

FIRST NATIONAL BANK ALASKA
Anchorage, Alaska

FINANCIAL STATEMENTS
December 31, 2019 and 2018

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INDEPENDENT AUDITOR'S REPORT

The Board of Directions and Shareholders
First National Bank Alaska
Anchorage, Alaska

Report on the Financial Statements

We have audited the accompanying financial statements of First National Bank Alaska, which comprise the statements of financial condition as of December 31, 2019 and 2018, and the related statements of income, comprehensive income, cash flows, and changes in shareholders' equity for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibilities

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of First National Bank Alaska, as of December 31, 2019 and 2018, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

We also have audited in accordance with auditing standards generally accepted in the United States of America, First National Bank Alaska's internal control over financial reporting as of December 31, 2019, based on criteria established in the 2013 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) relevant to reporting objectives for the express purpose of meeting the regulatory requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and our report dated March 3, 2020 expressed an unmodified opinion.

Crowe LLP
Crowe LLP

Oak Brook, Illinois
March 3, 2020

FIRST NATIONAL BANK ALASKA
STATEMENTS OF FINANCIAL CONDITION
December 31, 2019 and 2018
(Dollars in thousands, except per share data)

	<u>2019</u>	<u>2018</u>
ASSETS		
Cash and cash equivalents	\$ 127,657	\$ 108,557
Securities, available-for-sale	1,588,721	1,597,992
Real estate loans to be sold	15,459	18,459
Loans:		
Commercial and industrial	419,233	428,425
Real estate	1,575,317	1,506,953
Consumer and other;	17,061	19,495
Total loans, gross	<u>2,011,611</u>	<u>1,954,873</u>
Less: Allowance for loan losses	<u>19,500</u>	<u>19,400</u>
Total loans, net	1,992,111	1,935,473
Premises and equipment, net	49,011	46,673
Other real estate owned, net	1,343	1,625
Other assets	<u>33,952</u>	<u>44,687</u>
Total assets	<u>\$ 3,808,254</u>	<u>\$ 3,753,466</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Noninterest bearing	\$ 1,319,714	\$ 1,291,866
Interest bearing:		
Savings	643,326	654,431
NOW	187,543	194,508
Money market	122,085	162,783
Time	<u>115,117</u>	<u>116,705</u>
Total interest bearing	<u>1,068,071</u>	<u>1,128,427</u>
Total deposits	2,387,785	2,420,293
Securities sold under agreements to repurchase	859,425	809,020
Due to brokers	-	3,622
Other liabilities	<u>13,362</u>	<u>13,680</u>
Total liabilities	3,260,572	3,246,615
 Shareholders' equity:		
Common stock, \$10 par value (authorized: 4,000,000 shares) (issued and outstanding: 2019 – 3,167,510; 2018 – 3,168,630)	31,675	31,686
Surplus	40,000	40,000
Retained earnings	460,132	450,848
Accumulated other comprehensive income (loss)	<u>15,875</u>	<u>(15,683)</u>
Total shareholders' equity	<u>547,682</u>	<u>506,851</u>
Total liabilities and shareholders' equity	<u>\$ 3,808,254</u>	<u>\$ 3,753,466</u>

See accompanying notes to financial statements.

FIRST NATIONAL BANK ALASKA
STATEMENTS OF INCOME
Years ended December 31, 2019 and 2018
(Dollars in thousands, except per share data)

	<u>2019</u>	<u>2018</u>
Interest income and loan fees:		
Interest and fees on loans:		
Taxable	\$ 113,333	\$ 106,152
Nontaxable	<u>1,259</u>	<u>1,544</u>
Total interest and fees on loans	114,592	107,696
Interest and dividends on investment securities:		
Taxable	32,019	28,816
Nontaxable	<u>3,477</u>	<u>4,944</u>
Total interest and dividends on investment securities	35,496	33,760
Interest on cash and cash equivalents	<u>1,956</u>	<u>1,617</u>
Total interest and loan fee income	152,044	143,073
Interest expense:		
Interest on deposits	2,269	1,482
Interest on federal funds purchased and securities sold under agreements to repurchase	12,931	9,772
Interest on FHLB advances and other borrowed funds	<u>3</u>	<u>-</u>
Total interest expense	<u>15,203</u>	<u>11,254</u>
Net interest and loan fee income	136,841	131,819
Provision for loan losses	<u>298</u>	<u>1,993</u>
Net interest and loan fee income after provision for loan losses	136,543	129,826
Noninterest income:		
Bankcard fees	8,036	7,749
Service charges on deposit accounts	5,270	5,171
Gain on sale of mortgage loans	1,558	2,086
Mortgage loan servicing income	2,245	2,109
Net gains (losses) on investment securities	116	(1,950)
Gain on sale of other real estate owned	111	4,728
Other noninterest income	<u>6,087</u>	<u>6,580</u>
Total noninterest income	23,423	26,473
Noninterest expense:		
Salaries and employee benefits	56,698	55,186
Occupancy expense, net	8,021	8,332
Furniture and equipment expense	2,536	2,190
Bankcard expenses	2,340	2,143
Other noninterest expense	<u>16,353</u>	<u>17,705</u>
Total noninterest expense	<u>85,948</u>	<u>85,556</u>
Income before taxes	74,018	70,743
Provision for income taxes	<u>18,373</u>	<u>16,641</u>
Net income	<u>\$ 55,645</u>	<u>\$ 54,102</u>
Earnings per common share	\$ 17.56	\$ 17.07

See accompanying notes to financial statements.

FIRST NATIONAL BANK ALASKA
STATEMENTS OF COMPREHENSIVE INCOME
Years ended December 31, 2019 and 2018
(Dollars in thousands)

	<u>2019</u>	<u>2018</u>
Net income	\$ 55,645	\$ 54,102
Other comprehensive income (loss) –		
Unrealized gains (losses) on securities:		
Unrealized holding gains (losses) arising during the period, net of tax effect of \$(12,566) and \$3,539 in 2019 and 2018, respectively	31,641	(8,913)
Reclassification adjustment for (gains) losses included in net income, net of tax effect of \$33 and \$(554) in 2019 and 2018, respectively	<u>(83)</u>	<u>1,396</u>
Other comprehensive income (loss)	<u>31,558</u>	<u>(7,517)</u>
Comprehensive Income	<u>\$ 87,203</u>	<u>\$ 46,585</u>

See accompanying notes to financial statements.

FIRST NATIONAL BANK ALASKA
STATEMENTS OF CASH FLOWS
Years ended December 31, 2019 and 2018
(Dollars in thousands)

	<u>2019</u>	<u>2018</u>
Cash flows from operating activities		
Net income	\$ 55,645	\$ 54,102
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premium on investment securities, net	4,760	9,522
Loss from equity method investment	763	1,038
Depreciation, accretion and amortization	5,011	4,876
Provision for loan losses	298	1,993
Deferred taxes	163	1,995
Gain on sale of mortgage loans	(1,558)	(2,085)
Net gain on the sale of other real estate owned	(111)	(4,728)
Valuation adjustment on other real estate owned	156	129
Net (gain) loss on the sale of premises and equipment	35	(1,528)
Impairment loss on fixed assets	-	1,192
Net (gain) loss on investment securities	(116)	1,950
Real estate loans to be sold-originated	(118,934)	(144,940)
Real estate loans to be sold-shipped	122,418	143,391
Net (increase) decrease in other assets	(26)	11,232
Net increase (decrease) in other liabilities	<u>(2,907)</u>	<u>(17,387)</u>
Net cash provided by operating activities	65,597	60,752
 Cash flows from investing activities		
Proceeds from calls or maturities of securities, available-for-sale	380,445	198,835
Proceeds from sales of securities, available-for-sale	99,453	177,985
Purchase of securities, available-for-sale	(431,655)	(406,340)
Net purchases of Federal Home Loan Bank stock	(120)	(52)
Net redemptions of Federal Reserve Bank stock	1	-
Net decrease in loans	84,496	22,130
Purchase of participation loans	(145,668)	(159,556)
Proceeds from sales of premises and equipment	-	3,300
Purchase of land, premises and equipment	(6,171)	(3,778)
Improvements to other real estate owned	(9)	-
Proceeds from sales of other real estate owned	<u>802</u>	<u>13,481</u>
Net cash used in investing activities	(18,426)	(153,995)

(Continued)

FIRST NATIONAL BANK ALASKA
STATEMENTS OF CASH FLOWS
Years ended December 31, 2019 and 2018
(Dollars in thousands)

	<u>2019</u>	<u>2018</u>
Cash flows from financing activities		
Net decrease in total deposits	\$ (32,508)	\$ (17,524)
Net increase in securities		
sold under agreements to repurchase	50,405	121,956
Payments on notes and capital leases	(71)	(72)
Dividends paid	(45,628)	(36,134)
Retirement of common stock	<u>(269)</u>	<u>(477)</u>
Net cash provided by (used in) financing activities	<u>(28,071)</u>	<u>67,749</u>
 Increase (decrease) in cash and cash equivalents	 19,100	 (25,494)
Cash and cash equivalents, January 1	<u>108,557</u>	<u>134,051</u>
 Cash and cash equivalents, December 31	 <u>\$ 127,657</u>	 <u>\$108,557</u>
 Supplemental disclosures of cash flow information:		
Cash paid during the year for interest	\$ 14,922	\$ 11,169
Cash paid during the year for income taxes	18,265	13,481
 Noncash investing and financing activities:		
Transfer of loans to other real estate owned	\$ 612	\$ 1,180
Transfer of bank premises to other real estate owned	-	41
Bank financed sales of other real estate owned	-	238
Acquisition (settlement) of purchased loans and securities via short term payable	(3,622)	(5,478)
Right of use assets obtained in exchange for operating leases	1,648	-

