for impairment	2,106	5,595	995	941	446	10,083
Total	2,747	5,680	1,716	955	446	11,544
Gross loans:						
Individually evaluated for impairment	\$ 3,525	\$ 3,125	\$ 11,894	\$ 250	\$ —	\$ 18,794
Collectively evaluated for impairment	143,356	500,580	90,050	51,431	—	785,417
Total gross loans	\$ 146,881	\$ 503,705	\$ 101,944	\$ 51,681	\$ —	\$ 804,211

The ALLL totaled \$12.3 million or 1.30% of total gross loans at December 31, 2018 and \$11.9 million or 1.36% at December 31, 2017. As of December 31, 2018 and December 31, 2017, we had commitments to extend credit of \$235.8 million and \$227.7 million, respectively. The reserve for unfunded commitments recorded in *Other Liabilities* in the *Consolidated Balance Sheets* at December 31, 2018 and 2017 was \$695 thousand.

The ALLL is based upon estimates of future loan and lease losses and is maintained at a level considered adequate to provide for probable losses inherent in the outstanding loan portfolio. Our ALLL methodology incorporates management's current judgments, and reflects management's estimate of future loan and lease losses and risks inherent in the loan portfolio in accordance with ASC Topic 450 *Contingencies* and ASC Topic 310 *Receivables*.

The allowance is increased by provisions charged to expense and reduced by net charge-offs. In periodic evaluations of the adequacy of the allowance balance, management considers past loan and lease loss experience by type of credit, known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay, the estimated value of any underlying collateral, current economic conditions and other factors. We formally assess the adequacy of the ALLL on a monthly basis. These assessments include the periodic re-grading of classified loans based on changes in their individual credit characteristics including delinquency, seasoning, recent financial performance of the borrower, economic factors, changes in the interest rate environment and other factors as warranted. Loans are initially rated when originated. They are reviewed as they are renewed, when there is a new loan to the same borrower and/or when identified facts demonstrate heightened risk of default. Confirmation of the quality of our grading process is obtained by independent reviews conducted by outside consultants specifically hired for this purpose and by periodic examination by various bank regulatory agencies.

Management monitors delinquent loans continuously and identifies problem loans to be evaluated individually for impairment testing. For loans that are determined impaired, a formal impairment measurement is performed at least quarterly on a loan-by-loan basis.

Our method for assessing the appropriateness of the allowance includes specific allowances for identified problem loans, an allowance factor for categories of credits and allowances for changing environmental factors (e.g., portfolio trends, concentration of credit, growth, economic factors). Allowances for identified problem loans are based on specific analysis of individual credits. Loss estimation factors for loan categories are based on analysis of local economic factors applicable to each loan category. Allowances for changing environmental factors are management's best estimate of the probable impact these changes have had on the loan portfolio as a whole.

We believe that the ALLL was adequate as of December 31, 2018. There is, however, no assurance that future loan and lease losses will not exceed the levels provided for in the ALLL and could possibly result in additional charges to the provision for loan and lease losses. In addition, bank regulatory authorities, as part of their periodic examination of the Company, may require additional charges to the provision for loan and lease losses in future periods if warranted as a result of their review.

As of December 31, 2018, 81% of our gross loan portfolio is secured by real estate, and a significant decline in real estate market values may require an increase in the ALLL. Deterioration in economic conditions particularly in our markets may adversely affect our loan portfolio and may lead to additional charges to the provision for loan and lease losses.

Impaired loans are individually evaluated for impairment. If the measurement of each impaired loans' value is less than the recorded investment in the loan, we recognize this impairment and adjust the carrying value of the loan to fair value through the ALLL. For collateral dependent loans, this can be accomplished by charging off the impaired portion of the loan based on the underlying value of the collateral. For non-collateral dependent loans, we establish a specific component within the ALLL based on the present value of the future cash flows. If we determine the sources of repayment will not result in a reasonable probability that the carrying value of a loan can be recovered, the amount of a loan's specific impairment is charged off against the ALLL. Impairment reserves on non-collateral dependent restructured loans are measured by comparing the present value of expected future cash flows on the restructured loans discounted at the interest rate of the original loan agreement to the loan's carrying value. These impairment reserves are recognized as a specific component to be provided for in the ALLL.

The unallocated portion of the ALLL provides for coverage of credit losses inherent in the loan portfolio but not captured in the credit loss factors that are utilized in the risk rating-based component, or in the specific impairment reserve component of the ALLL, and acknowledges the inherent imprecision of all loss prediction models. As of December 31, 2018, the unallocated allowance amount represented 4% of the ALLL, compared to 3% at December 31, 2017.

While the ALLL composition is an indication of specific amounts or loan categories in which future charge-offs may occur, actual amounts may differ.

We have lending policies and procedures in place with the objective of optimizing loan income within an accepted risk tolerance level. We review and approve these policies and procedures annually. Monitoring and reporting systems supplement the review process with regular frequency as related to loan production, loan quality, concentrations of credit, potential problem loans, loan delinquencies, and nonperforming loans.

The following is a brief summary, by loan type, of management's evaluation of the general risk characteristics and underwriting standards:

Commercial Loans – Commercial loans are underwritten after evaluating the borrower's financial ability to maintain profitability including future expansion objectives. In addition, the borrower's qualitative qualities are evaluated, such as management skills and experience, ethical traits, and overall

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business acumen. Commercial loans are primarily extended based on the cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The borrower's cash flow may deviate from initial projections, and the value of collateral securing these loans may change.

Most commercial loans are generally secured by the assets being financed and other business assets such as accounts receivable or inventory. Management may also incorporate a personal guarantee; however, some short-term loans may be extended on an unsecured basis. Repayment of commercial loans secured by accounts receivable may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial Real Estate ("CRE") Loans – CRE loans are subject to similar underwriting standards and processes as commercial loans. CRE loans are viewed predominantly as cash flow loans and secondarily as loans collateralized by real estate. Generally, CRE lending involves larger principal amounts with repayment largely dependent on the successful operation of the property securing the loan or the business conducted on the collateralized property. CRE loans tend to be more adversely affected by conditions in the real estate markets or by general economic conditions.

The properties securing the CRE portfolio are diverse in terms of type and primary source of repayment. This diversity helps reduce our exposure to adverse economic events that affect any single industry. We monitor and evaluate CRE loans based on occupancy status (investor versus owner occupied), collateral, geography, and risk grade criteria.

Generally, CRE loans are made to developers and builders that are secured by non-owner occupied properties require the borrower to have had an existing relationship with the Company and a proven record of success. Construction loans are underwritten utilizing feasibility studies, sensitivity analysis of absorption and lease rates, and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of cost and value associated with the complete project (as-is value). These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment largely dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property, or an interim loan commitment from the Company until permanent financing is secured. These loans are closely monitored by on-site inspections, and are considered to have higher inherent risks than other CRE loans due to their ultimate repayment sensitivity to interest rate changes, governmental regulation of real property, general economic conditions, and the availability of long-term financing.

Residential Real Estate Loans – We do not originate consumer real estate mortgage loans. The majority of our loans secured by non owner occupied residential real estate are made either as part of a commercial relationship and subject to similar underwriting standards and processes as the CRE portfolio, or loans that were purchased in a prior year as part of a pool of loans. Purchased loan pools are evaluated based on risk characteristics established for each segmented group of loans. These characteristics include a significant emphasis on historical losses within each loan group, inherent risks for each, and specific loan class characteristics such as trends related to nonaccrual loans, past due loans, criticized loans, net charge-offs or recoveries, among other relevant credit risk factors. Residential equity lines of credit are included in the discussion of consumer loans below.

We originate some single family residence construction loans. The loan amounts are no greater than \$1 million and are short term real estate secured financing for the construction of a single family residence to be occupied by the owner. The loans have a draw down feature with interest only payments, and a balloon payment at the 12-month maturity. All of these loans are refinanced and paid-off by the borrower's permanent mortgage lender who provided the initial pre-approved mortgage financing. These loans are underwritten utilizing financial analysis of the borrower and are generally based upon estimates of cost and value associated with the complete project (as-is value). These estimates may be inaccurate. The loan disbursement and monitoring process is controlled utilizing similar processes as our CRE construction loans.

Consumer Loans – Our consumer loan originations are generally limited to home equity loans with nominal originations in unsecured personal loans. The portfolio also includes unsecured consumer home improvement loans and residential solar panel loans secured by UCC filings. We are highly dependent on third party credit scoring analysis to supplement the internal underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by management and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time, and documentation requirements.

We maintain an independent loan review program that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to the Board of Directors and Audit Committee. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as our policies and procedures.

Management's continuing evaluation of all known relevant quantitative and qualitative internal and external risk factors provides the foundation for the three major components of the ALLL: (1) historical valuation allowances established in accordance with ASC 450, Contingencies ("ASC 450") for groups of similarly situated loan pools; (2) general valuation allowances established in accordance with ASC 450 that are based on qualitative credit risk factors; and (3) specific valuation allowances established in accordance with ASC 310, Receivables ("ASC 310") that are based on estimated probable losses on specific impaired loans. All three components are aggregated and constitute the ALLL; while portions of the allowance may be allocated to specific credits, the allowance net of specific reserves is available for the remaining credits that management deems as "loss." It is our policy to classify a credit as loss with a concurrent charge-off when management considers the credit uncollectible and of such little value that its continuance as a bankable asset is not warranted. A loss classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer recognizing the likely credit loss of a valueless asset even though partial recovery may occur in the future.

Our loan portfolio is evaluated by general loan class including commercial, commercial real estate (which includes construction and other real estate), residential real estate (which includes 1-4 family and home equity loans), consumer and other loans. In accordance with ASC 450, historical valuation allowances are established for loan pools with similar risk characteristics common to each loan grouping. These loan pools are similarly risk-graded and each portfolio is evaluated by identifying all relevant risk characteristics that are common to these segmented groups of loans. These characteristics include a significant emphasis on historical losses within each loan group, inherent risks for each, and specific loan class characteristics such as trends related to nonaccrual loans, past due loans, criticized loans, net charge-offs or recoveries, among other relevant credit risk factors. We periodically review and update our historical loss ratios based on net charge-off experience for each loan and lease class. Other credit risk factors are also reviewed periodically and adjusted as necessary to account for any changes in potential loss exposure.

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General valuation allowances, as prescribed by ASC 450, are based on qualitative factors such as changes in asset quality trends, concentrations of credit or changes in concentrations of credit, changes in underwriting standards, changes in experience or depth of lending staff or management, the effectiveness of loan grading and the internal loan review function, and any other relevant factors. Management evaluates each qualitative component quarterly to determine the associated risks to the quality of our loan portfolio.

NOTE 6. PURCHASE OF FINANCIAL ASSETS

During the second quarter of 2018 we terminated an agreement to purchase a maximum par value of \$50.0 million in unsecured consumer home improvement loans from a third party originator. Prior to the termination, as we received principal payments on these purchased loans, new loans were purchased and the outstanding par value remained at approximately \$50.0 million.

Since inception through December 31, 2018, we have paid aggregate cash totaling \$137.3 million, and received aggregate cash repayments of \$92.1 million for \$45.2 million in net loans outstanding. The acquired loans were purchased without recourse or servicing rights and were recorded at fair value at the time of the purchase.

NOTE 7. PREMISES AND EQUIPMENT

The following table presents the major components of premises and equipment at December 31, 2018 and 2017.

(Amounts in thousands)

Premises and Equipment	2018	2017
Land	\$ 2,063	\$ 2,063
Land improvements	241	241
Bank buildings	13,076	12,976
Furniture, fixtures and equipment	12,682	12,639
Software	1,624	1,634
Assets not yet placed in service	72	337
Total premises and equipment	29,758	29,890
Less: accumulated depreciation and amortization	(16,639)	(15,142)
Premises and equipment, net	\$ 13,119	\$ 14,748

We record depreciation expense on a straight-line basis for all depreciable assets. Depreciation expense totaled \$1.7 million, \$2.1 million, and \$1.9 million, for the years ended December 31, 2018, 2017 and 2016, respectively. We have entered into a number of non-cancelable lease agreements with respect to various premises. See Note 15, *Commitments and Contingencies* in these *Notes to Consolidated Financial Statements* for more information regarding rental expense, rent income and minimum annual rental commitments under non-cancelable lease agreements.