See accompanying notes to financial statements

FIRST NATIONAL BANK ALASKA
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2019 and 2018
(Dollars in thousands, except per share data)

	Common Stock (\$10 Par Value)	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, January 1, 2018	\$ 31,708	\$ 40,000	\$ 433,335	\$ (8,166)	\$ 496,877
Net income	-	-	54,102	-	54,102
Other comprehensive loss, net of tax	-	-	-	(7,517)	(7,517)
Dividends declared - \$11.40 per share	-	-	(36,134)	-	(36,134)
Retirement of common stock (2,200 shares)	<u>(22)</u>	<u>-</u>	<u>(455)</u>	<u>-</u>	<u>(477)</u>
Balance, December 31, 2018	31,686	40,000	450,848	(15,683)	506,851
Prior period adjustment from change in security premium amortization method	-	-	(475)	-	(475)
Net income	-	-	55,645	-	55,645
Other comprehensive income, net of tax	-	-	-	31,558	31,558
Dividends declared - \$14.40 per share	-	-	(45,628)	-	(45,628)
Retirement of common stock (1,120 shares)	<u>(11)</u>	<u>-</u>	<u>(258)</u>	<u>-</u>	<u>(269)</u>
Balance, December 31, 2019	<u>\$ 31,675</u>	<u>\$ 40,000</u>	<u>\$ 460,132</u>	<u>\$ 15,875</u>	<u>\$ 547,682</u>

See accompanying notes to financial statements

FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
December 31, 2019 and 2018
(Dollars in thousands except per share data)

NOTE 1 - SIGNIFICANT ACCOUNTING AND REPORTING POLICIES

First National Bank Alaska (the Bank) is a full service commercial bank operated as a single segment, and as such, its principal activities include the receiving and lending of money. Additionally, the Bank provides trust banking services, escrow and contract collection services, bankcard services, and safe deposit box facilities. These services are for business, industry, and individuals primarily within the State of Alaska. Banking services are provided from 28 branches throughout Alaska. The accounting and reporting policies of the Bank conform with U.S. generally accepted accounting principles and the prevailing practices within the banking industry. Significant accounting and reporting policies are summarized below.

Subsequent Events: The Bank has evaluated subsequent events for recognition and disclosure through March 3, 2020, which is the date the financial statements were available to be issued.

Estimates: Use of accounting estimates in the preparation of financial statements, in order to conform with U.S. generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents: Cash and cash equivalents include cash and due from banks and overnight federal funds sold. Net cash flows are reported for customer loan and deposit transactions, securities sold under agreements to repurchase and federal funds purchased.

Securities, Available-for-Sale: Securities, available-for-sale are classified at the time of acquisition. The available-for-sale classification includes debt and marketable equity securities which are carried at estimated fair value. Unrealized holding gains or losses on securities, available-for-sale are included in other comprehensive income and as a separate component of shareholders' equity. Amortization of premiums and accretion of discounts are recognized using the level yield method. Realized gains and losses on sales of securities are computed using the specific identification method.

Management evaluates securities for other-than-temporary impairment (OTTI) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

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FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
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(Dollars in thousands except per share data)

NOTE 1 - SIGNIFICANT ACCOUNTING AND REPORTING POLICIES (Continued)

Real Estate Loans to be Sold: Real estate loans to be sold are carried at the lower of cost or fair value in the aggregate. The Bank records and holds for sale one-to-four family and multifamily real estate loans which are originated pursuant to investor programs. Net unrealized losses, if any, are recognized through a valuation allowance by charges to other noninterest expense.

Loans: The Bank grants real estate, commercial, and consumer loans to customers. A substantial portion of the loan portfolio is represented by real estate loans throughout Alaska. The ability of the Bank's debtors to honor their contracts is dependent upon real estate and general economic conditions.

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or pay-off, generally are reported at their outstanding unpaid principal balances adjusted for charge-offs and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the effective interest method.

The accrual of interest on all classes of real estate and commercial loans is normally discontinued at the time a loan is 90 days delinquent. Past due status is based on the contractual terms of the loan. All classes within consumer and other loans are typically charged off no later than 120 days delinquent. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

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

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

The general component is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of non-impaired loans in light of historical loss experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. The historical loss experience is determined by portfolio segment and is based on the actual loss history of the Bank over the most recent 3, 5 or 7 years for consumer, commercial and real estate loans, respectively. The actual loss experience is supplemented with other qualitative factors based on the risks present for each portfolio segment.

(Continued)

FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
December 31, 2019 and 2018
(Dollars in thousands except per share data)

NOTE 1 - SIGNIFICANT ACCOUNTING AND REPORTING POLICIES (Continued)

Management considers the following when assessing the risk of the loan portfolio segments:

Commercial and Industrial loans – are dependent on the strength of the industries of the related borrowers and the success of their businesses. Commercial loans are advanced for equipment purchases, to provide working capital or meet other financing needs of business enterprises. These loans may be secured by accounts receivable, inventory, equipment or other business assets. At the time of origination, financial information is obtained from the borrower to evaluate ability to repay the loans.

Real estate loans are considered by loan portfolio class as follows:

Commercial and Construction/Development loans – are dependent on the industries tied to these loans as well as the local real estate market. The loans are secured by the real estate, appraisals or other external valuations are obtained to support the loan amount. An evaluation of the project's cash flows is performed to evaluate the borrower's ability to repay the loan at the time of origination.

1-4 and multifamily residential loans – are affected by the local residential real estate market, the local economy, and, for variable rate mortgages, movement in indices tied to these loans. At the time of origination, the Bank evaluates the borrower's repayment ability through a review of credit scores and debt to income ratios. Appraisals or other external valuations are obtained to support the loan amount. Multifamily real estate loans are dependent on the industries tied to these loans as well as the local real estate market for the particular property segments. Appraisals or other external valuations are obtained to support the loan amount. An evaluation of the project's cash flows is performed to evaluate the borrower's ability to repay the loan at the time of origination.

Consumer and other loans – are dependent on local economies. Consumer loans are generally secured by consumer assets, but may be unsecured. At the time of origination, the Bank evaluates the borrower's repayment ability through a review of credit scores and an evaluation of debt to income ratios.

This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. While management does not expect a substantial decline in real estate values and economic conditions in Alaska, a decline in these values or economic activities could have an impact on the value of collateral securing the loans as well as the ability for the repayment of loans resulting in a higher allowance for loan losses in the future.

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

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FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
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(Dollars in thousands except per share data)

NOTE 1 - SIGNIFICANT ACCOUNTING AND REPORTING POLICIES (Continued)

Troubled debt restructurings are measured at the net present value of estimated future cash flows or where considered to be collateral dependent, the loan is reported, net, at the fair value of the collateral.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify all individual consumer loans for impairment disclosures.

Reserve for Unfunded Commitments: A reserve is established at a level that is considered adequate by management to provide for probable losses associated with commitments to lend funds under existing agreements. Management determines the adequacy of the reserve for unfunded commitments by evaluating the outstanding commitment levels, the expected conversion to loans, historical loss estimates, and other relevant factors. This evaluation is inherently subjective and actual losses may vary from current estimates. Changes in the reserve are reported in earnings in the periods they become known. The reserve for unfunded commitments is included in other liabilities in the accompanying statements of condition.

The recorded liability was \$900 at December 31, 2019 and 2018.

Premises and Equipment: Premises and equipment, including leasehold improvements and software, are stated at cost less accumulated depreciation and amortization. Depreciation on premises and equipment is calculated on a declining balance basis over the estimated useful lives of the assets. The estimated useful life of buildings is 39 years, with some external elements using 15 years. The estimated useful life of software is 3 years and furniture and equipment is 5 to 7 years. Equipment under capital leases is stated at the present value of minimum lease payments. Equipment held under capital leases and leasehold improvements are amortized over the shorter of the lease term or estimated useful life of the asset. Maintenance and repairs are expensed as incurred, while improvements and construction costs are capitalized.

Federal Reserve Bank: This stock is a required holding of capital stock of the Federal Reserve Bank and is carried in other assets in the accompanying statements of condition at cost and periodically evaluated for impairment based on ultimate recovery of par value (\$2,151 as of 2019 and 2018). Calculation of the stock requirement is based solely on the capital structure of the Bank.

Federal Home Loan Bank Stock: This is a required stock holding of the Federal Home Loan Bank of Des Moines and is carried in other assets in the accompanying statements of condition at cost and periodically evaluated for impairment based on ultimate recovery of par value (\$4,504 and \$4,384 as of 2019 and 2018, respectively). The minimum stock requirement is calculated based on the Bank's assets or qualifying loans, whichever applies.

(Continued)

FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
December 31, 2019 and 2018
(Dollars in thousands except per share data)

NOTE 1 - SIGNIFICANT ACCOUNTING AND REPORTING POLICIES (Continued)

Other Real Estate Owned (OREO): OREO consists of properties acquired through foreclosure and is carried at the lower of fair value at acquisition date or current estimated fair value net of disposal costs. Physical possession of residential real estate property collateralizing a consumer mortgage loan occurs when legal title is obtained upon foreclosure or when the borrower conveys all interest in the property to satisfy the loan through completion of a deed in lieu of foreclosure or a similar legal agreement. At the time the property is acquired, it is recorded at estimated fair value less costs to sell, with any difference between this value and the outstanding balance on the loan charged against the allowance for loan losses. Subsequent to foreclosure, costs associated with holding the property are charged to expense as incurred. Subsequent write-downs and gains and losses recognized on the sale of these properties are included in noninterest expense.

Other real estate owned also includes bank premises that were transferred to other real estate owned due to no longer using the premises for Bank purposes and related regulatory requirements for these types of assets. These transfers from premises and equipment are made at the lower of cost or fair value.

Loan Commitments and Related Financial Instruments: This includes off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Originated Mortgage Servicing Rights (OMSRs): OMSRs are capitalized based on their fair value when the corresponding loans are sold. The purchased or originated rights to service loans are amortized in relation to the estimated period of net servicing income. The carrying value of mortgage servicing rights (MSRs) is evaluated on a disaggregated basis relative to loans originated in a given quarter for impairment if there are changes in market conditions, payoffs or loan delinquencies. Impairment of MSRs is recognized through a charge to noninterest income when the MSRs' carrying amount exceeds its current fair value. MSRs are included in other assets in the accompanying statements of condition and are amortized into mortgage loan servicing income.

Transfers of Financial Assets: These are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Bank, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Mortgage Loan Servicing Fees: These are based on a percentage of the interest collected and are included in income as related loan payments from mortgagors are collected offset by the amortization of the servicing rights.

Investments in Limited Partnerships: Investments where the underlying assets are qualified affordable housing projects are accounted for using either the cost method or equity method, depending on investment ownership percentage. Under the cost method, the Bank amortizes the excess of the carrying amount of the investment over its estimated residual value during the periods in which tax credits are allocated to the Bank. The amortization is included in other noninterest expense. Under the equity method, the Bank includes its proportionate share of income or loss in other noninterest income or expense.

(Continued)

FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
December 31, 2019 and 2018
(Dollars in thousands except per share data)

NOTE 1 - SIGNIFICANT ACCOUNTING AND REPORTING POLICIES (Continued)

Bankcard Fees: These include income from interchange fees on both credit and debit cards, merchant fees earned on credit transactions, and miscellaneous set up and equipment rental fees. The Bank recognizes fee revenue as it is earned and collectability is reasonably assured. Expenses related to rebate reward programs are recorded when earned by cardholders.

Income Taxes: Income taxes are accounted for in accordance with Accounting Standards Codification (ASC) Topic 740. A current income tax asset or liability is recognized for estimated taxes payable or refundable on current year income tax returns. A deferred tax asset or liability is recognized for future tax effects attributable to temporary differences arising between the tax bases of assets or liabilities and their reported amounts in the financial statements. The measurement of current and deferred tax assets and liabilities is based on provisions of enacted tax law. The effect of a change in tax rates on deferred taxes is recognized in income in the period that includes the enactment date. In the event the Bank does not expect to realize future tax benefits, a valuation allowance would be established to reduce the amount of deferred tax assets.

A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

The Bank recognizes interest and/or penalties related to income tax matters in income tax expense.

Earnings Per Common Share: These are computed on the basis of the weighted average number of shares outstanding. The weighted average number of shares outstanding were 3,168,566 and 3,169,582 for 2019 and 2018, respectively. The Bank does not have any potentially dilutive securities.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

Fair Values of Financial Instruments: These are estimated using relevant market information and other assumptions, as more fully disclosed in estimated fair value of financial instruments footnote. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

Reclassifications: Reclassifications have been made to conform 2018 financial statement data with the 2019 presentation. Reclassifications had no effect on prior year net income or shareholders' equity.

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FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
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NOTE 1 - SIGNIFICANT ACCOUNTING AND REPORTING POLICIES (Continued)

New Accounting Standards:

On January 1, 2019, the Bank adopted Topic 842, Leases, and subsequent amendments thereto, which requires the Bank to recognize most leases on the balance sheet. The Bank adopted the standard under a modified retrospective approach as of the date of adoption and elected to apply the practical expedient of carrying over of historical lease determination and lease classification conclusions.

The adoption of the leasing standard resulted in the recognition a right to use asset and lease liability of \$1,525. These amounts were determined based on the present value of remaining minimum lease payments, discounted using the Bank's incremental borrowing rate as of the date of adoption. There was not material impact to the timing of expense or income recognition in the Consolidated Income Statements. Prior periods were not restated and continue to be presented under legacy GAAP. Disclosures about the Bank's leasing activities are presented in Note 11 – Leases.

In March 2017, the FASB amended existing guidance over the premium amortization period on purchased callable debt securities. The amendment require the premium recognized upon the purchase of the callable debt securities to be amortized to the earliest call date, which is expected to better align the amortization period of the premium to the expectation incorporated in marketing pricing. These amendments are effective for annual periods beginning after December 15, 2018. The effect of adopting this standard on January 1, 2019, resulted in a cumulative-effect adjustment recognized in retained earnings at the beginning of the period of adoption of \$475.

In June 2016, the FASB amended existing guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to-maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor. For debt securities with other-than-temporary impairment, the guidance will be applied prospectively. For all other assets within the scope of CECL, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective. These amendments were initially effective for annual periods beginning after December 15, 2020. During 2019, FASB delayed the effective periods beginning after December 15, 2022. The Bank has created a CECL implementation team and has been working with an external vendor regarding the development of a CECL-compliant model and gathering of the requisite data. At this time, management is still evaluating the impact of the standard.

NOTE 2 - CASH AND CASH EQUIVALENTS

The Bank is required to maintain an average daily reserve balance with the Federal Reserve Bank, or maintain such reserve balance in cash. The average daily reserve balance for the two-week maintenance period which encompassed December 31, 2019 and 2018 was \$21,443 and \$22,704, respectively.

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FIRST NATIONAL BANK ALASKA
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NOTE 3 - SECURITIES

The amortized cost and fair value of securities, available-for-sale are shown by contractual maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Amortized cost and fair values of securities, available-for-sale by maturity date, as of December 31, 2019:

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
<u>December 31, 2019</u>				
U.S. Treasury securities maturities:				
Within 1 year	\$ 135,862	\$ 274	\$ 1	\$ 136,135
One to 5 years	<u>130,559</u>	<u>2,363</u>	<u>-</u>	<u>132,922</u>
Total	<u>266,421</u>	<u>2,637</u>	<u>1</u>	<u>269,057</u>
U.S. government-sponsored enterprises maturities:				
Within 1 year	129,516	119	46	129,589
One to 5 years	357,512	2,692	195	360,009
Five to 10 years	242,180	6,767	208	248,739
After 10 years	<u>24,099</u>	<u>149</u>	<u>250</u>	<u>23,998</u>
Total	<u>753,307</u>	<u>9,727</u>	<u>699</u>	<u>762,335</u>
States and political subdivisions maturities:				
Within 1 year	2,347	12	-	2,359
One to 5 years	33,446	782	-	34,228
Five to 10 years	62,160	2,997	-	65,157
After 10 years	<u>79,358</u>	<u>2,140</u>	<u>159</u>	<u>81,339</u>
Total	<u>177,311</u>	<u>5,931</u>	<u>159</u>	<u>183,083</u>
Mortgage-backed securities: residential	1,684	-	12	1,672
Mortgage-backed securities: commercial	123,938	936	192	124,682
Corporate bonds maturities:				
Within 1 year	46,328	134	4	46,458
One to 5 years	170,439	2,675	15	173,099
Five to 10 years	<u>27,113</u>	<u>1,222</u>	<u>-</u>	<u>28,335</u>
Total	<u>243,880</u>	<u>4,031</u>	<u>19</u>	<u>247,892</u>
Total securities, available-for-sale	<u>\$ 1,566,541</u>	<u>\$ 23,262</u>	<u>\$ 1,082</u>	<u>\$ 1,588,721</u>

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NOTES TO FINANCIAL STATEMENTS
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NOTE 3 - SECURITIES (Continued)

Within the state and political subdivisions category, the largest concentrations of securities, available-for-sale are held in Texas with 51%, Washington with 25%, and Hawaii with 9% of the category.

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2019, were as follows:

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<u>2019</u>						
Available-for-sale:						
U.S. Treasury	\$ 9,994	\$ 1	\$ -	\$ -	\$ 9,994	\$ 1
U.S. government-sponsored enterprises	63,695	458	86,449	241	150,144	699
States and political subdivisions	19,366	159	-	-	19,366	159
Mortgage-backed – residential	-	-	1,672	12	1,672	12
Mortgage-backed - commercial	44,531	192	-	-	44,531	192
Corporate bonds	<u>5,070</u>	<u>5</u>	<u>15,095</u>	<u>14</u>	<u>20,165</u>	<u>19</u>
Total	<u>\$ 142,656</u>	<u>\$ 815</u>	<u>\$ 103,216</u>	<u>\$ 267</u>	<u>\$ 245,872</u>	<u>\$ 1,082</u>

The unrealized holding losses on investments are the result of increasing interest rates. The contractual terms of these investments do not permit the issuer to redeem the securities at a price less than par, or at a time in which the securities amortized cost would be less than par. Unrealized losses on U.S. Treasury, U.S. government-sponsored enterprises, states and political subdivisions and corporate bonds have not been recognized into income because the issuer(s) bonds are of high credit quality, management does not intend to sell and it is likely that management will not be required to sell the securities prior to their anticipated recovery, and the decline in fair value is largely due to changes in interest rates and other market conditions. The fair value is expected to recover as the bonds approach maturity.

At December 31, 2019, all of the mortgage-backed securities held by the Bank were issued by U.S. government corporations (Ginnie Mae) or U.S. government-sponsored entities (Fannie Mae and Freddie Mac), institutions which the government has affirmed its commitment to support. Because the decline in fair value is attributable to changes in interest rates and illiquidity, and not credit quality, and because the Bank does not have the intent to sell these mortgage-backed securities and it is likely that it will not be required to sell the securities before their anticipated recovery, the Bank does not consider these securities to be other-than-temporarily impaired.