NOTE 8. OTHER REAL ESTATE OWNED (OREO)

OREO represents real estate to which we have taken legal title in partial or full satisfaction of loans and properties originally acquired for branch expansion but no longer intended to be used for that purpose. OREO is recorded at fair value less costs to sell. Additional expenditures for improvements that increase the fair value of the property as it is prepared for sale are added to the property's cost basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the ALLL. Thereafter, management periodically performs valuations and the property is carried at the lower of the cost or fair value less expected selling costs. Subsequent valuation adjustments and net expenses incurred from OREO property are recorded in *noninterest expense*, in the *Consolidated Statements of Income*.

The following table presents the changes in OREO for the years ended December 31, 2018, 2017, and 2016.

(Amounts in thousands)

OREO	Years Ended December 31,		
	2018	2017	2016
Balance at beginning of year	\$ 35	\$ 759	\$ 1,423
Additions	140	1,071	189
Dispositions	(144)	(1,743)	(745)
Valuation adjustments	—	(52)	(108)
Total	\$ 31	\$ 35	\$ 759

For the year ended December 31, 2018, we transferred five foreclosed properties in the amount of \$140 thousand to OREO. During this period, we sold five properties with balances of \$144 thousand for a net gain of \$73 thousand. The December 31, 2018 OREO balance consists of one 1-4 family residential real estate property in the amount of \$31 thousand.

NOTE 9. INTANGIBLE ASSETS

In March of 2016, as part of our branch acquisition, we recorded a core deposit intangible of \$1.8 million and goodwill of \$665 thousand. The acquired core deposit base provides value as a source of below market rate funds and the realization of interest cost savings is a fundamental rationale for assuming these deposit liabilities. The cost savings is defined as the difference between the cost of funds on our new deposits (i.e., interest and net maintenance costs) and the cost of an equal amount of

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funds from an alternative source having a similar term as the new deposit base. Our core deposit intangible was recorded at fair value which was derived by using the income approach and represents the present value of the cost savings over the projected term of our new deposit base.

The core deposit intangible is being amortized on a straight-line basis over the estimated useful life of the deposits, which is eight years, with no expected residual value. For tax purposes, the core deposit intangible is being amortized over 15 years.

As of December 31, 2018, we have recorded the following amounts related to the core deposit intangible.

<i>(Amounts in thousands)</i>		December 31,
Intangibles		2018
Gross carrying amount	\$	1,804
Accumulated amortization		(628)
Core deposit intangible, net	\$	<u>1,176</u>

The following table sets forth, as of December 31, 2018, the total estimated future amortization of intangible assets:

<i>(Amounts in thousands)</i>		Amount
For the year ended December 31,		
2019	\$	225
2020		225
2021		225
2022		225
2023		225
2024 and thereafter		51
Total	\$	<u>1,176</u>

Goodwill is calculated as the amount of cash paid in excess of the fair value of the net assets acquired in the transaction. Goodwill is not amortized, but is annually reviewed for impairment. No impairment of goodwill was deemed necessary based on the 2018 annual review for impairment. For tax purposes, goodwill is being amortized over 15 years.

NOTE 10. OTHER ASSETS

Other assets consist of the following at December 31, 2018 and 2017.

<i>(Amounts in thousands)</i>		2018	2017
Federal Home Loan Bank of San Francisco stock	\$	5,892	\$ 4,537
Qualified Zone Academy Bonds		4,740	4,740
Interest receivable		4,609	4,462
Investments in affordable housing partnerships		3,020	3,529
Prepaid expenses		1,075	1,132
Investment in CRA fund		1,036	1,011
Loan servicing receivables		625	643
SBA payments in process		411	179
Investment in Bank of Commerce Holdings Trust II		310	310
Other		767	129
Total	\$	<u>22,485</u>	<u>\$ 20,672</u>

NOTE 11. INTEREST-BEARING DEPOSITS

The following table presents the major types of interest-bearing deposits at December 31, 2018 and 2017.

<i>(Amounts in thousands)</i>		As of December 31,	
Interest-bearing deposits		2018	2017
Demand - interest-bearing	\$	252,202	\$ 260,221
Money market accounts		265,093	236,769
Savings accounts		114,840	110,837
Certificates of deposit, less than \$250,000		96,510	130,681
Certificates of deposit, \$250,000 and over		55,872	58,574
Total interest-bearing deposits	\$	<u>784,517</u>	<u>\$ 797,082</u>

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The following table presents interest expense for the major types of interest-bearing deposits for the years ended December 31, 2018, 2017 and 2016.

(Amounts in thousands)

Deposit Interest Expense	For the year ended December 31,		
	2018	2017	2016
Demand - interest-bearing	\$ 414	\$ 274	\$ 201
Money market accounts	646	470	322
Savings accounts	288	200	174
Certificates of deposit, less than \$250,000	1,100	1,429	1,537
Certificates of deposit, \$250,000 and over	810	759	642
Total interest-bearing deposits	<u>\$ 3,258</u>	<u>\$ 3,132</u>	<u>\$ 2,876</u>

The following table presents the scheduled maturities of all certificates of deposit as of December 31, 2018.

(Amounts in thousands)

Amounts due in:	
2019	\$ 83,928
2020	28,912
2021	26,419
2022	9,676
2023	3,422
Thereafter	25
Total certificates of deposit	<u>\$ 152,382</u>

The following table presents the scheduled maturities of certificates of deposit of \$250 thousand or more as of December 31, 2018.

(Amounts in thousands)

Amounts due in:	
Three months or less	\$ 9,144
Over three months through six months	5,405
Over six months through twelve months	5,583
Over twelve months	35,740
Total certificates of deposit of \$250 thousand or more	<u>\$ 55,872</u>

NOTE 12. TERM DEBT

Term debt at December 31, 2018 and 2017 consisted of the following.

(Amounts in thousands)

	2018	2017
Senior debt	\$ 3,496	\$ 7,096
Unamortized debt issuance costs	(2)	(6)
Subordinated debt	10,000	10,000
Unamortized debt issuance costs	(89)	(132)
Net term debt	<u>\$ 13,405</u>	<u>\$ 16,958</u>

Future contractual maturities of term debt at December 31, 2018 are as follows.

(Amounts in thousands)	2019	2020	2021	2022	2023	Thereafter	Total
Senior debt	\$ 1,000	\$ 2,496	\$ —	\$ —	\$ —	\$ —	\$ 3,496
Subordinated debt	—	—	—	—	—	10,000	10,000
Total future maturities	<u>\$ 1,000</u>	<u>\$ 2,496</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 10,000</u>	<u>\$ 13,496</u>

Federal Home Loan Bank of San Francisco Borrowings

We have an available line of credit with the Federal Home Loan Bank of San Francisco of \$395.5 million subject to certain collateral requirements, namely the amount of pledged loans and investment securities. The line of credit is secured by an investment in Federal Home Loan Bank of San Francisco stock, certain real estate secured

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loans that have been specifically pledged to the Federal Home Loan Bank of San Francisco pursuant to collateral requirements, and certain pledged securities held in the Bank's investment securities portfolio.

The Bank had no borrowings outstanding under secured lines of credit from the Federal Home Loan Bank of San Francisco at December 31, 2018 and December 31, 2017. The average balance outstanding on Federal Home Loan Bank of San Francisco term advances during the year ended December 31, 2018 and year ended December 31, 2017 was \$22.5 million and \$302 thousand respectively. The maximum amount outstanding from the Federal Home Loan Bank of San Francisco at any month end during the year ended December 31, 2018 and year ended December 31, 2017 was \$70.0 million and \$10.0 million respectively.

As of December 31, 2018, the Bank was required to hold an investment in Federal Home Loan Bank of San Francisco stock of \$5.9 million recorded in Other Assets in the Consolidated Balance Sheets. Our investments in Federal Home Loan Bank of San Francisco stock are restricted investment securities, carried at cost, evaluated for impairment, and excluded from securities accounted for under ASC Topic 320 and ASC Topic 321.

We have pledged \$449.5 million of our commercial real estate and residential real estate loans as collateral for the line of credit with the Federal Home Loan Bank of San Francisco. As of December 31, 2018, we also pledged \$30.9 million in securities to the Federal Home Loan Bank of San Francisco.

Senior Debt

In December of 2015, the Holding Company entered into a senior debt loan agreement to borrow \$10.0 million from another financial institution. The original loan terms required monthly principal installments of \$83 thousand, plus accrued and unpaid interest, commencing on January 1, 2016, continuing to, and including December 10, 2020 and a final scheduled payment of \$5.0 million due on the maturity date of December 10, 2020. The loan may be prepaid in whole or in part at any time without any prepayment penalty. The principal amount of the loan bears interest at a variable rate, resetting monthly that is equal to the sum of the current three-month LIBOR plus 400 basis points. In December of 2015, the Holding Company incurred senior debt issuance costs of \$15 thousand, which are being amortized over the initial term of the loan as additional interest expense. The loan is secured by a pledge from the Holding Company of all of the outstanding stock of Redding Bank of Commerce.

Subordinated Debt

In December of 2015, the Holding Company issued \$10.0 million in aggregate principal amount of fixed to floating rate Subordinated Notes due in 2025. The Subordinated Debt initially bears interest at 6.88% per annum for a five-year term, payable semi-annually. Thereafter, interest on the Subordinated Debt will be paid at a variable rate equal to three month LIBOR plus 526 basis points, payable quarterly until the maturity date. In December of 2015, the Holding Company incurred subordinated debt issuance costs of \$210 thousand, which are being amortized over the initial five-year-term as additional interest expense.

The Subordinated Debt is subordinate and junior in right of payment to the prior payment in full of all existing and future claims of creditors and depositors of the Holding Company and its subsidiaries, whether now outstanding or subsequently created. The Subordinated Debt ranks equally with all other unsecured subordinated debt, except any which by its terms is expressly stated to be subordinated to the Subordinated Debt. The Subordinated Debt ranks senior to all preferred stock and common stock of the Holding Company and all future junior subordinated debt obligations. The Subordinated Debt is recorded as term debt on the Holding Company's balance sheet; however, for regulatory purposes, it is treated as Tier 2 capital by the Holding Company.

The Subordinated Debt will mature on December 10, 2025 but may be prepaid at the Holding Company's option and with regulatory approval at any time on or after five years after the Closing Date or at any time upon certain events, such as a change in the regulatory capital treatment of the Subordinated Debt or the interest on the Subordinated Debt is no longer deductible by the Holding Company for United States federal income tax purposes.

Federal Funds

We have entered into nonbinding federal funds line of credit agreements with three financial institutions to support short-term liquidity needs. The lines totaled \$35.0 million at December 31, 2018 and had interest rates ranging from 2.64% to 3.28%. Advances under the lines are subject to funds availability, continued borrower eligibility, and may have consecutive day usage restrictions. The credit arrangements are reviewed and renewed annually. At December 31, 2018 and 2017, we had no outstanding federal funds purchased balances and no outstanding advances on any of the Bank's lines of credit.

Federal Reserve Bank

We have an available line of credit with the Federal Reserve Bank totaling \$17.3 million subject to collateral requirements, namely the amount of certain pledged loans.

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NOTE 13. JUNIOR SUBORDINATED DEBENTURES

The Company has one wholly-owned trust formed in 2005 to issue trust preferred securities and related common securities. The following table presents information about the Trust as of December 31, 2018 and 2017.

(Amounts in thousands)

Trust Name	Issue Date	Issued Amount	Rate	Effective Rate	Maturity Date	Redemption Date
Bank of Commerce Holdings Trust II	July 29, 2005	\$ 10,310	Floating ⁽²⁾	⁽¹⁾	September 15, 2035	⁽³⁾

⁽¹⁾ Effective rate as of December 31, 2018 and 2017 of 4.37% and 3.17%, respectively.

⁽²⁾ Contractual interest rate of junior subordinated debentures based on three month LIBOR plus 1.58% adjusted quarterly.

⁽³⁾ Redeemable at the Company's option on any March 15, June 15, September 15, or December 15.

The \$10.3 million of junior subordinated debentures issued to Trust II as of December 31, 2018 and 2017, are reflected in the *Consolidated Balance Sheets*. The common stock issued by Trust II in the amount of \$310 thousand is recorded in *Other Assets* in the *Consolidated Balance Sheets*, at December 31, 2018 and 2017. All of the debentures issued to Trust II, less the common stock of Trust II, qualified as Tier 1 capital as of December 31, 2018 and 2017, under guidance issued by the Federal Reserve Board.