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FIRST NATIONAL BANK ALASKA
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NOTE 3 - SECURITIES (Continued)

The amortized cost and fair value of securities, available-for-sale are shown by contractual maturity. Amortized cost and fair values of securities, available-for-sale by maturity date, as of December 31, 2018:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
<u>December 31, 2018</u>				
U.S. Treasury securities maturities:				
Within 1 year	\$ 112,469	\$ 8	\$ 179	\$ 112,298
One to 5 years	<u>213,504</u>	<u>825</u>	<u>1,404</u>	<u>212,925</u>
Total	<u>325,973</u>	<u>833</u>	<u>1,583</u>	<u>325,223</u>
U.S. government-sponsored enterprises maturities:				
Within 1 year	117,646	-	590	117,056
One to 5 years	486,955	120	8,654	478,421
Five to 10 years	134,576	800	2,650	132,726
After 10 years	<u>8,000</u>	<u>19</u>	<u>-</u>	<u>8,019</u>
Total	<u>747,177</u>	<u>939</u>	<u>11,894</u>	<u>736,222</u>
States and political subdivisions maturities:				
Within 1 year	18,139	-	41	18,098
One to 5 years	28,992	16	127	28,881
Five to 10 years	75,591	110	1,452	74,249
After 10 years	<u>41,268</u>	<u>63</u>	<u>566</u>	<u>40,765</u>
Total	<u>163,990</u>	<u>189</u>	<u>2,186</u>	<u>161,993</u>
Mortgage-backed securities: residential	2,214	-	63	2,151
Mortgage-backed securities: commercial	79,608	-	2,105	77,503
Corporate bonds maturities:				
Within 1 year	33,691	-	104	33,587
One to 5 years	257,234	112	5,625	251,721
Five to 10 years	<u>10,017</u>	<u>-</u>	<u>425</u>	<u>9,592</u>
Total	<u>300,942</u>	<u>112</u>	<u>6,154</u>	<u>294,900</u>
Total securities, available-for-sale	<u>\$ 1,619,904</u>	<u>\$ 2,073</u>	<u>\$ 23,985</u>	<u>\$ 1,597,992</u>

Within the state and political subdivisions category, the largest concentrations of securities, available-for-sale are held in Texas with 38%, Washington with 26%, and Alaska with 14% of the category.

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NOTE 3 - SECURITIES (Continued)

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2018, were as follows:

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
<u>2018</u>						
Available-for-sale:						
U.S. Treasury	\$ 84,198	\$ 180	\$ 115,894	\$ 1,403	\$ 200,092	\$ 1,583
U.S. government-sponsored enterprises	153,833	1,483	465,650	10,411	619,483	11,894
States and political subdivisions	48,917	456	92,059	1,730	140,976	2,186
Mortgage-backed – residential	-	-	2,151	63	2,151	63
Mortgage-backed - commercial	-	-	77,503	2,105	77,503	2,105
Corporate bonds	<u>71,208</u>	<u>1,126</u>	<u>196,662</u>	<u>5,028</u>	<u>267,870</u>	<u>6,154</u>
Total	<u>\$ 358,156</u>	<u>\$ 3,245</u>	<u>\$ 949,919</u>	<u>\$ 20,740</u>	<u>\$ 1,308,075</u>	<u>\$ 23,985</u>

Investment securities with carrying amounts of \$1,275,164 and \$1,264,564 at December 31, 2019 and 2018, respectively, were pledged to secure public and trust deposits, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

Realized gains on the disposition of investment securities totaled \$334 and \$95 in 2019 and 2018, respectively. Realized losses on the disposition of investment securities were \$218 and \$2,045 for 2019 and 2018, respectively.

NOTE 4 - LOANS

The loan portfolio consists of the following at December 31:

	<u>2019</u>	<u>2018</u>
Commercial and industrial	\$ 419,233	\$ 428,425
Real estate construction	346,951	335,157
Real estate mortgage	235,933	250,407
Real estate commercial	992,433	921,389
Consumer and other	<u>17,061</u>	<u>19,495</u>
Loans, gross	<u>\$ 2,011,611</u>	<u>\$ 1,954,873</u>

There were unamortized premiums of \$2,805 and \$3,847 from purchased government guaranteed loans and multifamily real estate loans as of December 31, 2019 and 2018, respectively. The Bank purchased \$16,827 and \$46,613 of government guaranteed loans in 2019 and 2018, respectively. The government guaranteed loan balances were \$132,792 and \$133,981 as of December 31, 2019 and 2018, respectively. Government guaranteed loans are included in commercial and industrial loans. Multifamily loans are included in real estate mortgage.

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NOTES TO FINANCIAL STATEMENTS
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NOTE 4 - LOANS (Continued)

Real estate loans serviced for others as of December 31, 2019 and 2018 were \$1,271,279 and \$1,285,471, respectively. Custodial balances, associated with these loans and held in noninterest bearing demand accounts, amounted to \$11,466 and \$9,577 as of December 31, 2019 and 2018, respectively.

As of December 31, 2019 and 2018 the aggregate indebtedness of all related parties (directors and executive officers of the Bank and their family members) was \$14,796 and \$12,652, respectively.

NOTE 5 - ALLOWANCE FOR LOAN LOSSES

The following is an analysis of the changes in the allowance for loan losses by portfolio segment for the period ended:

	Commercial and Industrial	Real Estate	Consumer and Other	Total
<u>2019</u>				
Allowance for loan losses:				
Beginning balance, January 1, 2019	\$ 5,495	\$ 13,530	\$ 375	\$ 19,400
Provision for loan losses	(302)	378	222	298
Loans charged-off	(17)	(414)	(363)	(794)
Recoveries	<u>324</u>	<u>106</u>	<u>166</u>	<u>596</u>
Ending Balance, December 31, 2019	<u>\$ 5,500</u>	<u>\$ 13,600</u>	<u>\$ 400</u>	<u>\$ 19,500</u>
<u>2018</u>				
Allowance for loan losses:				
Beginning balance, January 1, 2018	\$ 3,715	\$ 13,710	\$ 400	\$ 17,825
Provision for loan losses	1,655	331	7	1,993
Loans charged-off	(185)	(578)	(277)	(1,040)
Recoveries	<u>310</u>	<u>67</u>	<u>245</u>	<u>622</u>
Ending Balance, December 31, 2018	<u>\$ 5,495</u>	<u>\$ 13,530</u>	<u>\$ 375</u>	<u>\$ 19,400</u>

(Continued)

FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2019 and 2018:

	Commercial and <u>Industrial</u>	Real <u>Estate</u>	Consumer and <u>Other</u>	<u>Total</u>
<u>2019</u>				
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 2,590	\$ 410	\$ -	\$ 3,000
Collectively evaluated for impairment	<u>2,910</u>	<u>13,190</u>	<u>400</u>	<u>16,500</u>
Total ending allowance balance	<u>\$ 5,500</u>	<u>\$ 13,600</u>	<u>\$ 400</u>	<u>\$ 19,500</u>
Loans:				
Individually evaluated for impairment	\$ 14,178	\$ 12,589	\$ -	\$ 26,767
Collectively evaluated for impairment	<u>406,440</u>	<u>1,570,578</u>	<u>17,026</u>	<u>1,994,044</u>
Total loans outstanding balance	<u>\$ 420,618</u>	<u>\$ 1,583,167</u>	<u>\$ 17,026</u>	2,020,811
Deferred loan fees, net				<u>(9,200)</u>
Total loans				<u>\$ 2,011,611</u>
	Commercial and <u>Industrial</u>	Real <u>Estate</u>	Consumer and <u>Other</u>	<u>Total</u>
<u>2018</u>				
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 2,350	\$ 500	\$ -	\$ 2,850
Collectively evaluated for impairment	<u>3,145</u>	<u>13,030</u>	<u>375</u>	<u>16,550</u>
Total ending allowance balance	<u>\$ 5,495</u>	<u>\$ 13,530</u>	<u>\$ 375</u>	<u>\$ 19,400</u>
Loans:				
Individually evaluated for impairment	\$ 16,546	\$ 16,545	\$ -	\$ 33,091
Collectively evaluated for impairment	<u>413,270</u>	<u>1,497,685</u>	<u>19,456</u>	<u>1,930,411</u>
Total loans outstanding balance	<u>\$ 429,816</u>	<u>\$ 1,514,230</u>	<u>\$ 19,456</u>	1,963,502
Deferred loan fees, net				<u>(8,629)</u>
Total loans				<u>\$ 1,954,873</u>

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (Continued)

The following table summarizes our nonaccrual loans and loans past due by loan class as of December 31, 2019 and 2018:

	<u>30-89 Days Past Due</u>	<u>Greater Than 89 Days Past Due</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>Non-accrual</u>
December 31, 2019						
Commercial and industrial	\$ 1,642	\$ 32	\$ 1,674	\$ 418,944	\$ 420,618	\$ 2,244
Real Estate						
Construction and development	673	-	673	348,097	348,770	857
1- 4 and multifamily residential	652	121	773	235,894	236,667	781
Commercial real estate	832	160	992	996,738	997,730	2,937
Consumer and other	<u>65</u>	<u>5</u>	<u>70</u>	<u>16,956</u>	<u>17,026</u>	<u>-</u>
Total	<u>\$ 3,864</u>	<u>\$ 318</u>	<u>\$ 4,182</u>	<u>\$ 2,016,629</u>	2,020,811	6,819
Deferred loan fees, net					(9,200)	(50)
Total loans					<u>\$ 2,011,611</u>	<u>\$ 6,769</u>
December 31, 2018						
Commercial and industrial	\$ 1,431	\$ 110	\$ 1,541	\$ 428,275	\$ 429,816	\$ 2,534
Real Estate						
Construction and development	110	-	110	336,825	336,935	315
1- 4 and multifamily residential	1,067	219	1,286	249,793	251,079	1,327
Commercial real estate	1,321	753	2,074	924,142	926,216	3,701
Consumer and other	<u>29</u>	<u>11</u>	<u>40</u>	<u>19,416</u>	<u>19,456</u>	<u>-</u>
Total	<u>\$ 3,958</u>	<u>\$ 1,093</u>	<u>\$ 5,051</u>	<u>\$ 1,958,451</u>	1,963,502	7,877
Deferred loan fees, net					(8,629)	(50)
Total loans					<u>\$ 1,954,873</u>	<u>\$ 7,827</u>

As of December 31, 2019 and 2018, \$121 and \$0 thousand in loans were greater than 89 days past due and in accrual status.

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FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents information related to impaired loans, net of deferred fees, by class of loans as of December 31, 2019:

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
<u>December 31, 2019</u>						
With no allowance recorded:						
Commercial and industrial	\$ 2,128	\$ 1,708	\$ -	\$ 1,889	\$ 173	\$ 175
Real estate						
Construction and other	1,169	1,063	-	1,060	94	95
1-4 and multifamily residential	1,841	1,742	-	1,876	149	150
Commercial real estate	6,548	5,266	-	5,384	462	469
Consumer and other	-	-	-	-	-	-
Subtotal	<u>11,686</u>	<u>9,779</u>	<u>-</u>	<u>10,209</u>	<u>878</u>	<u>889</u>
With an allowance recorded:						
Commercial and industrial	12,518	12,431	2,590	13,484	1,044	1,014
Real estate						
Construction and other	406	379	160	395	24	33
1-4 and multifamily residential	821	783	50	841	64	64
Commercial real estate	3,690	3,310	200	3,467	255	252
Consumer and other	-	-	-	-	-	-
Subtotal	<u>17,435</u>	<u>16,903</u>	<u>3,000</u>	<u>18,187</u>	<u>1,387</u>	<u>1,363</u>
Total	<u>\$ 29,121</u>	<u>\$ 26,682</u>	<u>\$ 3,000</u>	<u>\$ 28,396</u>	<u>\$ 2,265</u>	<u>\$ 2,252</u>

(Continued)

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents information related to impaired loans, net of deferred fees, by class of loans as of December 31, 2018:

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
<u>December 31, 2018</u>						
With no allowance recorded:						
Commercial and industrial	\$ 2,349	\$ 1,990	\$ -	\$ 1,984	\$ 187	\$ 190
Real estate						
Construction and other	810	780	-	814	49	53
1-4 and multifamily residential	2,257	2,196	-	1,912	149	158
Commercial real estate	12,440	10,772	-	11,015	865	857
Consumer and other	-	-	-	-	-	-
Subtotal	<u>17,856</u>	<u>15,738</u>	<u>-</u>	<u>15,725</u>	<u>1,250</u>	<u>1,258</u>
With an allowance recorded:						
Commercial and industrial	14,541	14,510	2,350	7,260	113	41
Real estate						
Construction and other	684	626	220	431	46	37
1-4 and multifamily residential	1,187	1,158	140	1,110	82	85
Commercial real estate	957	954	140	709	45	45
Consumer and other	-	-	-	-	-	-
Subtotal	<u>17,369</u>	<u>17,248</u>	<u>2,850</u>	<u>9,510</u>	<u>286</u>	<u>208</u>
Total	<u>\$ 35,225</u>	<u>\$ 32,986</u>	<u>\$ 2,850</u>	<u>\$ 25,235</u>	<u>\$ 1,536</u>	<u>\$ 1,466</u>

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (Continued)

The Bank categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Bank analyzes loans individually by classifying loans as to credit risk. Formal analysis of classified loans is performed quarterly, including all loans 60 days delinquent. Ongoing evaluation of certain performing loans is conducted through internal credit examinations and loan committee reviews.

The Bank uses the following definitions for risk ratings:

Pass/Watch: Loans classified as pass/watch include current loans performing in accordance with contractual terms, pools of homogenous residential real estate and installment/consumer loans that are not individually risk rated and loans which exhibit certain risk factors that require greater than usual monitoring by management.

Special Mention: Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard: Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful/Loss: Loans classified as doubtful/loss have all the weaknesses inherent in those classified as 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 following table summarizes our internal risk rating by loan class based on the most recent analysis performed as of December 31, 2019 and 2018:

	<u>Pass/ Watch</u>	<u>Special Mention</u>	<u>Sub- Standard</u>	<u>Doubtful/ Loss</u>	<u>Total</u>
<u>December 31, 2019</u>					
Commercial and Industrial	\$ 404,588	\$ 1,216	\$ 14,212	\$ 602	\$ 420,618
Real Estate,					
Construction and development	347,020	-	1,750	-	348,770
1-4 and multifamily residential	230,415	1,014	5,202	36	236,667
Commercial real estate	984,453	2,712	10,565	-	997,730
Consumer and other	<u>17,024</u>	<u>2</u>	<u>-</u>	<u>-</u>	<u>17,026</u>
Total	<u>\$ 1,983,500</u>	<u>\$ 4,944</u>	<u>\$ 31,729</u>	<u>\$ 638</u>	2,020,811
Deferred loan fees, net					<u>(9,200)</u>
Total					<u>\$ 2,011,611</u>

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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (Continued)

	<u>Pass/ Watch</u>	<u>Special Mention</u>	<u>Sub- Standard</u>	<u>Doubtful/ Loss</u>	<u>Total</u>
<u>December 31, 2018</u>					
Commercial and Industrial	\$ 409,812	\$ 940	\$ 16,631	\$ 2,433	\$ 429,816
Real Estate,					
Construction and development	334,631	-	2,098	206	336,935
1-4 and multifamily residential	243,784	1,052	6,104	139	251,079
Commercial real estate	912,193	1,208	12,715	100	926,216
Consumer and other	<u>19,456</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>19,456</u>
Total	<u>\$ 1,919,876</u>	<u>\$ 3,200</u>	<u>\$ 37,548</u>	<u>\$ 2,878</u>	1,963,502
Deferred loan fees, net					<u>(8,629)</u>
Total					<u>\$ 1,954,873</u>

Troubled Debt Restructurings:

At December 31, 2019 and 2018, the Bank had loans of \$20,088 and \$25,770 classified as troubled debt restructurings, respectively, which are included in impaired loans. These loans had allocated specific reserves of \$2,626 and \$2,219 at December 31, 2019 and 2018, respectively. The Bank has committed to lend \$135 and \$56 as of December 31, 2019 and 2018, respectively, to customers with outstanding loans that are classified as troubled debt restructurings.

At December 31, 2019 \$17,754 of troubled debt restructurings were performing and \$2,334 were nonaccrual and impaired. At December 31, 2018, \$22,933 of troubled debt restructurings were performing and \$2,837 were nonaccrual and impaired.

During the year ended December 31, 2019, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk or a temporary deferral of all or part of the original periodic principal payments.

Commercial loans: There were two restructurings of commercial loans. There was one restructuring of stated interest rate, as well as two maturity date extensions of one and two months.

There were no restructurings of construction loans, 1-4 and multifamily residential loans, commercial real estate loans, and consumer loans.

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FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
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NOTE 5 - ALLOWANCE FOR LOAN LOSSES (Continued)

During the year ended December 31, 2018, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk or a temporary deferral of all or part of the original periodic principal payments.

Commercial loans: There were three restructurings of commercial loans with maturity date extensions of 1.35 and 3 years.

1-4 and multifamily residential loans: There were three restructurings of 1-4 and multifamily residential loans. There were two maturity date extensions of 15.4 and 15.9 years. All three loans had a temporary deferral of all or part of the original periodic principal payments.

There were no restructurings of construction loans, commercial real estate loans, and consumer loans.

The following table presents loans by class modified as troubled debt restructurings that occurred during the years ended December 31, 2019 and 2018:

	<u>Number of Loans</u>	<u>Pre-Modification Outstanding Recorded Investment</u>	<u>Post-Modification Outstanding Recorded Investment</u>
2019 Troubled Debt Restructurings:			
Commercial	2	\$ 1,528	\$ 1,101
Real estate:			
Construction and other	-	-	-
1-4 and multifamily residential	-	-	-
Commercial real estate	-	-	-
Consumer and other	-	-	-
	<u>2</u>	<u>\$ 1,528</u>	<u>\$ 1,101</u>
2018 Troubled Debt Restructurings:			
Commercial	3	\$ 12,871	\$ 12,254
Real estate:			
Construction and other	-	-	-
1-4 and multifamily residential	3	114	114
Commercial real estate	-	-	-
Consumer and other	-	-	-
	<u>6</u>	<u>\$ 12,985</u>	<u>\$ 12,368</u>

The troubled debt restructurings described in the above table had allocated specific reserves of \$427 and \$2,155 as of December 31, 2019 and 2018 and resulted in no charge-offs during the years ended December 31, 2019 and 2018.

There were no loans that defaulted (became at least 60 days past due) during December 31, 2019 and 2018 after having been modified as a troubled debt restructuring within the previous 12 months.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Bank's internal underwriting policy.

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NOTE 6 - PREMISES AND EQUIPMENT

The following is a summary of the major components of premises and equipment as of December 31:

	<u>2019</u>	<u>2018</u>
Land	\$ 13,516	\$ 13,516
Bank premises	78,235	72,912
Leasehold improvements	122	122
Furniture and equipment	37,228	34,808
Construction in process	650	2,589
Total premises and equipment	<u>129,751</u>	<u>123,947</u>
Less: Accumulated depreciation and amortization	<u>80,740</u>	<u>77,274</u>
Premises and equipment, net	<u>\$ 49,011</u>	<u>\$ 46,673</u>

Depreciation and amortization expense on premises and equipment for the years ended December 31, 2019 and 2018 totaled \$3,798 and \$3,599, respectively.