NOTE 14. OTHER LIABILITIES

Other liabilities consist of the following at December 31, 2018 and 2017.

(Amounts in thousands)

	2018	2017
Deferred compensation – directors fees	\$ 3,846	\$ 3,823
Salary continuation	3,462	3,387
Severance payable	760	790
Accrued employee incentives	1,522	1,170
Reserve for unfunded commitments	695	695
Dividend payable on common stock	651	486
Delayed equity contributions - affordable housing tax credit partnerships	343	361
Deferred income	283	315
Other loan servicing liabilities	188	235
Other	1,602	895
Total	<u>\$ 13,352</u>	<u>\$ 12,157</u>

NOTE 15. COMMITMENTS AND CONTINGENCIES

Lease Commitments – We lease nine sites under non-cancelable operating leases. The leases contain various provisions for increases in rental rates, based on predetermined escalation schedules. Substantially all of the leases include the option to extend the lease term one or more times following expiration of the initial term.

The following table sets forth rent expense and rent income for the years ended December 31, 2018 and 2017.

	December 31,		
(Amounts in thousands)	2018	2017	2016
Rent income ⁽¹⁾	\$ —	\$ 46	\$ 78
Rent expense	922	841	707
Net rent expense	<u>\$ 922</u>	<u>\$ 795</u>	<u>\$ 629</u>

⁽¹⁾ Rental income is derived from OREO properties

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The following table sets forth, as of December 31, 2018, the future minimum lease payments under non-cancelable operating leases

(Amounts in thousands)

Amounts due in:

2019	\$	866
2020		884
2021		899
2022		807
2023		335
Thereafter		1,032
Total	\$	4,823

Financial Instruments with Off-Balance Sheet Risk

Our consolidated financial statements do not reflect various commitments and contingent liabilities that arise in the normal course of our business and involve elements of credit, liquidity, and interest rate risk. In the normal course of business we are party to financial instruments with off-balance sheet credit risk to meet the financing needs of our customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. These instruments involve elements of credit and interest rate risk similar to the amounts recognized in the *Consolidated Balance Sheets*. The contract or notional amounts of these instruments reflect the extent of our involvement in particular classes of financial instruments.

The following table presents a summary of our commitments and contingent liabilities at December 31.

(Amounts in thousands)

	2018	2017
Commitments to extend credit	\$ 223,882	\$ 217,714
Standby letters of credit	8,548	6,692
Affordable housing grants	3,338	3,338
Total commitments and contingent liabilities	\$ 235,768	\$ 227,744

We were not required to perform on any financial guarantees for the years ended December 31, 2018 and 2017. At December 31, 2018, approximately \$8.4 million of standby letters of credit expire within one year, and \$118 thousand expire thereafter.

Affordable Housing Grants

In fulfilling our CRA responsibilities, we are a sponsor for various nonprofit organizations that receive cash grants from the Federal Home Loan Bank of San Francisco. Those grants require the nonprofit organization to comply with stipulated conditions of the grant over specified periods of time which typically vary from 10 to 15 years. If the nonprofit organization fails to comply, Federal Home Loan Bank of San Francisco can require us to refund the amount of the grant to Federal Home Loan Bank of San Francisco. To mitigate this contingent credit risk, Credit Administration underwrites the financial strength of the nonprofit organization and reviews their systems of internal control to determine, as best as possible, that they will not fail to comply with the conditions of the grant.

Reserve for Unfunded Commitments

The reserve for unfunded commitments, which is included in *Other Liabilities* on the *Consolidated Balance Sheets*, was \$695 thousand at December 31, 2018 and 2017. The adequacy of the reserve for unfunded commitments is reviewed on a quarterly basis, based upon changes in the amount of commitments, loss experience, and economic conditions. When necessary, the provision expense is recorded in other noninterest expense in the *Consolidated Statements of Income*.

Death Benefit Agreement

The Company has entered into agreements with certain employees to pay a cash benefit to designated beneficiaries following the death of the employee. The payment will be made only if, at the time of death, the deceased employee was employed by the Bank and the Bank owned a life insurance policy on the employee's life. Depending on specific facts and circumstances, the payment amount can vary up to a maximum of \$225 thousand per employee and may be taxable to the recipient. Neither the employee nor the designated recipient has a claim against the Bank's life insurance policy on the employee's life.

Legal Proceedings

We are involved in various pending and threatened legal actions arising in the ordinary course of business and if necessary, we maintain reserves for losses from legal actions, which are both probable and estimable. In our opinion, the disposition of claims currently pending will not have a material adverse effect on our financial position or results of operations.

Concentrations of Credit Risk

We grant many loans collateralized by real estate. In our judgment, a concentration exists in real estate related loans, which represented approximately 81% and 77% of our gross loan portfolio at December 31, 2018 and December 31, 2017, respectively. We underwrite real estate loans in accordance with loan policies that set underwriting criteria, including property types, loan-to-value limits and minimum debt service coverage ratios. We employ a variety of real estate concentration risk management tools including monitoring of limits on concentration levels, limits by property type and geography, annual property reviews including site visits and portfolio stress testing.

Although we believe such concentrations have no more than the normal risk of collectability, a substantial decline in the economy in general, material increases in interest rates, changes in tax policies, tightening credit or refinancing markets, or a decline in real estate values in our principal market areas in particular, could have an

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adverse impact on the repayment of these loans. Business and personal incomes, cash flows from rental operations, proceeds from the sale of real property, or proceeds from refinancing, represent the primary sources of repayment for a majority of these loans.

We recognize the credit risks inherent in dealing with other depository institutions. Accordingly, to prevent excessive exposure to other depository institutions in aggregate or individually, we have established general standards for selecting correspondent banks as well as internal limits for allowable exposure to other depository institutions in aggregate or individually. In addition, we have an investment policy that sets forth limitations that apply to all investments with respect to credit rating and concentrations with an issuer.

NOTE 16. EMPLOYEE BENEFITS AND RETIREMENT PLANS

Profit sharing plan – In 1985, we adopted a profit sharing 401(k) plan for eligible employees to be funded out of the earnings of the Company. The employees' contributions are limited to the maximum amount allowable under IRS Section 402(G). The Company's contributions include a matching contribution of 100% of the first 3% of salary deferred and 50% of the next 2% of salary deferred. Discretionary contributions are also permitted. We made matching contributions aggregating \$549 thousand, \$494 thousand, and \$457 thousand for the years ended December 31, 2018, 2017 and 2016, respectively. No discretionary contributions were made over the three year reporting period.

Salary continuation plan – In April of 2001, the Board of Directors approved the implementation of the Supplemental Executive Retirement Plan (SERP), which is a non-qualified executive benefit plan under which we agree to pay certain executives covered by the SERP plan additional benefits in the future in return for continued satisfactory performance.

Benefits under the salary continuation plan differ by participating executive and include a benefit generally payable commencing upon a designated retirement date for a fixed period of ten years, disability or termination of employment, and a death benefit for the participants' designated beneficiaries. Whole life insurance policies were purchased as an investment to provide for our contractual obligation to pay pre-retirement death benefits and to recover our cost of providing benefits. The executive is the insured under the policy, while we are the owner and beneficiary.

The Company accrues for these future benefits from the effective date of the agreements until the executives' expected final payment date. The amount of accrued benefits approximates the present value of the benefits expected to be provided at retirement. Compensation expense under the salary continuation plan totaled \$532 thousand, \$577 thousand, and \$551 thousand for the years ended December 31, 2018, 2017 and 2016, respectively. As of December 31, 2018, and 2017, the vested benefit payable was \$3.5 million and \$3.4 million, respectively. We use the FTSE Pension Liability Index as a guideline to establish the discount rate used to present value the benefits under the salary continuation plan.

Directors deferred fee compensation – On December 19, 2013, the Board of Directors adopted a Directors Deferred Compensation Plan, which was amended and restated on February 20, 2018, (the "2013 Plan") to replace the Directors Deferred Compensation Plan dated January 1, 1993 as amended (the "1993 Plan"). Both plans allow the eligible Director to voluntarily elect to defer some or all of his or her current fees in exchange for the Company's promise to pay a deferred benefit. The deferred fees are credited with interest and the accrued liability is paid to the Director at retirement. Directors must stop the deferral of compensation once their total deferred benefit reaches \$500 thousand.

The interest rate in the 2013 Plan is equal to the Bloomberg 20-year Investment Grade Financial Institutions Index (IGFII) rate (or a similar reference rate we select if that rate is not published) in effect on the interest accrual date, plus two percent. The 2013 Plan is only available to independent directors and, as a nonqualified deferred compensation plan, is not subject to nondiscrimination requirements applicable to qualified plans. No deferred compensation is payable to a director until separation from service, whereupon all such compensation, together with interest thereon shall be provided to such Director, or his beneficiary within thirty (30) days. The Director may designate payments to be made in a lump sum or in monthly installments over a period not to exceed 120 months.

Although deferrals under the 1993 Plan have ceased, the 1993 Plan remains in effect for all amounts previously deferred in the plan. Under the 1993 Plan, at retirement, Directors are granted the option of continuing to accrue interest on deferred payments at a variable rate of Wall Street Journal prime plus 3.00% or at a fixed rate of 10%. The Director may designate payments to be made in a lump sum or in monthly installments over a period not to exceed 180 months.

Deferred compensation expense recorded in other noninterest expense totaled \$309 thousand, \$292 thousand, and \$281 thousand for the years ended December 31, 2018, 2017, and 2016, respectively. As of December 31, 2018, and 2017, the vested benefit payable recorded in *Other Liabilities* in the *Consolidated Balance Sheets* was \$3.8 million.

NOTE 17. SHAREHOLDERS' EQUITY AND STOCK PLANS

On January 31, 2019 we issued 1,834,142 shares of common stock, and paid \$15.3 million in cash as part of our acquisition of Merchants Holding Company ("Merchants"). Merchants shareholders now hold, in the aggregate, approximately 10% of our outstanding common stock. The acquisition added \$85.3 million in loans, \$190.2 million in deposits and \$107.4 million in investment securities after fair value adjustments to our bank as of January 31, 2019. See Note 23 *Acquisition* in these *Notes to Consolidated Financial Statements* for additional information on the acquisition.

On May 10, 2017, we completed the sale of 2,738,096 shares of our common stock at a public offering price of \$10.50 and received net proceeds of \$26.8 million. These proceeds were used to fund our acquisition of Merchants Holding Company and to repay certain borrowings.

Stock Plans – The 2008 Stock Option Plan was approved by the Holding Company's shareholders on May 15, 2007 ("the Plan"). The Plan was amended and restated by the 2010 Equity Incentive Plan which was approved by the Holding Company's shareholders on May 18, 2010. A further amendment and restatement of the Plan was approved by the Holding Company's shareholders on May 15, 2012. The Plan provides for equity awards including stock options, restricted stock and restricted stock units which may constitute incentive stock options ("ISO") under Section 422(a) of the Internal Revenue Code of 1986, as amended, or non-statutory stock options ("NSO") to key personnel of the Company, including Directors. The Plan provides that ISO and NSO under the Plan may not be granted at less than 100% of fair market value of the Holding Company's common stock on the date of the grant. Vesting may be accelerated in case of an option holder's death, disability, and retirement or in case of a change of control. At December 31, 2018, approximately 152 thousand common shares were available for future grants under the Plan.

We recognized \$46 thousand in tax benefits from vesting of restricted stock and \$216 thousand in proceeds from stock options exercised during the year ended December 31, 2018. Proceeds from stock options exercised were \$245 thousand and \$10 thousand for the years ended December 31, 2017 and 2016, respectively.

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Stock Option Activity

There were no new stock options awarded during the three years ended December 31, 2018. The following tables summarize information about stock option activity for the years ended December 31, 2018, 2017 and 2016.