NOTE 7 - OTHER REAL ESTATE OWNED

The following is an analysis of the changes in other real estate owned:

	<u>2019</u>	<u>2018</u>
Balance, January 1	\$ 1,790	\$ 15,267
Acquired upon foreclosure	612	1,180
Transfers from bank premises	-	41
Capitalized improvements	9	-
Dispositions	(1,003)	(14,593)
Depreciation	-	(105)
Balance, December 31	<u>1,408</u>	<u>1,790</u>
Less Devaluation Reserves:		
Balance, January 1	(165)	(5,392)
Impairments subsequent to foreclosure	(156)	(129)
Dispositions	256	5,356
Balance, December 31	<u>(65)</u>	<u>(165)</u>
Other real estate owned, net	<u>\$ 1,343</u>	<u>\$ 1,625</u>

Net gains on sales of other real estate owned included in other noninterest expense for the years ended December 31, 2019 and 2018, totaled \$111 and \$4,728, respectively. Operating expenses, net of rental income totaled \$65 and \$144 for the years ended December 31, 2019 and 2018, respectively.

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NOTE 8 - MORTGAGE SERVICING RIGHTS

The following is an analysis of the changes in mortgage servicing rights:

	<u>2019</u>	<u>2018</u>
Balance, January 1,	\$ 2,740	\$ 2,825
Additions -		
Capitalization of servicing assets	1,073	1,210
Subtractions:		
Amortization	(958)	(1,045)
Accelerated amortization due to early payoffs	<u>(244)</u>	<u>(250)</u>
Balance, December 31,	<u>\$ 2,611</u>	<u>\$ 2,740</u>

Mortgage loan servicing income is comprised of the following:

	<u>2019</u>	<u>2018</u>
Mortgage loan servicing fees	\$ 3,447	\$ 3,404
Amortization of costs	(958)	(1,045)
Accelerated amortization due to early payoffs	<u>(244)</u>	<u>(250)</u>
Mortgage loan servicing income	<u>\$ 2,245</u>	<u>\$ 2,109</u>

Mortgage servicing rights (MSRs) are accounted for under the amortization method. MSRs are included in other assets. MSRs are initially recorded at estimated fair value and are then amortized in proportion to and over the period of estimated net servicing income. The fair value of MSRs is estimated at the present value of the estimated expected future cash flows using a discount rate equivalent with the risks involved. MSRs are amortized against mortgage loan servicing income over seven years based upon prepayment assumptions. Those prepayment assumptions predict mortgages will pay off or refinance at lower levels during the first 30 months and at a constant level over the remaining 54 months. Accordingly, MSRs are amortized against mortgage loan servicing income at higher levels during the initial 30 months. If actual payments received exceed the prepayment assumptions, an impairment is recorded. Fair value of MSRs exceed amortized cost for each individual stratum. Accordingly, there has been no impairment for 2019 and 2018.

NOTE 9 - DEPOSITS

Total deposits by type of depositor as of December 31:

	<u>2019</u>	<u>2018</u>
Deposits of individuals, partnerships, and corporations	\$ 2,342,377	\$ 2,356,948
Deposits of U.S. government	1,193	1,212
Deposits of states and political subdivisions	43,918	61,773
Other deposits	<u>297</u>	<u>360</u>
Total deposits	<u>\$ 2,387,785</u>	<u>\$ 2,420,293</u>

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NOTE 9 – DEPOSITS (Continued)

As of December 31, 2019 and 2018 the aggregate deposits of related parties (directors and executive officers of the Bank and their family members) were \$7,364 and \$9,354, respectively.

Time deposits have aggregate maturities as of December 31 as follows:

<u>Maturity:</u>	<u>2019</u>
2020	103,109
2021	5,757
2022	3,514
2023	1,731
2024	<u>1,006</u>
Total time deposits	<u>\$ 115,117</u>

Time deposits that meet or exceed the FDIC Insurance Limit of \$250 were \$43,218 and \$45,149 as of December 31, 2019 and 2018, respectively.

NOTE 10 - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Investment securities, primarily including U.S. Treasuries and U.S. government-sponsored enterprises, with carrying amounts of \$1,077,862 and \$1,011,342 at December 31, 2019 and 2018, respectively, were pledged to secure securities sold under agreements to repurchase. As of December 31, 2019 all repurchase agreements matured within 1 business day.

As of December 31, 2019 and 2018, aggregate repurchase agreement balances of related parties (directors and executive officers of the Bank and their family members) were \$144 and \$638, respectively.

NOTE 11 - LEASES

The Bank adopted ASU 2016-02 using the modified retrospective approach with an effective date as of January 1, 2019. Prior year financial statements were not recast under the new standard and, therefore, those amounts are not presented below. We elected the practical expedients allowing us to carryforward our historical assessments of (1) whether contracts are or contain leases, (2) lease classification and (3) initial direct costs. The Bank also elected the practical expedient to not separate lease components from non-lease components for all operating leases.

The Bank is party to various operating leases for the rental of premises and equipment. Total rental expenses for Bank premises and equipment were \$421 and \$324 as of December 31, 2019 and 2018, respectively.

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FIRST NATIONAL BANK ALASKA
NOTES TO FINANCIAL STATEMENTS
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NOTE 11 – LEASES (Continued)

The Bank has lease agreements for land and office facilities that it occupies to operate several retail branch locations that are classified as operating leases and are recognized on the balance sheet as right-of-use ("ROU") assets and lease liabilities. The Bank uses the rate implicit in each lease as the discount rate to determine the lease liability, which is the present value of lease payments not yet paid at the lease commencement date. If the rate implicit in each lease is not readily determinable, the Bank uses its incremental borrowing rate as of the lease commencement date as the discount rate. As of December 31, 2019, the Bank has operating lease ROU assets of \$1,562 and operating lease liabilities of \$1,562.

In 2017, the Bank entered into an obligation for a finance lease covering mail equipment. The gross amount of mail equipment, including installation costs, and related accumulated amortization under the finance lease was \$358 and \$270 as of December 31, 2019. Amortization of assets held under finance leases is included with depreciation expense.

The table below reconciles future undiscounted cash flows for finance and operating leases with initial terms of one year or more as of December 31, 2019 to the finance lease obligations and operating lease liabilities recorded on the balance sheet.

	<u>Finance Leases</u>	<u>Operating Leases</u>
Year ended December 31:		
2020	\$ 72	\$ 200
2021	72	150
2022	12	137
2023	-	139
2024	-	119
Thereafter	-	<u>3,386</u>
Total undiscounted lease payments	<u>156</u>	<u>4,131</u>
Less: imputed interest	<u>-</u>	<u>(2,569)</u>
Net finance lease obligations and operating lease liabilities	<u>\$ 156</u>	<u>\$ 1,562</u>
Finance lease weighted average remaining lease term (years)		2.17
Finance lease weighted average discount rate		0.10%
Operating lease weighted average remaining lease term (years)		55.30
Operating lease weighted average discount rate		4.42%

Subsequent to December 31, 2019, the Bank entered into a lease for branch retail space beginning March 1, 2020. The additional lease liability associated with this lease is estimated to be \$145.

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NOTE 12 - SHAREHOLDERS' EQUITY

Since November 2008, the Bank has been authorized to repurchase up to a value of \$100,000 of its outstanding common stock on the open market and through privately negotiated transactions. The original program term expired in August 2009 and has been renewed annually since that period. The existing authority expires April 17, 2020.

Repurchase transactions are accounted for as a reduction in common stock and retained earnings. Repurchases are funded from available capital and retired. These transactions have not impacted the surplus balance of \$40,000 as of December 31, 2019 and 2018, which is maintained to comply with regulatory requirements. Changes to surplus require regulatory approval.

During 2019, the Bank repurchased a total of 1,120 shares of common stock representing an annual aggregate purchase value of \$269 at an average price per share of \$239.80. During 2018, the Bank repurchased a total of 2,200 shares of common stock representing an annual aggregate value of \$477, at an average price per share of \$217.00. Cumulative shares of 280,080 have been repurchased under the program since inception for a combined purchase total of \$45,342.

At the January 30, 2020 Board of Directors meeting, cash dividends of \$3.20 per share were declared, payable March 15, 2020 to shareholders of record as of March 1, 2020.

NOTE 13 - LITIGATION

From time to time in the normal course of business, various claims are asserted against the Bank. Management and legal counsel are of the opinion that ultimate resolution of the matters presently known to exist will not have a material effect on the Bank's financial statements.

The Bank's payment services include acquisition of Visa credit card transactions from merchants who use the Bank's merchant services. In order to be able to acquire those transactions the Bank is a member of the Visa U.S.A. credit card association.

During 2004, Discover Financial Services, Inc. filed an action against Visa U.S.A. and others seeking treble damages and injunctive relief under Federal antitrust laws. Also in 2004, American Express Travel Related Services Company, Inc. filed a similar action against Visa U.S.A. and others. There was other related litigation as well.

During 2007, Visa closed a restructuring of its organization. As part of this reorganization, the Visa U.S.A. by-laws were amended and included an indemnification provision whereby the Bank, as a member of Visa U.S.A., is required to indemnify Visa for acts and omissions of the Bank related to the Visa network and for certain specified litigation involving Visa U.S.A. An escrow arrangement was established anticipating the use of escrowed funds to pay the amount of certain Visa U.S.A. litigation expenses and settlements, including the Discover and American Express cases discussed above. Consequently, under ASC Topic 460, the Bank was required to measure the indemnification obligation related to the Visa litigation at fair value.