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term
Options outstanding December 31, 2016	188,900	\$ 5.08	\$ 834,625	5.66
Exercised	(51,900)	\$ 4.73	\$ 245,450	4.42
Forfeited	(2,500)	\$ 4.05	n/a	n/a
Options outstanding December 31, 2017	134,500	\$ 5.24	\$ 704,350	4.76
Exercised	(37,100)	\$ 5.82	\$ 215,685	2.96
Forfeited	—	\$ —	n/a	n/a
Options outstanding December 31, 2018	<u>97,400</u>	\$ 5.02	\$ 488,665	4.11
Exercisable at December 31, 2018	93,400	\$ 4.98	\$ 465,345	4.03

	For the Years Ended December 31,		
	2018	2017	2016
(Amounts in thousands, except per share information)			
Stock option expense	\$ 8	\$ 23	\$ 24

	At December 31,		
	2018	2017	2016
Unrecognized compensation costs related to non-vested stock option payments	\$ —	\$ 17	\$ 29
Number of exercisable shares	93	119	157

Stock options vest at 20% per year from the date of the grant. The unrecognized compensation costs are expected to be recognized over a weighted average period of two years.

Restricted Stock Activity

The following tables summarize information about unvested restricted shares and restricted shares granted for the years ended December 31, 2018, 2017 and 2016.

	Number of Shares	Weighted Average Grant Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term
Unvested restricted shares December 31, 2016	67,180	\$ 5.84	\$ 638,210	1.38
Granted	45,070	\$ 10.35	\$ 466,328	1.32
Vested	(37,761)	\$ 5.79	\$ 218,600	n/a
Unvested restricted shares December 31, 2017	<u>74,489</u>	\$ 8.60	\$ 640,255	1.03
Granted	29,913	\$ 11.50	\$ 344,000	1.07
Vested	(37,634)	\$ 7.53	\$ 283,433	n/a
Unvested restricted shares December 31, 2018	<u>66,768</u>	\$ 10.50	\$ 700,820	0.97

	For the Years Ended December 31,		
	2018	2017	2016
(Amounts in thousands, except per share information)			
Restricted stock compensation expense	\$ 185	\$ 196	\$ 215
Restricted stock awards weighted average grant date fair value per share	\$ 11.50	\$ 10.35	\$ 5.74

	At December 31,		
	2018	2017	2016
Unrecognized compensation costs related to non-vested restricted stock payments	\$ 470	\$ 414	\$ 205

Restricted shares vest over a three to five year service period. Unvested restricted shares have no dividend or voting rights. The unrecognized compensation costs are expected to be recognized over a weighted average period of two years.

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Stock Grant Activity

The following tables summarize information about shares granted as employee compensation for the years ended December 31, 2018 and 2017.

	Number of Shares	Weighted Average Grant Price	Stock Grant Compensation Expense
Shares granted during the year ended December 31, 2018	4,653	\$ 11.50	\$ 53,510
Shares granted during the year ended December 31, 2017	4,868	\$ 10.05	\$ 48,923

Dividends

Presented below is a summary of cash dividends paid to common shareholders, recorded as a reduction of retained earnings. The holders of unvested restricted stock awards are not entitled to dividends on unvested shares. On December 19, 2018, we declared a cash dividend of \$0.04 per share, payable on January 11, 2019 to shareholders of record at the close of business on January 2, 2019.

	For the Years Ended December 31,		
(Amounts in thousands, except per share information)	2018	2017	2016
Cash dividends paid to common shareholders	\$ 2,274	\$ 1,776	\$ 1,603
Cash dividends paid per common share	\$ 0.14	\$ 0.12	\$ 0.12

NOTE 18. REGULATORY CAPITAL

The Holding Company and the Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that if undertaken, could have a direct material effect on our Consolidated Financial Statements.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices.

On July 2, 2013, the federal banking agencies substantially amended the regulatory risk-based capital rules applicable to the Holding Company and the Bank. Effective January 1, 2015 the new rules created “Common equity tier 1,” a new measure of regulatory capital closer to pure tangible common equity than the present Tier 1 definition; The required minimum risk-based capital ratio for Common equity tier 1 is 4.5 percent and with a 2.5 percent capital conservation buffer. The capital conservation buffer of 2.5 percent was phased in between 2016 and 2019.

The new capital rules required the Bank to meet the capital conservation buffer requirement by 2019 in order to avoid constraints on capital distributions, such as dividends and equity repurchases, and certain bonus compensation for executive officers. These new capital rules also change the risk-weights of certain assets for purposes of the risk-based capital ratios and phase out certain instruments as qualifying capital.

The capital amounts and the Bank’s prompt corrective action classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies. Quantitative measures established by regulation to ensure capital adequacy, require the Company and the Bank to maintain minimum amounts and ratios set forth in the following table as defined in the regulations. Management believes as of December 31, 2018 that the Company and the Bank met all capital adequacy requirements to which they are subject.

The Crapo Bill, signed into law in May 2018, simplifies the regulatory capital rules for financial institutions and their holding companies with total consolidated assets of less than \$10 billion and instructed the federal banking regulators to establish a single “Community Bank Leverage Ratio” of between 8% and 10%. On November 21, 2018, the FDIC published a proposed Community Bank Leverage Ratio of 9%. Any qualifying depository institution or its holding company that exceeds the Community Bank Leverage Ratio will be considered to have met generally applicable leverage and risk-based regulatory capital requirements and considered to be “well capitalized” under the prompt corrective action rules discussed above. It is difficult at this time to predict when or how the new standards under the Crapo Bill will ultimately be applied to us or what specific impact the Crapo Bill (and any implementing rules and regulations) will have on community banks.

As of December 31, 2018, the most recent notification from the FDIC categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized”, an institution must maintain minimum ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank’s capital rating category.

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The Holding Company's and the Bank's actual capital amounts and ratios as of December 31, 2018 and 2017 are presented in the following table.

	Capital		Actual Ratio	Well Capitalized Requirement		Minimum Capital Requirement		Applicable Capital Conservation		Minimum Capital Ratio plus Capital Conservation Buffer			
(Amounts in thousands)	Amount			Amount	Ratio	Amount	Ratio	Buffer	Amount	Ratio			
At December 31, 2018:													
Company													
Common equity tier 1 capital ratio	\$	139,488	12.79 %	n/a	n/a	\$	49,072	4.50 %	1.875 %	\$	69,519	6.375 %	
Tier 1 capital ratio	\$	149,488	13.71 %	n/a	n/a	\$	65,429	6.00 %	1.875 %	\$	85,876	7.875 %	
Total capital ratio	\$	172,475	15.82 %	n/a	n/a	\$	87,239	8.00 %	1.875 %	\$	107,686	9.875 %	
Tier 1 leverage ratio	\$	149,488	11.21 %	n/a	n/a	\$	53,079	4.00 %	n/a	\$	53,079	4.00 %	
Bank													
Common equity tier 1 capital ratio	\$	144,245	13.23 %	\$	70,856	6.50 %	\$	49,054	4.50 %	1.875 %	\$	69,493	6.375 %
Tier 1 capital ratio	\$	144,245	13.23 %	\$	87,207	8.00 %	\$	65,405	6.00 %	1.875 %	\$	85,844	7.875 %
Total capital ratio	\$	157,232	14.42 %	\$	109,009	10.00 %	\$	87,207	8.00 %	1.875 %	\$	107,646	9.875 %
Tier 1 leverage ratio	\$	144,245	10.81 %	\$	66,712	5.00 %	\$	53,369	4.00 %	n/a	\$	53,369	4.00 %
At December 31, 2017:													
Company													
Common equity tier 1 capital ratio	\$	125,745	12.26 %	n/a	n/a	\$	46,169	4.50 %	1.25 %	\$	58,994	5.750 %	
Tier 1 capital ratio	\$	135,745	13.23 %	n/a	n/a	\$	61,559	6.00 %	1.25 %	\$	74,384	7.250 %	
Total capital ratio	\$	158,365	15.44 %	n/a	n/a	\$	82,079	8.00 %	1.25 %	\$	94,903	9.250 %	
Tier 1 leverage ratio	\$	135,745	10.86 %	n/a	n/a	\$	50,008	4.00 %	n/a	\$	50,008	4.00 %	
Bank													
Common equity tier 1 capital ratio	\$	129,139	12.58 %	\$	66,703	6.50 %	\$	46,179	4.50 %	1.25 %	\$	59,006	5.750 %
Tier 1 capital ratio	\$	129,139	12.58 %	\$	82,096	8.00 %	\$	61,572	6.00 %	1.25 %	\$	74,399	7.250 %
Total capital ratio	\$	141,760	13.81 %	\$	102,620	10.00 %	\$	82,096	8.00 %	1.25 %	\$	94,923	9.250 %
Tier 1 leverage ratio	\$	129,139	10.33 %	\$	62,486	5.00 %	\$	49,989	4.00 %	n/a	\$	49,989	4.00 %

Our principal source of cash is dividends received from the Bank, which are subject to government regulation and limitations on the Bank's ability to pay dividends. We also have trust preferred securities, senior debt and subordinated debt agreements with provisions that may impact our ability to pay dividends on our common stock to our common shareholders.

NOTE 19. DERIVATIVES

During March of 2016, we paid off a \$75.0 million Federal Home Loan Bank of San Francisco borrowing (the "hedged instrument") and terminated all of our interest rate swaps (active and forward starting). Prior to the time of termination, a \$2.3 million unrealized pretax loss on swaps was carried in *Other Liabilities* in our *Consolidated Balance Sheets*. At termination, we immediately reclassified the loss to noninterest expense.

For derivative financial instruments accounted for as hedging instruments, we formally designate and document, at inception, the financial instrument as a hedge of a specific underlying exposure, the risk management objective, and the manner in which the effectiveness of the hedge will be assessed. We formally assess both at inception and at each reporting period thereafter, whether the derivative financial instruments used in hedging transactions are effective in offsetting changes in cash flows of the related underlying exposures. Any ineffective portion of the changes in cash flow of the instruments is recognized immediately into earnings.

ASC 815-10, *Derivatives and Hedging* ("ASC 815") requires companies to recognize all derivative instruments as assets or liabilities at fair value in the Consolidated Balance Sheets. In accordance with ASC 815, we designated our interest rate swaps as cash flow hedges of certain active and forecasted variable rate Federal Home Loan Bank of San Francisco advances. Changes in the fair value of the hedging instrument, except any ineffective portion, were recorded in accumulated other comprehensive income (loss) until earnings were impacted by the hedged instrument. No components of our hedging instruments were excluded from the assessment of hedge effectiveness in hedging exposure to variability in cash flows.

Classification of the gain or loss in the *Consolidated Statements of Income* upon release from accumulated other comprehensive income (loss) is the same as that of the underlying exposure. We discontinue the use of hedge accounting prospectively when (1) the derivative instrument is no longer effective in offsetting changes in fair value or cash flows of the underlying hedged item; (2) the derivative instrument expires, is sold, terminated, or exercised; or (3) designating the derivative instrument as a hedge is no longer appropriate. When we discontinue hedge accounting because it is no longer probable that an anticipated transaction will occur in the originally expected period, or within an additional two-month period thereafter, changes to fair value that were recorded in accumulated other comprehensive loss are recognized immediately in earnings.

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The following table summarizes the losses recorded during the years ended December 31, 2016 and their locations within the *Consolidated Statements of Income*.

(Amounts in thousands)

Description	Consolidated Statement of Operations	2016
Interest rate swap ⁽¹⁾	Interest on term debt	\$ 396
Forward starting interest rate swap - terminated ⁽²⁾	Other noninterest expense	2,325
Total		<u>\$ 2,721</u>

⁽¹⁾ Losses represent tax effected amounts reclassified from accumulated other comprehensive loss pertaining to net settlement recorded during the period on active interest rate swaps.

⁽²⁾ Losses represent tax effected amounts reclassified from accumulated other comprehensive loss pertaining to the terminated active and forward starting interest rate swaps.

The losses on all derivative instruments (active and forward starting interest rate swaps) designated as cash flow hedges recorded in accumulated other comprehensive loss and reclassified into earnings during the year ended December 31, 2016 was \$1.6 million, net of tax.

NOTE 20. FAIR VALUES

The following table presents estimated fair values of our financial instruments as of December 31, 2018 and 2017, whether or not recognized or recorded at fair value in the Consolidated Balance Sheets. The table indicates the fair value hierarchy of the valuation techniques we utilized to determine such fair value. Non-financial assets and non-financial liabilities defined by the FASB ASC 820, Fair Value Measurement, such as Bank premises and equipment, deferred taxes and other liabilities are excluded from the table. In addition, we have not disclosed the fair value of financial instruments specifically excluded from disclosure requirements of FASB ASC 825, Financial Instruments, such as bank-owned life insurance policies. The prior period fair values for loans disclosed are not determined in a manner consistent with the current period fair values disclosed because of a change in the methodology due to the adoption of ASU 2016-01 as described in Note 2 *Summary of Significant Accounting Policies* in these Notes to Consolidated Financial Statements.

(Amounts in thousands)

(Amounts in thousands)		Carrying Amounts	Fair Value Measurements Using					
December 31, 2018			Level 1	Level 2	Level 3			
Financial assets								
Cash and cash equivalents	\$	47,365	\$	47,365	\$	—	\$	—
Securities available-for-sale	\$	256,928	\$	—	\$	256,928	\$	—
Net loans	\$	935,886	\$	—	\$	—	\$	936,697
Federal Home Loan Bank of San Francisco stock	\$	5,892	\$	5,892	\$	—	\$	—
Financial liabilities								
Deposits	\$	1,131,716	\$	—	\$	1,129,795	\$	—
Term Debt	\$	13,405	\$	—	\$	13,323	\$	—
Junior subordinated debenture	\$	10,310	\$	—	\$	14,183	\$	—

(Amounts in thousands)

(Amounts in thousands)		Carrying Amounts	Fair Value Measurements Using			
December 31, 2017			Level 1	Level 2	Level 3	
Financial assets						
Cash and cash equivalents	\$	66,970	\$	66,970	\$	—
Securities available-for-sale	\$	266,943	\$	—	\$	266,943
Net loans	\$	869,620	\$	—	\$	—
Federal Home Loan Bank of San Francisco stock	\$	4,536	\$	4,536	\$	—
Financial liabilities						
Deposits	\$	1,102,732	\$	—	\$	1,101,523
Term Debt	\$	16,958	\$	—	\$	16,918
Junior subordinated debenture	\$	10,310	\$	—	\$	10,206

Fair Value Hierarchy

Level 1 valuations utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that we have the ability to access.

Level 2 valuations utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 valuations include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3

Valuations are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect estimates of assumptions

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that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety.

We maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The following tables present information about our assets and liabilities measured at fair value on a recurring basis, and indicate the fair value hierarchy of the valuation techniques we utilized to determine such fair value, as of December 31, 2018 and December 31, 2017.

(Amounts in thousands)

Recurring Basis	Fair Value at December 31, 2018			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities				
U.S. government and agencies	\$ 40,087	\$ —	\$ 40,087	\$ —
Obligations of states and political subdivisions	50,530	—	50,530	—
Residential mortgage-backed securities and collateralized mortgage obligations	138,503	—	138,503	—
Corporate securities	2,922	—	2,922	—
Commercial mortgage-backed securities	24,762	—	24,762	—
Other investment securities	124	—	124	—
Total assets measured at fair value	<u>\$ 256,928</u>	<u>\$ —</u>	<u>\$ 256,928</u>	<u>\$ —</u>

(Amounts in thousands)

Recurring Basis	Fair Value at December 31, 2017			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities				
U.S. government and agencies	\$ 40,369	\$ —	\$ 40,369	\$ —
Obligations of states and political subdivisions	78,844	—	78,844	—
Residential mortgage-backed securities and collateralized mortgage obligations	114,592	—	114,592	—
Corporate securities	4,992	—	4,992	—
Commercial mortgage-backed securities	26,641	—	26,641	—
Other investment securities	1,505	—	1,505	—
Total assets measured at fair value	<u>\$ 266,943</u>	<u>\$ —</u>	<u>\$ 266,943</u>	<u>\$ —</u>

Recurring Items

Debt Securities – The available-for-sale securities amount in the recurring fair value table above represents securities that have been adjusted to their fair values. For these securities, we obtain fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions among other things. We have determined that the source of these fair values falls within Level 2 of the fair value hierarchy.

Transfers Between Fair Value Hierarchy Levels

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer. There were no transfers between levels of the fair value hierarchy during the years ended December 31, 2018 or 2017.

Assets and Liabilities 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. These adjustments to fair value generally result from the application of lower of cost or fair value accounting or write-downs of individual assets due to impairment. The following tables present information about our assets and liabilities at December 31, 2018 and December 31, 2017 measured at fair value on a nonrecurring basis for which a nonrecurring change in fair value has been recorded during the reporting period.

The amounts disclosed below present the fair values at the time the nonrecurring fair value measurements were made, and not necessarily the fair values as of the date reported upon.

(Amounts in thousands)

Nonrecurring basis	Fair Value at December 31, 2018			
	Total	Level 1	Level 2	Level 3
Other real estate owned	\$ 31	\$ —	\$ —	\$ 31
Total assets measured at fair value	<u>\$ 31</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 31</u>

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(Amounts in thousands)

	Fair Value at December 31, 2017			
	Total	Level 1	Level 2	Level 3
Nonrecurring basis				
Collateral dependent impaired loans	\$ 60	\$ —	\$ —	\$ 60
Other real estate owned	35	—	—	35
Total assets measured at fair value	\$ 95	\$ —	\$ —	\$ 95

The following table presents the losses resulting from nonrecurring fair value adjustments for the years ended December 31, 2018, 2017 and 2016 related to assets outstanding at December 31, 2018, 2017, and 2016.

(Amounts in thousands)

	December 31,		
	2018	2017	2016
Fair value adjustments			
Collateral dependent impaired loans	\$ —	\$ 20	\$ 1,183
Other real estate owned	21	38	77
Total	\$ 21	\$ 58	\$ 1,260

For the year ended December 31, 2018, one property is included in the OREO balance with an aggregate carrying value of \$52 thousand that was written down to fair value of \$31 thousand, resulting in a \$21 thousand adjustment to ALLL.

The loan amounts above represent impaired, collateral dependent loans that have been adjusted to fair value during the respective reporting period. When we identify a collateral dependent loan as impaired, we measure the impairment using the current fair value of the collateral, less selling costs. Depending on the characteristics of a loan, the fair value of collateral is generally estimated by obtaining external appraisals. If we determine that the value of the impaired loan is less than the recorded investment in the loan, we recognize this impairment and adjust the carrying value of the loan to fair value through the ALLL.

The OREO amount above represents impaired real estate that has been adjusted to fair value during the respective reporting period. The loss represents impairments on OREO for fair value adjustments based on the fair value of the real estate. The determination of fair value is based on recent appraisals of the foreclosed properties, which take into account recent sales prices adjusted for unobservable inputs, such as opinions provided by local real estate brokers and other real estate experts. OREO fair values are adjusted for estimated selling costs that are based off the adjusted fair value are 42% for the remaining properties in OREO. We record OREO as a nonrecurring Level 3 fair value.

Limitations

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

Fair value estimates are based on current on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

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NOTE 21. INCOME TAXES

The following table presents components of income tax expense included in the *Consolidated Statements of Income* for each of the past three years.

<i>(Amounts in thousands)</i>	Current	Deferred	Total
Year ended December 31, 2018:			
Federal	\$ 773	\$ 292	\$ 1,065
State	1,733	303	2,036
Affordable housing partnership amortization	528	—	528
	<u>\$ 3,034</u>	<u>\$ 595</u>	<u>\$ 3,629</u>
Year ended December 31, 2017:			
Federal	\$ 2,005	\$ 2,837	\$ 4,842
State	1,474	(76)	1,398
Affordable housing partnership amortization	688	—	688
	<u>\$ 4,167</u>	<u>\$ 2,761</u>	<u>\$ 6,928</u>
Year ended December 31, 2016:			
Federal	\$ 283	\$ 409	\$ 692
State	582	86	668
Affordable housing partnership amortization	598	—	598
Total	<u>\$ 1,463</u>	<u>\$ 495</u>	<u>\$ 1,958</u>

Our effective tax rate is calculated as our provision for income taxes divided by income before provision for income taxes. Income tax expense attributable to income before income taxes differed from the amounts computed by applying the U.S. federal income tax rate of 21% for 2018 and 34% for 2017 and 2016 to income before income taxes.

The following table presents a reconciliation of income taxes computed at the federal statutory rate to the actual effective rate for the years ended December 31, 2018, 2017, and 2016.

	2018	2017	2016
Income tax at the federal statutory rate	21.0 %	34.0 %	34.0 %
Deferred tax asset write-down	— %	17.5 %	5.0 %
State franchise tax, net of federal tax benefit	8.3 %	6.5 %	6.1 %
Amortization of affordable housing credit partnerships	2.7 %	4.8 %	8.1 %
Officer life insurance	(0.6) %	(2.5) %	(2.9) %
Tax-exempt interest	(1.8) %	(5.2) %	(10.9) %
Affordable housing credits and benefits	(3.8) %	(5.7) %	(11.7) %
Accelerated depreciation - cost segregation study	(2.5) %	— %	— %
Reversal of uncertain tax position	(5.1) %	— %	— %
Other	0.5 %	(0.8) %	(0.7) %
Effective Tax Rate	<u>18.7 %</u>	<u>48.5 %</u>	<u>27.1 %</u>

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The following table reflects the effects of temporary differences that give rise to the components of the net deferred tax asset as of December 31, 2018 and 2017.

<i>(Amounts in thousands)</i>	2018	2017
Deferred tax assets:		
Allowance for loan and lease losses	\$ 3,634	\$ 3,526
Deferred compensation plan and salary continuation plan	2,385	2,365
State franchise tax	474	291
Acquisition costs	274	274
Net unrealized loss on securities available-for-sale	1,262	134
Interest received on non-accrual loans	86	105
Other	403	484
Total deferred tax assets	8,518	7,179
Deferred tax liabilities:		
Deferred loan origination costs and fees	(579)	(619)
Basis difference in fixed assets	(874)	—
Other	(26)	(55)
Total deferred tax liabilities	(1,479)	(674)
Net deferred tax asset	\$ 7,039	\$ 6,505

We are not required to establish a valuation allowance for the deferred tax assets as management believes it is more likely than not that the deferred tax assets of \$8.5 million and \$7.2 million at December 31, 2018 and 2017, respectively will be realized principally through future reversals of existing taxable temporary differences. We further believe that future taxable income will be sufficient to realize the benefits of temporary deductible differences that cannot be realized through the reversal of future temporary taxable differences.

We have investments in Qualified Zone Academy Bonds ("QZAB") of \$4.7 million at December 31, 2018 and 2017 recorded in *Other Assets* in the *Consolidated Balance Sheets*. We also have investments in QZAB of \$1.0 million at December 31, 2018 and 2017 recorded in *Securities available-for-sale* in the *Consolidated Balance Sheets*. The investments provide funds for capital improvements at local schools and are repaid at maturity in 2031, 2033 and 2046. In exchange for the investment we receive a federal tax credit at a rate determined at the settlement of the investment by the US Treasury. We account for the benefit for these tax credit investments using the deferred cost reduction method.

For the years ended December 31, 2018 and 2017, we expect to carryforward a California capital loss in the amount of \$53 thousand which will expire in 2020.

See Note 22 *Qualified Affordable Housing Partnership Investments* in these *Notes to Consolidated Financial Statements*, for further details on our affordable housing project investments.

We have no unrecognized tax benefits at December 31, 2018 compared to \$988 thousand at December 31, 2017.

We file income tax returns in the U.S. federal jurisdiction, and the State of California. Income tax returns filed are subject to examination by the U.S. federal, state, and local income tax authorities. While no income tax returns are currently being examined, we are no longer subject to tax examination by tax authorities for years prior to fiscal year 2015 for federal tax returns and fiscal year 2014 for state and local tax returns.

During 2018 we completed a cost segregation study and a tangible property review, to shorten the depreciable lives of certain assets and accelerate the tax depreciation deduction on our 2017 federal income tax return. As a result, we recorded a benefit to our 2018 book provision for income taxes of \$484 thousand.

In September of 2016, we filed amended federal and state tax returns for tax years 2011, 2012, 2013, and 2014. The amendments were filed to properly recognize tax events in years 2011 and 2013 that were improperly recognized in years 2011 through 2014. The IRS rejected the 2011 amended tax return citing the statute for assessment had expired. Accordingly, \$988 thousand of taxes due to the taxing authorities pursuant to the 2011 amended federal tax return was returned to us. The statute of limitations on the 2014 amended federal tax return passed in 2018 and we reversed our uncertain tax position and recognized the \$988 thousand benefit in our provision for income taxes.