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NOTE 13 – LITIGATION (Continued)

In late 2007 and 2008, respectively, Visa Inc., Visa U.S.A. and Visa International entered into agreements with American Express and Discover Financial Services to resolve all current litigation between them. Under the agreements Visa Inc. agreed to pay American Express \$2,065,000 and \$1,888,000 to Discover Financial Services. The Bank's membership proportion according to the number of shares it was issued upon restructuring is 0.01691% after share repurchase adjustments.

The Bank has carried reserves for litigation expense for proportional exposure under these matters deemed covered litigation by VISA Inc. since 2007. The reserve is \$1,500 as of December 31, 2019 and 2018. The Bank has not recorded in its financial statements any value for its membership interest in Visa Inc.

The Bank has a \$1,500 escrow receivable as of December 31, 2019 and 2018, respectively, representing the Bank's proportionate share of remaining escrowed funds Visa set aside to the purpose of settling these litigation claims.

The specified litigation discussed above includes outstanding unresolved claims against Visa U.S.A., which are complex and subject to substantial uncertainty and unspecified damages. As such, the ultimate outcome of the cases and corresponding indemnification may be significantly different than the value estimated in the December 31, 2019 financial statements.

NOTE 14 - EMPLOYEE BENEFIT PLANS

The Bank offers a 401(k) plan for all employees whom have attained 18 years of age. Participants are allowed to make voluntary salary deferral of up to 50% of their eligible pay subject to certain limitations. For 2019, the maximum amount that may be deferred by participants is \$19. Additionally, participants who reach the age of 50 by the end of the calendar year are eligible to make a "catch-up contribution" in an amount up to \$6. The participant's salary deferral plus any earnings they generate are 100% vested.

The Bank will make matching contributions equal to 50% of the portion of each participant's before-tax contributions (excluding "catch-up contributions") that do not exceed 7.5% of the participant's eligible pay. Matching contributions made by the Bank, including any earnings generated, are vested beginning at 20% after completion of one full year of service, increasing 20% each year until fully vested at five years of service. The 2019 combined limit of all employee and employer contributions to an individual participant's account is \$56.

The Bank has a qualified non-contributory profit sharing plan for all employees. The annual profit sharing contribution can be made only from profits and the amount is determined by the Board of Directors.

The contribution to the profit sharing and 401(k) plan was \$2,217 and \$1,721 for the years ended December 31, 2019 and 2018, respectively.

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NOTE 15 - PROVISION FOR INCOME TAXES

The provision for income taxes is comprised of the following as of December 31:

	<u>2019</u>	<u>2018</u>
Current:		
Federal	\$ 13,509	\$ 10,583
State	<u>4,701</u>	<u>4,062</u>
Total current	<u>18,210</u>	<u>14,645</u>
Deferred:		
Federal	120	1,474
State	<u>43</u>	<u>522</u>
Total deferred	<u>163</u>	<u>1,996</u>
Provision for income taxes	<u>\$ 18,373</u>	<u>\$ 16,641</u>

Income tax expense differed from the Federal statutory rate of 21% for 2019 and 2018 for the following reasons:

	<u>2019</u>	<u>%</u>	<u>2018</u>	<u>%</u>
Tax expense at federal statutory rate	\$ 15,544	21.00%	\$ 14,856	21.00%
Increase (decrease) resulting from:				
State tax, net of Federal tax effect	3,842	5.19	3,601	5.09
Disallowed interest expense	148	0.20	174	0.24
Interest exempt from federal taxation	(981)	(1.33)	(1,286)	(1.82)
Low income housing tax credits	(170)	(0.23)	(667)	(0.94)
Other items, net	<u>(10)</u>	<u>(0.01)</u>	<u>(37)</u>	<u>(0.05)</u>
Provision for income taxes	<u>\$ 18,373</u>	<u>24.82%</u>	<u>\$ 16,641</u>	<u>23.52%</u>

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NOTES TO FINANCIAL STATEMENTS
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NOTE 15 - PROVISION FOR INCOME TAXES (Continued)

The tax effect of temporary differences that give rise to the Bank's deferred tax assets and deferred tax liabilities are comprised of the following:

	<u>2019</u>	<u>2018</u>
Deferred tax assets:		
Allowance for loan losses	\$ 5,543	\$ 5,515
Mortgage servicing rights	396	394
Interest collected on nonperforming loans	755	740
Vacation accrual	1,103	1,012
Accumulated depreciation and amortization	504	743
Other real estate owned valuation reserve	225	244
Net unrealized holding loss on securities, available-for-sale	-	6,229
Low income housing projects	558	427
Other	724	800
Total deferred tax assets	9,808	16,104
Deferred tax liabilities:		
Net unrealized holding gain on securities, available-for-sale	6,305	-
Net deferred loan fees	2,879	2,736
Deferred loan costs	517	532
Other	1,178	1,210
Total deferred tax liabilities	10,879	4,478
Net deferred tax (liabilities) assets	\$ (1,071)	\$ 11,626

Net deferred tax assets are included in other assets and net deferred tax liabilities are included in other liabilities in the statements of financial condition. The Bank believes that it is more likely than not that the previous taxes paid and results of future operations will generate sufficient taxable income to realize deferred tax assets.

The Bank does not have any material uncertain tax positions or unrecognized tax benefits for additional disclosure in the financial statements.

The total amount of interest and penalties recorded in the income statement for the years ended December 31, 2019 and 2018 were immaterial and no amounts are accrued for interest and penalties at December 31, 2019 or 2018.

The Bank is subject to U.S. federal income tax as well as income tax for the state of Alaska and various other state income and franchise taxes. The Bank is no longer subject to examination by taxing authorities for years before 2016.

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NOTE 16 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

GAAP requires disclosure of the estimated fair values of certain financial assets and liabilities, both on and off-balance sheet, for which it is practical to estimate the fair value. Because the estimated fair values provided herein exclude disclosure of the fair value of certain other financial instruments and all non-financial instruments, any aggregation of the estimated fair value amounts presented would not represent the underlying value of the Bank. Examples of non-financial instruments having significant value include the future earnings potential of significant customer relationships and the value of the Bank's trust department operations and other fee-generating businesses. In addition, other significant assets including property, plant, and equipment and mortgage servicing rights for portfolio loans are not considered financial instruments and, therefore, have not been valued.

Various methodologies and assumptions have been utilized in management's determination of the estimated fair value of the Bank's financial instruments, which are detailed below. The fair value estimates are made at a discrete point in time based on relevant market information. Because no market exists for a significant portion of these financial instruments, fair value estimates are based on judgments regarding future expected economic conditions, loss experience, and risk characteristics of the financial instruments. These estimates are subjective, involve uncertainties, and cannot be determined with precision. Changes in assumptions could significantly affect the estimates

The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2019 and 2018. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date, and current estimates of fair value may differ significantly from the amounts presented herein.

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NOTE 16 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Amounts and estimated fair value of financial instruments as of December 31,

	2019		2018	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	\$ 127,657	\$ 127,657	\$ 108,557	\$ 108,557
Securities, available-for-sale	1,588,721	1,588,721	1,597,992	1,597,992
Real estate loans to be sold	15,459	15,520	18,459	18,531
Loans:				
Commercial and industrial	413,733	412,538	422,930	419,280
Real estate	1,561,717	1,591,609	1,493,423	1,521,449
Consumer and other	16,661	16,968	19,120	19,771
Total loans, net	1,992,111	2,021,115	1,935,473	1,960,500
Federal Reserve Bank stock	2,151	N/A	2,151	N/A
Federal Home Loan Bank stock	4,504	N/A	4,384	N/A
Interest receivable	17,306	17,306	17,138	17,138
Financial liabilities:				
Deposits:				
Non-interest bearing	1,319,714	1,319,714	1,291,866	1,291,866
Interest bearing:				
Savings	643,326	643,326	654,431	654,431
NOW	187,543	187,543	194,508	194,508
Money market	122,085	122,085	162,783	162,783
Time	115,117	116,005	116,705	117,679
Total interest bearing	1,068,071	1,068,959	1,128,427	1,129,401
Total deposits	2,387,785	2,388,673	2,420,293	2,421,267
Securities sold under agreements to repurchase	859,425	859,425	809,020	809,020
Interest payable	479	479	197	197

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NOTE 16 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

In accordance with ASC Topic 820, we measure some of the financial assets and financial liabilities disclosed in the following tables at fair value in three levels based on the markets in which the assets and liabilities are traded and reliability of the assumptions used to determine fair value. The levels are:

- Level 1 Valuations for assets and liabilities traded in active exchange markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets, liabilities, or funds. Level 1 includes U.S. Treasury Securities.
- Level 2 Valuations for assets and liabilities traded in less active dealer, or broker markets, such as quoted prices for similar assets or liabilities or quoted prices in markets that are not active. Level 2 includes U. S. government-sponsored enterprises, securities of state and political subdivisions, residential mortgage-backed securities, and corporate bonds. Valuations are usually obtained from third party pricing services for identical or comparable assets or liabilities.
- Level 3 Valuations for assets and liabilities that are derived from other valuation methodologies, such as option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

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NOTE 16 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Assets measured at fair value on a recurring basis:

	Total	Fair Value Measurements Using		
		Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>2019</u>				
<u>Securities:</u>				
U.S. Treasury securities	\$ 269,057	\$ 269,057	\$ -	\$ -
U.S. government-sponsored enterprises	762,335	-	762,335	-
States and political subdivisions	183,083	-	183,083	-
Mortgage-backed securities – residential	1,672	-	1,672	-
Mortgage-backed securities – commercial	124,682	-	124,682	-
Corporate bonds	<u>247,892</u>	<u>-</u>	<u>247,892</u>	<u>-</u>
Securities total	<u>\$ 1,588,721</u>	<u>\$ 269,057</u>	<u>\$ 1,319,664</u>	<u>\$ -</u>
<u>2018</u>				
<u>Securities:</u>				
U.S. Treasury securities	\$ 325,223	\$ 325,223	\$ -	\$ -
U.S. government-sponsored enterprises	736,222	-	736,222	-
States and political subdivisions	161,993	-	161,993	-
Mortgage-backed securities – residential	2,151	-	2,151	-
Mortgage-backed securities – commercial	77,503	-	77,503	-
Corporate bonds	<u>294,900</u>	<u>-</u>	<u>294,900</u>	<u>-</u>
Securities total	<u>\$ 1,597,992</u>	<u>\$ 325,223</u>	<u>\$ 1,272,769</u>	<u>\$ -</u>

For investment securities, where quoted prices are available in an active market for identical securities they are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated by using pricing models and quoted prices of securities with similar characteristics and securities are classified as Level 2.