The following table presents our uncertain tax position at December 31, 2018 and 2017.

<i>(Amounts in thousands)</i>	2018	2017
Balance, beginning of period	\$ 988	\$ 988
Tax positions resolved during the year	(988)	—
Balance, end of period	\$ —	\$ 988

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE 22. QUALIFIED AFFORDABLE HOUSING PARTNERSHIP INVESTMENTS

Our investments in Qualified Affordable Housing Partnerships that generate Low Income Housing Tax Credits (“LIHTC”) and deductible operating losses totaled \$3.0 million at December 31, 2018. These investments are recorded in *Other Assets* with a corresponding funding obligation of \$343 thousand recorded in *Other Liabilities* in our *Consolidated Balance Sheets*. We have invested in four separate LIHTC partnerships, which provide the Company with CRA credit. Additionally, the investments in LIHTC partnerships provide us with tax credits and with operating loss tax benefits over an approximately 18-year period. None of the original investments will be repaid. The tax credits and the operating loss tax benefits that are generated by each of the properties are expected to exceed the total value of the investments we made and provide returns on the investments of between 3% and 5% over the life of the investment. The investments in LIHTC partnerships are being accounted for using the proportional amortization method, under which we amortize the initial cost of an investment in proportion to the amount of the tax credits and other tax benefits received, and recognize the net investment performance in the *Consolidated Statements of Income* as a component of income tax expense.

The following table presents our original investment in LIHTC partnerships, the current recorded investment balance, and the unfunded liability balance of each investment at December 31, 2018 and 2017. In addition, the table reflects the tax credits and tax benefits, amortization of the investment and the net impact to our income tax provision for the years ended December 31, 2018 and 2017.

	At December 31, 2018			For the year ended December 31, 2018		
	Original Investment Value	Current Recorded Investment	Unfunded Liability Obligation	Tax Credits and Benefits	Amortization of Investments	Net Income Tax Benefit
<i>(Amounts in thousands)</i>						
Qualified Affordable Housing Partnerships						
Raymond James California Housing Opportunities Fund II	\$ 2,000	\$ 1,022	\$ 28	\$ 200	\$ 179	\$ 21
WNC Institutional Tax Credit Fund 38, L.P.	1,000	489	—	126	100	26
Merritt Community Capital Corporation Fund XV, L.P.	2,500	1,270	315	226	206	20
California Affordable Housing Fund	2,454	239	—	31	43	(12)
Total	\$ 7,954	\$ 3,020	\$ 343	\$ 583	\$ 528	\$ 55

	At December 31, 2017			For the year ended December 31, 2017		
	Original Investment Value	Current Recorded Investment	Unfunded Liability Obligation	Tax Credits and Benefits	Amortization of Investments	Net Income Tax Benefit
<i>(Amounts in thousands)</i>						
Qualified Affordable Housing Partnerships						
Raymond James California Housing Opportunities Fund II	\$ 2,000	\$ 1,182	\$ 20	\$ 227	\$ 179	\$ 48
WNC Institutional Tax Credit Fund 38, L.P.	1,000	589	—	131	108	23
Merritt Community Capital Corporation Fund XV, L.P.	2,500	1,476	341	252	237	15
California Affordable Housing Fund	2,454	282	—	171	164	7
Total	\$ 7,954	\$ 3,529	\$ 361	\$ 781	\$ 688	\$ 93

The following table presents our generated tax credits and tax benefits from investments in qualified affordable housing partnerships for the years ended December 31, 2018, 2017 and 2016.

	For the Years Ended December 31,					
	2018		2017		2016	
	Generated Tax Credits	Tax Benefits from Taxable Losses	Generated Tax Credits	Tax Benefits from Taxable Losses	Generated Tax Credits	Tax Benefits from Taxable Losses
<i>(Amounts in thousands)</i>						
Qualified Affordable Housing Partnerships						
Raymond James California Housing Opportunities Fund II	\$ 170	\$ 30	\$ 176	\$ 51	\$ 184	\$ 54
WNC Institutional Tax Credit Fund 38, L.P.	111	15	114	17	107	36
Merritt Community Capital Corporation Fund XV, L.P.	192	34	200	52	206	60
California Affordable Housing Fund	5	26	126	45	158	47
Total	\$ 478	\$ 105	\$ 616	\$ 165	\$ 655	\$ 197

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Notes to Consolidated Financial Statements

Our generated tax credits and benefits were partially offset by the amortization of the principal investment balances of \$528 thousand, \$688 thousand and \$598 thousand for the years ended December 31, 2018, 2017 and 2016, respectively.

The following table reflects the anticipated net income tax benefit at December 31, 2018, that is expected to be recognized over the remaining lives of the investments and has been updated to reflect the lower tax rate in the Tax Cuts and Jobs Act enacted on December 22, 2017.

(Amounts in thousands)

Qualified Affordable Housing Partnerships:	Raymond James	WNC Institutional	Merritt Community	California	Total
Anticipated income tax benefit, net less	California Housing	Tax Credit	Capital Corporation	Affordable Housing	Income Tax
amortization of investments	Opportunities Fund II	Fund 38, L.P.	Fund XV, L.P.	Fund	Benefit, Net
2019	\$ 19	\$ 17	\$ 4	\$ (14)	\$ 26
2020	19	17	4	(14)	26
2021	19	16	4	(14)	25
2022	19	14	3	(13)	23
2023 and thereafter	32	27	6	(31)	34
Total	<u>\$ 108</u>	<u>\$ 91</u>	<u>\$ 21</u>	<u>\$ (86)</u>	<u>\$ 134</u>

NOTE 23. ACQUISITION

On January 31, 2019 we completed the acquisition of Merchants Holding Company ("Merchants"), to extend our presence in the Sacramento marketplace. Merchants, headquartered in Sacramento, California, was the parent company of The Merchants National Bank of Sacramento ("Merchants Bank"), a 97-year-old bank with approximately \$211.7 million in assets as of January 31, 2019. Merchants Bank operated one full service branch and one limited service branch in the Sacramento metropolitan area.

We paid \$15.3 million in cash and issued 1,834,142 shares of common stock to Merchants shareholders who now hold, in the aggregate, approximately 10% of our outstanding common stock. One former member of the Merchants board now serves on our board of directors. The acquisition added \$85.3 million in loans, \$190.2 million in deposits and \$107.4 million in investment securities after fair value adjustments to our bank as of January 31, 2019.

The acquisition of Merchants constituted a business combination and has been accounted for using the acquisition method of accounting. The assets acquired and liabilities assumed, both tangible and intangible, were recorded at their fair values as of the acquisition date in accordance with ASC 805, Business Combinations. Due to the timing of the acquisition, fair values related to loans, deferred tax assets, other assets and other liabilities are preliminary and subject to refinement as additional information regarding the closing date fair values becomes available. The Bank engaged third party specialists to assist in valuing certain assets, including investment securities, loans, real estate and the core deposit intangible that resulted from the acquisition. The acquisition was treated as a "reorganization" within the definition of section 368(a) of the Internal Revenue Code and is generally considered tax-free for U.S. federal income tax purposes.

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Notes to Consolidated Financial Statements

The preliminary calculation of goodwill recorded during the first quarter of 2019 is detailed below.

<i>(Amounts in thousands)</i>	As Recorded by Merchants Holding Company	Preliminary Fair Value And Other Acquisition Related Adjustments	As Recorded by the Company
Consideration paid:			
Cash			\$ 15,300
Stock 1,834,142 shares at \$10.69 per share			19,607
Total consideration			<u>\$ 34,907</u>
Assets acquired:			
Cash and fed funds sold	\$ 12,425	\$ —	\$ 12,425
Investment securities	107,931	(551)	107,380
Loans, gross	87,570	(2,292)	85,278
Allowance for loan and lease losses	(1,286)	1,286	—
Interest receivable	688	—	688
Premises and equipment, net	378	1,856	2,234
Deferred tax asset, net	1,374	(1,287)	87
Federal Home Loan Bank of San Francisco stock	1,454	—	1,454
Life insurance	755	—	755
Other assets	371	(10)	361
Core deposit intangible	—	4,353	4,353
Total assets acquired	<u>\$ 211,660</u>	<u>\$ 2,542</u>	<u>\$ 215,015</u>
Liabilities assumed:			
Demand and savings deposits	\$ 152,213	\$ —	\$ 152,213
Certificates of deposit	38,003	—	38,003
Total deposits	190,216	—	190,216
Other liabilities	916	15	931
Total liabilities assumed	<u>\$ 191,132</u>	<u>\$ 15</u>	<u>\$ 191,147</u>
Net identifiable assets acquired over liabilities assumed	<u>\$ 20,528</u>	<u>\$ 3,340</u>	<u>\$ 23,868</u>
Goodwill			<u>\$ 11,039</u>

Goodwill

As a result of the Merchants acquisition, we have recorded a provisional amount of goodwill totaling \$11.0 million, which represents the excess of the total purchase price paid over the fair value of the assets acquired, net of the fair values of liabilities assumed. The goodwill recorded is preliminary and subject to refinement as additional information regarding the closing date fair values becomes available. We are in the process of obtaining and reviewing valuation reports for the acquired loans and completing the final federal and state income tax returns for Merchants. We also expect that there may be additional fair value adjustments to the other assets and other liabilities as work to finalize the entries to record the transaction. Goodwill is amortized over 15 years for tax purposes.

Goodwill reflects the expected value of Merchants reputation in the community, stable customer base and expected synergies created through the combined operations with our company.

The following is a description of the methods used to determine the fair values of significant assets and liabilities whose fair values are different from their carrying amounts on Merchants' books at acquisition date presented above.

Investment Securities

Fair values for securities were obtained from an independent pricing service and are based on quoted market prices, where available. If quoted market prices were not available, fair value estimates were based on observable inputs including quoted market prices for similar instruments, quoted market prices that are not in an active market, other inputs that are observable in the market or a discounted cash flow model.

Loans

We engaged a third party to assist us in determining the fair values for the loans acquired from Merchants based upon the present values of the expected cash flows and market-derived discount rates. There were no loans acquired with evidence of deterioration of credit quality since origination for which we believe it is probable that we

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Consolidated Financial Statements

will be unable to collect all contractually required payments receivable. The amounts recognized for loans have been determined only provisionally. Due to the timing of the transaction, we are still in the process of evaluating the fair value of the acquired loans.

Premises and Equipment

We engaged an independent licensed appraiser to determine the fair value of the acquired branch located in Sacramento. The fair value of tangible personal property was not material.

Deferred Tax Assets

The deferred income tax assets are recorded to reflect the differences in the carrying values of the acquired assets and liabilities for financial reporting purposes and the basis for federal income tax purposes at the company's statutory federal and state income tax rate. The amounts recognized for deferred tax assets have been determined only provisionally, and will not be finalized until the 2018 and 2019 tax returns for Merchants have been completed.

Core Deposit Intangible

We recorded a core deposit intangible asset of \$4.4 million for the deposits acquired in the Merchants acquisition during the first quarter of 2019. The core deposit intangible represents the estimated future benefits of acquired deposits and is booked separately from the related deposits. The value of the core deposit intangible asset was determined using a discounted cash flow approach to arrive at the cost differential between the core deposits (non-maturity deposits such as transaction, savings and money market accounts) and alternative funding sources. It was calculated as the present value of the difference in cash flows between maintaining the core deposits (interest and net maintenance costs) and the cost of an equal amount of funds with a similar term from an alternative source. The core deposit intangible is amortized on an accelerated basis over an estimated eight-year life, and is evaluated periodically for impairment. No impairment loss was recognized in 2018. At December 31, 2018, the future estimated amortization expense on the CDI from the Merchants acquisition is as follows:

<i>(Amounts in thousands)</i>	2019	2020	2021	2022	2023	Thereafter	Total
Core deposit intangible amortization	\$ 499	\$ 544	\$ 544	\$ 544	\$ 544	\$ 1678	\$ 4,353

Pro Forma Results of Operations

The following table presents pro forma information of the combined entity as if the acquisition occurred on January 1, 2016. The pro forma information does not necessarily reflect the results of operations that would have resulted had the acquisition been completed at the beginning of the periods presented, nor is it indicative of the results of operations in future periods. Furthermore, cost savings and other business synergies related to the acquisition are not reflected in the pro forma amounts.

Pro forma revenue and earnings

<i>(Amounts in thousands)</i>	2018	2017	2016
Net interest income	\$ 52,948	\$ 46,592	\$ 41,287
Net income	\$ 16,313 ⁽¹⁾	\$ 8,069	\$ 6,566

⁽¹⁾ Net income for 2018 includes acquisition-related costs of \$1.3 million for both entities

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Notes to Consolidated Financial Statements

NOTE 24. EARNINGS PER COMMON SHARE

The following table presents a computation of basic and diluted earnings per share for the years ended December 31, 2018, 2017 and 2016.

(Amounts in thousands, except per share information)

Earnings Per Share	2018	2017	2016
Numerators:			
Net income	\$ 15,730	\$ 7,344	\$ 5,259
Denominators:			
Weighted average number of common shares outstanding - basic ⁽¹⁾	16,248	15,207	13,367
Effect of potentially dilutive common shares ⁽²⁾	84	103	58
Weighted average number of common shares outstanding - diluted	16,332	15,310	13,425
Earnings per common share:			
Basic	\$ 0.97	\$ 0.48	\$ 0.39
Diluted	\$ 0.96	\$ 0.48	\$ 0.39
Anti-dilutive options not included in earnings per share calculation	—	—	45
Anti-dilutive restricted shares not included in diluted earnings per share calculation	—	7	—

⁽¹⁾ Excludes unvested restricted shares because they do not have dividend or voting rights.

⁽²⁾ Represents the effects of the assumed exercise of stock options and vesting of non-participating restricted shares.

On January 31, 2019 we completed our acquisition of Merchants Holding Company, the parent company of The Merchants National Bank of Sacramento in a stock and cash transaction. We paid \$15.3 million in cash and issued 1,834,142 shares of BOCH common stock for all of the outstanding shares of Merchants common stock,

On May 10, 2017, the Company announced the closing of its underwritten public offering, at the public offering price of \$10.50 per share. The total number of shares of common stock sold by the Company was 2,738,096 shares. Net proceeds raised in the offering, after underwriting discounts and expenses of the offering, were \$26.8 million.

NOTE 25. RELATED PARTY TRANSACTIONS

Some of the directors and executive officers (and their associated or affiliated companies) were customers of and had banking transactions with us in the ordinary course of our business and we expect to have such transactions in the future. All deposits, loans and commitments to fund loans included in such transactions were made in compliance with the applicable laws on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons of similar creditworthiness.

The following table presents a summary of aggregate activity involving related party borrowers for the years ended December 31, 2018 and 2017.

(Amounts in thousands)	2018	2017
Balance at beginning of year	\$ 13,230	\$ 13,424
Advances on existing lines of credit	31,281	29,166
Principal repayments	(34,150)	(29,360)
Reclassifications ⁽¹⁾	(871)	—
Balance at end of year	\$ 9,490	\$ 13,230

⁽¹⁾ Represents loans that were once considered related party but are no longer considered related party, or loans that were not related party that subsequently became related party loans.

At December 31, 2018 and 2017, deposits of related parties amounted to \$11.8 million and \$6.7 million, respectively. As of December 31, 2018 and 2017, there were no related party loans which were past due or adversely classified. At December 31, 2018 and 2017 there was \$9.9 million, and \$12.4 million, respectively, in outstanding loan commitments to related parties. In our opinion, these transactions did not involve more than a normal risk of collectability or present other unfavorable terms.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE 26. PARENT COMPANY FINANCIAL STATEMENTS

Condensed Balance Sheets

Year ended December 31,

(Amounts in thousands)

	2018	2017
Assets:		
Cash	\$ 19,425	\$ 23,984
Investment in:		
Redding Bank of Commerce	143,078	130,658
Bank of Commerce Mortgage	(64)	(64)
Bank of Commerce Holdings Trust II	310	310
Other assets	157	169
Total Assets	\$ 162,906	\$ 155,057
Liabilities and shareholders' equity:		
Term debt:		
Senior debt, net	\$ 3,494	\$ 7,090
Subordinated debt, net	9,911	9,868
Junior subordinated debentures	10,310	10,310
Other liabilities	870	525
Total liabilities	24,585	27,793
Shareholders' equity	138,321	127,264
Total liabilities and shareholders' equity	\$ 162,906	\$ 155,057

Condensed Statements of Income

Year Ended December 31,

(Amounts in thousands)

	2018	2017	2016
Income:			
Other income	\$ 12	\$ 9	\$ 7
Dividends from subsidiaries	4,000	2,200	4,200
Total income	4,012	2,209	4,207
Expenses:			
Management fees paid to subsidiaries	303	278	259
Interest expense	1,461	1,452	1,409
Noninterest expense	1,433	474	345
Total expenses	3,197	2,204	2,013
Income before income taxes and equity in undistributed net income of subsidiaries	815	5	2,194
Income tax expense	1	1	1
Income before equity in undistributed net income of subsidiaries	814	4	2,193
Equity in undistributed net income of subsidiaries	14,916	7,340	3,066
Net income	\$ 15,730	\$ 7,344	\$ 5,259

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Consolidated Financial Statements

Condensed Statements of Cash Flows

Year Ended December 31,

(Amounts in thousands)

	2018	2017	2016
Cash flows from operating activities:			
Net income	\$ 15,730	\$ 7,344	\$ 5,259
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	(14,916)	(7,340)	(3,066)
Amortization of debt issuance costs	49	44	40
Provision for depreciation and amortization	22	6	—
Decrease in other assets	69	32	6
Increase (decrease) in other liabilities	227	59	(137)
Net cash provided by operating activities	1,181	145	2,102
Cash flows from investing activities:			
Purchases of premises and equipment	(80)	(82)	—
Net cash used by investing activities	(80)	(82)	—
Cash flows from financing activities:			
Repayment of term debt	(3,602)	(1,819)	(1,001)
Cash dividends paid on common stock	(2,274)	(1,776)	(1,603)
Proceeds from stock options exercised	216	245	10
Net proceeds from issuance of common stock	—	26,778	—
Net cash provided by (used in) financing activities	(5,660)	23,428	(2,594)
Net increase (decrease) in cash and cash equivalents	(4,559)	23,491	(492)
Cash and cash equivalents at the beginning of year	23,984	493	985
Cash and cash equivalents at the end of year	\$ 19,425	\$ 23,984	\$ 493
Supplemental disclosures of non cash financing activities:			
Stock issued under employee plans	\$ 45	\$ 41	\$ —
Vested and granted restricted stock issued under employee plans	\$ —	\$ —	\$ 84

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Notes to Consolidated Financial Statements

NOTE 27. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The following tables present the summary of results for the eight quarters ended December 31, 2018.

2018

<i>(Amounts in thousands, except for share information)</i>	March 31, 2018	June 30, 2018	September 30, 2018	December 31, 2018	Four Quarters
Net interest income	\$ 11,345	\$ 11,580	\$ 12,127	\$ 12,494	\$ 47,546
Noninterest income	982	962	943	1,132	4,019
Noninterest expense	8,033	7,671	7,634	8,868	32,206
Income before provision for income tax	4,294	4,871	5,436	4,758	19,359
Provision for income tax	1,053	1,253	1,404	(81)	3,629
Income available to common shareholders	\$ 3,241	\$ 3,618	\$ 4,032	\$ 4,839	\$ 15,730
Earnings per share - basic	\$ 0.20	\$ 0.22	\$ 0.25	\$ 0.30	\$ 0.97
Weighted average shares - basic	16,225	16,245	16,252	16,265	16,248
Earnings per share - diluted	\$ 0.20	\$ 0.22	\$ 0.25	\$ 0.30	\$ 0.96
Weighted average shares - diluted	16,310	16,325	16,342	16,345	16,332

2017

<i>(Amounts in thousands, except for share information)</i>	March 31, 2017	June 30, 2017	September 30, 2017	December 31, 2017	Four Quarters
Net interest income	\$ 9,734	\$ 10,175	\$ 10,584	\$ 10,869	\$ 41,362
Provision for loan and lease losses	200	300	—	450	950
Noninterest income	1,471	995	1,076	1,282	4,824
Noninterest expense	7,990	7,726	7,357	7,891	30,964
(Loss) income before provision for income tax	3,015	3,144	4,303	3,810	14,272
Provision for income tax	763	935	1,427	3,803	6,928
(Loss) income available to common shareholders	\$ 2,252	\$ 2,209	\$ 2,876	\$ 7	\$ 7,344
(Loss) earnings per share - basic	\$ 0.17	\$ 0.15	\$ 0.18	\$ —	\$ 0.48
Weighted average shares - basic	13,416	15,014	16,191	16,195	15,207
(Loss) earnings per share - diluted	\$ 0.17	\$ 0.15	\$ 0.18	\$ —	\$ 0.48
Weighted average shares - diluted	13,521	15,113	16,288	16,306	15,310

Item 9 - Changes In and Disagreements with Accountants on Accounting and Financial Disclosure

There have been no changes in or disagreements with accountants or auditors on accounting and financial disclosure.

Item 9a - Controls and Procedures

Disclosure Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of the Company's management, including its President and Chief Executive Officer and its Chief Financial Officer, of the effectiveness of its disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based on that evaluation, the President and Chief Executive Officer and the Chief Financial Officer concluded that these disclosure controls and procedures were effective.

Disclosure controls and procedures, no matter how well designed and implemented, can provide only reasonable assurance of achieving an entity's disclosure objectives. The likelihood of achieving such objectives is affected by limitations inherent in disclosure controls and procedures. These include the fact that human judgment in decision-making can be faulty and that breakdowns in internal controls can occur because of human failures such as simple errors, mistakes or intentional circumvention of the established processes.

Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed by, or under the supervision of, the Company's Chief Executive Officer and the Chief Financial Officer and implemented by the Company's Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America.

The 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 in the United States of America, 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.

On a quarterly basis, we carry out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Principal Financial Officer (whom is also our Principal Accounting Officer) of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934. As of December 31, 2018, our management, including our Chief Executive Officer, and Principal Financial Officer, concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to us that is required to be included in our periodic SEC filings.

Although we change and improve our internal controls over financial reporting on an ongoing basis, we do not believe that any such changes occurred in the fourth quarter of 2018 that materially affected or are reasonably likely to materially affect our internal control over financial reporting.

This annual report includes an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting.

Item 9b - Other Information

None to report.

Part III

Item 10 - Directors, Executive Officers And Corporate Governance

The response to this item is incorporated by reference to Bank of Commerce Holdings Proxy Statement for the 2019 Annual Meeting of shareholders (the “Proxy Statement”) under the captions “Section 16(a) Beneficial Ownership Reporting Compliance”, “Voting Securities and Ownership of Certain Beneficial Holders”, “Certain Relationships and Related Transactions and Director Independence”, and “Committees of the Board of Directors”.

Item 11 - Executive Compensation

The response to this item is incorporated by reference to the Proxy Statement, under the captions “Information on Director and Executive Compensation” and “Compensation Discussion and Analysis”.

Item 12 - Security Ownership Of Certain Beneficial Owners And Management And Related Shareholder Matters

The response to this item is incorporated by reference to the Proxy Statement, under the caption “Voting Securities and Ownership of Certain Beneficial Holders”.

Item 13 - Certain Relationships and Related Transactions and Director Independence

The response to this item is incorporated by reference to the Proxy Statement.

Item 14 - Principal Accounting Fees and Services

The response to this item is incorporated by reference to the Proxy Statement, under the caption “Report of the Audit and Qualified Legal Compliance Committee.”

Part IV

Item 15 - Exhibits and Financial Statement Schedules

(a) The following documents are filed as a part of this Form 10-K:

(1) Financial Statements:

Reference is made to the Index to Consolidated Financial Statements under Item 8 in Part II of this Form 10-K.