Where there is limited activity or less transparency around inputs to the valuation, investment securities are classified within Level 3 of the valuation hierarchy. No securities were classified as Level 3 during 2019 and 2018.

The majority of the Bank's investments are in high-quality short term U.S. Treasury, U.S. government-sponsored enterprise bonds where the fair values are determined by the Bank's pricing service using quoted prices of similar securities. As of December 31, 2019 the Bank had no investments in Fannie Mae or Freddie Mac common or preferred stock.

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NOTE 16 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Assets measured at fair value on a nonrecurring basis:

	<u>Total</u>	Quoted Prices in Active Markets For Identical Assets <u>Level 1</u>	Significant Other Observable Inputs <u>Level 2</u>	Significant Unobservable Inputs <u>Level 3</u>
<u>December 31, 2019</u>				
Impaired loans:				
Commercial and Industrial	\$ 9,823	\$ -	\$ -	\$ 9,823
Real estate	4,043	-	-	4,043
Other real estate owned – Construction and development	<u>90</u>	<u>-</u>	<u>-</u>	<u>90</u>
Total	<u>\$ 13,956</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 13,956</u>
<u>December 31, 2018</u>				
Impaired loans:				
Commercial and Industrial	\$ 12,138	\$ -	\$ -	\$ 12,138
Real estate	2,213	-	-	2,213
Other real estate owned – Construction and development	<u>499</u>	<u>-</u>	<u>-</u>	<u>499</u>
Total	<u>\$ 14,850</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 14,850</u>

The fair value of impaired loans is based on the value of the collateral securing those loans and is determined using the sale or market comparison. The market comparison evaluates the sales price of similar properties or assets in the same market area. Impaired loans that are measured for impairment using the fair value of the collateral for collateral dependent loans resulted in an additional provision for loan losses of \$207 and \$1,636 for the years ended December 31, 2019 and 2018, respectively.

The fair value of other real estate owned is based upon the current appraised values of the properties. Appraisals are obtained at least annually and reductions in value are recorded as a valuation loss through a charge to expense. Other real estate owned measured at fair value less costs to sell resulted in write-downs of \$64 and \$71 for the years ended December 31, 2019 and 2018, respectively.

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NOTE 16 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at December 31, 2019 and 2018:

<u>December 31, 2019</u>	<u>Fair value</u>	<u>Valuation Technique</u>	<u>Unobservable Input</u>	<u>Range (Weighted Average)</u>
Loans – Commercial and Industrial	\$ 9,823	Sales comparison approach	Adjustment for differences between the comparable sales	-2.56% to -39.91% (-3.36%)
Loans – Real estate	\$ 4,043	Sales comparison approach	Adjustment for differences between the comparable sales	12.92% to -0.19% (-4.00%)
Other real estate owned – Construction and Development	\$ 90	Sales comparison approach	Adjustment for differences between the comparable sales	-5.00% to -5.00% (-5.00%)
<u>December 31, 2018</u>	<u>Fair value</u>	<u>Valuation Technique</u>	<u>Unobservable Input</u>	<u>Range (Weighted Average)</u>
Loans – Commercial and Industrial	\$ 12,138	Sales comparison approach	Adjustment for differences between the comparable sales	-2.56% to -14.57% (-2.84%)
Loans – Real estate	\$ 2,213	Sales comparison approach	Adjustment for differences between the comparable sales	-0.29% to -30.3% (-6.06%)
Other real estate owned – Construction and Development	\$ 499	Sales comparison approach	Adjustment for differences between the comparable sales	-9.75% to -9.75% (-9.75%)

ASC Topic 825 provides an option to selectively report financial assets and financial liabilities at fair value and establishes presentation and disclosure requirements. The Bank did not elect the fair value option for any additional financial assets or liabilities as of December 31, 2019. The Bank may adopt this guidance for financial assets and liabilities in the future as permitted under the guidance.

NOTE 17 - CREDIT ARRANGEMENTS

The Bank had a committed line of credit, secured by investment securities, of \$104,575 and \$103,672 from the Federal Reserve Bank at a rate of 2.25% and 3.00% as of December 31, 2019 and 2018, respectively. The Bank had a line of credit from Federal Home Loan Bank Des Moines, secured by loans, of \$53,820 and \$100,000 at a rate of 1.73% and 2.63% as of December 31, 2019 and 2018, respectively. In addition, the Bank also had federal funds arrangements available from unaffiliated banks totaling \$145 and \$80 at a rate estimated at 1.75% – 2.00% and 2.64% – 3.00% as of December 31, 2019 and 2018 respectively. There were no outstanding balances against these lines of credit as of December 31, 2019 or 2018.

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NOTE 18 - COMMITMENTS AND CONTINGENCIES

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These instruments include standby letters of credit, loan commitments, subscriptions for the purchase of stock in the Federal Reserve Bank, and commitments to purchase and sell securities. The credit and market risks involved in issuing letters of credit and loan commitments are essentially the same as those involved in extending loans to customers. Such transactions are made under the same terms, including interest rates and collateral, as those prevailing at the same time for comparable on-balance-sheet transactions.

To reduce credit risk, related to the use of credit-related financial instruments, the Bank might deem it necessary to obtain collateral. The amount and nature of the collateral obtained is based on the Bank's credit evaluation of the customer. Collateral varies but may include cash, securities, accounts receivable, inventory, premises and equipment, and real estate.

Amounts of off-balance-sheet commitments as of December 31,

	<u>2019</u>	<u>2018</u>
Loan commitments	\$ 558,935	\$ 485,473
Bankcard commitments	66,914	60,133
Commitments to fund mortgage loans to be sold	<u>38,049</u>	<u>31,368</u>
Total loan commitments	<u>\$ 663,898</u>	<u>\$ 576,974</u>
Commitments at fixed interest rates	\$ 320,838	\$ 233,296
Commitments at variable interest rates	<u>343,060</u>	<u>343,678</u>
Total loan commitments	<u>\$ 663,898</u>	<u>\$ 576,974</u>
Standby and commercial letters of credit	\$ 10,904	\$ 10,259
Subscriptions to purchase Federal Reserve Bank stock	2,151	2,151

Commitments to make loans are generally made for periods of 90 days or less. At December 31, 2019, the fixed rate loan commitments have interest rates ranging from 3.0% to 16.5%.

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NOTE 19 - REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possible additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements.

The directors of the Bank may declare and pay dividends as frequently and of such amount of undivided profits as they judge prudent, subject to certain restrictions on capital accounts as defined in Federal banking regulations.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. Banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.5% by 2019. The capital conservation buffer for 2019 is 2.5%. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes, as of December 31, 2019, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2019, the most recent notifications from the Comptroller of the Currency (OCC) categorized the Bank as well capitalized under the regulatory framework for prompt corrective action for both 2019 and 2018. To be categorized as well capitalized, the Bank is required to maintain minimum total risk-based, Common Tier I, Tier I risk-based, Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

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NOTE 19 - REGULATORY MATTERS (Continued)

The Bank's actual amounts and ratios at December 31, 2019 and 2018 are as follows:

	<u>Actual</u>		<u>Minimum Requirement for Capital Adequacy Purposes Plus Fully Phased In Capital Conservation Buffer</u>		<u>Minimum Requirement to Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<u>2019</u>						
Total capital (to risk-weighted assets)	\$ 552,207	21.11%	\$274,661	10.50%	\$261,582	10.00%
Tier I capital (to risk-weighted assets)	531,807	20.33%	222,344	8.50%	209,265	8.00%
Common Tier I (CET1)	531,807	20.33%	183,107	7.00%	170,028	6.50%
Tier I capital (to average assets)	531,807	13.76%	154,572	4.00%	193,215	5.00%
<u>2018</u>						
Total capital (to risk-weighted assets)	\$ 542,834	20.89%	\$272,896	10.50%	\$259,901	10.00%
Tier I capital (to risk-weighted assets)	522,534	20.11%	220,916	8.50%	207,921	8.00%
Common Tier I (CET1)	522,534	20.11%	181,931	7.00%	168,936	6.50%
Tier I capital (to average assets)	522,534	13.62%	153,499	4.00%	191,874	5.00%

The Bank's principal source of funds for dividend payments is net income and cash provided by operations. Banking regulations limit the amount of dividends that may be paid without prior approval of the OCC. Under these regulations, the amount of dividends that may be paid in any calendar year is subject to the current year's net profits (net income less dividends paid), combined with the retained net profits of the preceding two years, subject to the minimum requirements for capital adequacy in the table above. The maximum dividend that can be paid as of December 31, 2019 is \$32,701 without OCC approval.