(2) Financial Statement Schedules:

All schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

(3) Exhibits:

(Material Contracts Listed as 10.1 - 10.19)

Exhibit No.	Exhibit Description	Form	SEC File No.	Original Exhibit No.	Filing Date	Filed Herewith
3.1	<u>Restated Articles of Incorporation</u>	10-Q	000-25135	3.1	8/5/2016	
3.2	<u>Amended and Restated Bylaws</u>	8-K	000-25135	3.2	12/20/2017	
4.1	<u>Promissory Note between Bank of Commerce Holdings and NexBank SSB, dated December 10, 2015</u>	8-K	000-25135	4.1	12/14/2015	
4.2	<u>Form of 6.875% Fixed to Floating Rate Subordinated Note due December 10, 2025</u>	8-K	000-25135	4.2	12/14/2015	
10.1*	<u>1993 Directors Deferred Compensation Plan</u>	10-12G	000-25135	10.7	12/4/1998	
10.2*	<u>Form of Deferred Compensation Agreement used in connection with 1993 Directors Deferred Compensation Plan</u>	10-12G	000-25135	10.8	12/4/1998	
10.3*	<u>Amendments to the 1993 Deferred Compensation Plan</u>	10-K	000-25135	10.8	3/11/2014	
10.4*	<u>Amended and Restated 2010 Equity Incentive Plan ("2010 Equity Incentive Plan")</u>	DEF 14A	000-25135	Appendix A	3/9/2012	
10.5*	<u>Form of Stock Option Agreement used in connection with 2010 Equity Incentive Plan</u>	10-K	000-25135	10.7	3/8/2016	
10.6*	<u>Form of Notice of Exercise of Stock Option used in connection with 2010 Equity Incentive Plan</u>	10-K	000-25135	10.8	3/8/2016	
10.7*	<u>Form of Restricted Stock Agreement used in connection with 2010 Equity Incentive Plan</u>	10-K	000-25135	10.9	3/8/2016	
10.8*	<u>Form of Stock Grant Agreement used in connection with 2010 Equity Incentive Plan</u>	10-K	000-25135	10.10	3/8/2016	
10.9*	<u>Amended and Restated Salary Continuation Agreement with Randall S. Eslick, dated November 19, 2013</u>	10-K	000-25135	10.10	3/11/2014	
10.10*	<u>Amended and Restated Salary Continuation Agreement with Samuel D. Jimenez, dated December 17, 2013</u>	10-K	000-25135	10.12	3/11/2014	
10.11*	<u>Salary Continuation Agreement with Robert H. Muttera, dated January 17, 2014</u>	10-K	000-25135	10.18	3/11/2014	
10.12*	<u>Amendment to the Salary Continuation Agreements</u>	10-Q	000-25135	10.1	4/28/2017	
10.13*	<u>Amended and Restated 2013 Directors Deferred Compensation Plan and Participant Election Form</u>	10-K	000-25135	10.12	3/9/2018	
10.14	<u>Loan Agreement by and between Bank of Commerce Holdings and NexBank SSB, dated December 10, 2015</u>	8-K	000-25135	10.1	12/14/2015	
10.15	<u>Pledge and Security Agreement between Bank of Commerce Holdings and NexBank SSB, dated December 10, 2015</u>	8-K	000-25135	10.2	12/14/2015	
10.16	<u>Subordinated Note Purchase Agreement between Bank of Commerce Holdings and The Purchasers named Herein, dated December 10, 2015</u>	8-K	000-25135	10.3	12/14/2015	
10.17*	<u>Amended and Restated Employment Agreement with Randall S. Eslick dated February 21, 2017.</u>	10-K	000-25135	10.20	3/15/2017	

10.18*	<u>Amended and Restated Employment Agreement with James A. Sundquist dated February 21, 2017.</u>	10-K	000-25135	10.21	3/15/2017	
10.19*	<u>Amended and Restated Employment Agreement with Samuel D. Jimenez dated February 21, 2017.</u>	10-K	000-25135	10.22	3/15/2017	
10.20*	<u>Amended and Restated Employment Agreement with Robert H. Muttera dated February 21, 2017.</u>	10-K	000-25135	10.23	3/15/2017	
10.21*	<u>Form of Indemnification Agreement</u>	8-K	000-25135	10.1	12/20/2017	
10.22*	<u>Amendment to Amended and Restated Employment Agreement with Randall S. Eslick dated May 3, 2018</u>	10-Q	000-25135	10.1	5/4/2018	
10.23*	<u>Amendment to Amended and Restated Employment Agreement with James A. Sundquist dated May 3, 2018</u>	10-Q	000-25135	10.2	5/4/2018	
10.24*	<u>Amendment to Amended and Restated Employment Agreement with Samuel D. Jimenez dated May 3, 2018</u>	10-Q	000-25135	10.3	5/4/2018	
10.25*	<u>Amendment to Amended and Restated Employment Agreement with Robert H. Muttera dated May 3, 2018</u>	10-Q	000-25135	10.4	5/4/2018	
14	<u>Code of Ethics for Senior Financial Officers</u>	8-K	000-25135	14.1	5/21/2015	
21.1	<u>Subsidiaries of the Company</u>					X
23.1	<u>Consent of Moss Adams LLP</u>					X
24	<u>Power of Attorney (included on signature page to this report)</u>					X
31.1	<u>Certification of Randall S. Eslick pursuant to Exchange Act Rule 13a-14(a) or 15d — 14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>					X
31.2	<u>Certification of James A. Sundquist pursuant to Exchange Act Rule 13a-14(a) or 15d — 14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>					X
32.1	<u>Certification pursuant to Section 1350</u>					X
101.INS	XBRL Instance Document					X
101.SCH	XBRL Taxonomy Extension Schema Document					X
101.CAL	XBRL Taxonomy Calculation Linkbase Document					X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document					X
101.LAB	XBRL Taxonomy Label Linkbase Document					X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document					X
* Executive Contract, Compensatory Plan or Arrangement						

Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 12, 2019.

BANK OF COMMERCE HOLDINGS

By /s/ Randall S. Eslick

Randall S. Eslick

President and Chief Executive Officer

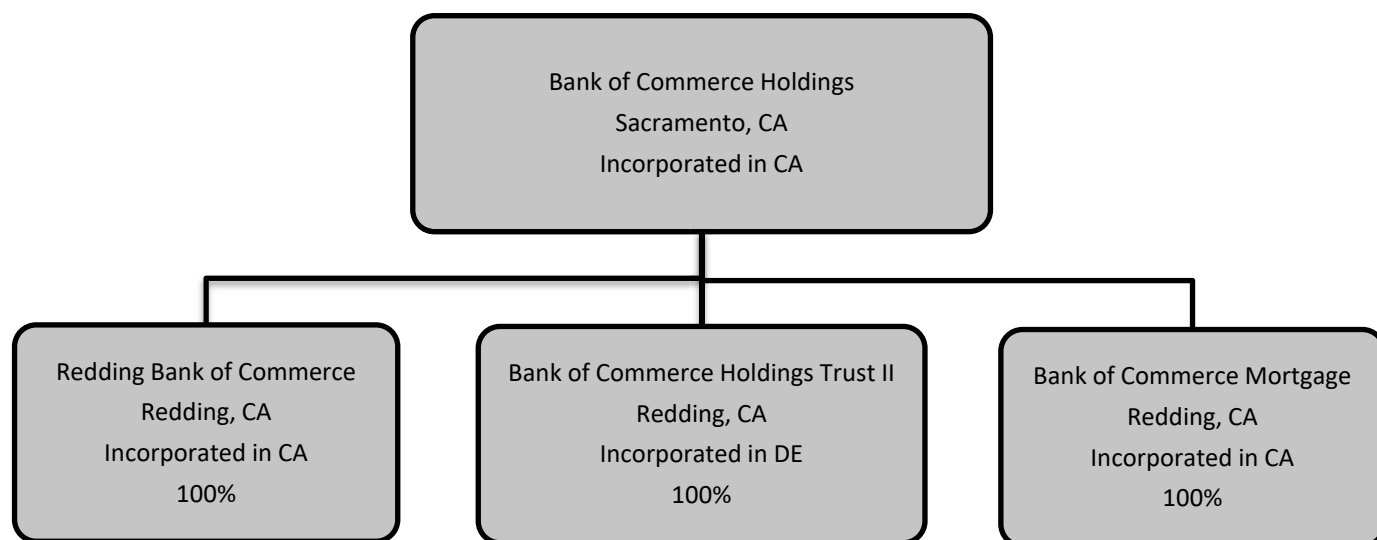
POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Randall S. Eslick and James A. Sundquist, and each of them, his true and lawful attorneys-in-fact, each with full power of substitution, for him in any and all capacities, to sign any amendments to this report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact or their substitute or substitutes may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated.

Name	Title	Date
/s/ Randall S. Eslick	President and Chief Executive Officer, Director (Principal Executive Officer)	March 12, 2019
/s/ James A. Sundquist	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 12, 2019
/s/ Lyle L. Tullis	Chairman of the Board	March 12, 2019
/s/ Orin N. Bennett	Director	March 12, 2019
/s/ Gary R. Burks	Director	March 12, 2019
/s/ Joseph Q. Gibson	Director	March 12, 2019
/s/ Jon W. Halfhide	Director	March 12, 2019
/s/ David J. Inderkum	Director	March 12, 2019
/s/ Linda J. Miles	Director	March 12, 2019
/s/ Karl L. Silberstein	Director	March 12, 2019
/s/ Terence J. Street	Director	March 12, 2019

Subsidiaries of the Company as of December 31, 2018



CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statements No. 333-143321 and 333-71683 on Form S-8 of Bank of Commerce Holdings of our report dated March 12, 2019, relating to the consolidated financial statements and the effectiveness of internal control over financial reporting appearing in this Annual Report on Form 10-K of Bank of Commerce Holdings for the year ended December 31, 2018.

/s/ Moss Adams LLP

Sacramento, California
March 12, 2019

CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a), AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Randall S. Eslick, certify that:

- 1) I have reviewed this Annual Report on Form 10-K of Bank of Commerce Holdings (the “registrant”);
- 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(s) 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, registrant’s internal control over financial reporting; and;
- 5) The registrant’s other certifying officer(s) 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.

/s/ RANDALL S. ESLICK
Randall S. Eslick
President and Chief Executive Officer
(Principal Executive Officer)

Dated March 12, 2019

CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a), AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, James A. Sundquist, certify that:

- 1) I have reviewed this Annual Report on Form 10-K of Bank of Commerce Holdings (the “registrant”);
- 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(s) 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(s) 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.

/s/ JAMES A. SUNDQUIST

James A. Sundquist

Executive Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)

Dated March 12, 2019

CERTIFICATION OF CHIEF EXECUTIVE AND FINANCIAL OFFICERS PURSUANT TO SECTION 906

The following certification shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of Bank of Commerce Holdings, a California corporation, for the year ended December 31, 2018, as filed with the Securities and Exchange Commission, each of the undersigned officers of Bank of Commerce Holdings certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to his respective knowledge:

- (1) the accompanying report on Form 10-K of the Company for the year ended December 31, 2018, as filed with the Securities and Exchange Commission (the “Report”), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Bank of Commerce Holdings for the periods presented therein.

Date: March 12, 2019

/s/ Randall S. Eslick
Chief Executive Officer

Date: March 12, 2019

/s/ James A. Sundquist
Chief Financial Officer

A signed original of the above certification has been provided to Bank of Commerce Holdings and will be retained by Bank of Commerce Holdings and furnished to the Securities and Exchange Commission or its staff upon request.

CORPORATE INFORMATION

Transfer Agent and Registrar

Broadridge Corporate Issuer Solutions
P.O. Box 1342
Brentwood, NY 11717

877.830.4936
shareholder@broadridge.com

Independent Auditors

Moss Adams LLP
Sacramento, CA

Legal Counsel

Miller Nash Graham & Dunn LLP
Seattle, WA

Investment Banker

Raymond James & Associates, Inc.
San Francisco, CA

NASDAQ SYMBOL

BOCH

Annual Meeting

11:00 a.m. Pacific Time
May 21, 2019

Bank of Commerce Holdings

555 Capitol Mall
Third Floor Boardroom
Sacramento, CA 95814

Reports

The Company's annual report for 2018 on Form 10-K, which is required to be filed with the SEC, is available to any shareholder without charge. The report is available on the Company's website at: bankofcommerceholdings.com

The report also may be obtained by written request to:

Corporate Secretary

Bank of Commerce Holdings
1901 Churn Creek Road
Redding, CA 96002



Our acquisition of **MERCHANTS HOLDING COMPANY** is very exciting and is an integral part of our **STRATEGIC GROWTH** objective.

— **Randall S. Eslick** | PRESIDENT AND CEO,
BANK OF COMMERCE HOLDINGS



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bankofcommerceholdings.com