

Section 1: 10-Q (QUARTERLY REPORT)

UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number: 000-11486



CONNECTONE BANCORP, INC.
(Exact Name of Registrant as Specified in Its Charter)

New Jersey
(State or Other Jurisdiction of
Incorporation or Organization)

52-1273725
(IRS Employer
Identification No.)

301 Sylvan Avenue
Englewood Cliffs, New Jersey 07632
(Address of Principal Executive Offices) (Zip Code)

201-816-8900
(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act.

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

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

Common Stock, no par value:
(Title of Class)

32,239,928 shares
(Outstanding as of November 1, 2018)

Table of Contents

| | Page |
|------------------------------------------------------------------------------------------------------------------------------|-------------|
| PART I – FINANCIAL INFORMATION | |
| Item 1. Financial Statements | |
| Consolidated Statements of Condition at September 30, 2018 (unaudited) and December 31, 2017 | 3 |
| Consolidated Statements of Income for the three and nine months ended September 30, 2018 and 2017 (unaudited) | 4 |
| Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and 2017 (unaudited) | 5 |
| Consolidated Statements of Changes in Stockholders' Equity for the nine months ended September 30, 2018 and 2017 (unaudited) | 6 |
| Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017 (unaudited) | 7 |
| Notes to Consolidated Financial Statements (unaudited) | 8 |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 47 |
| Item 3. Qualitative and Quantitative Disclosures about Market Risks | 60 |
| Item 4. Controls and Procedures | 61 |
| PART II – OTHER INFORMATION | |
| Item 1. Legal Proceedings | 62 |
| Item 1a. Risk Factors | 62 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 63 |
| Item 3. Defaults Upon Senior Securities | 63 |
| Item 4. Mine Safety Disclosures | 63 |
| Item 5. Other Information | 63 |
| Item 6. Exhibits | 64 |
| SIGNATURES | |

Item 1. Financial Statements

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CONDITION

| | September 30, 2018 | December 31, 2017 |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| (in thousands, except for share data) | (unaudited) | |
| ASSETS | | |
| Cash and due from banks | \$ 37,058 | \$ 52,565 |
| Interest-bearing deposits with banks | 118,790 | 97,017 |
| Cash and cash equivalents | 155,848 | 149,582 |
| Securities available-for-sale | 410,039 | 435,284 |
| Equity securities | 11,403 | - |
| Loans held-for-sale | 270 | 24,845 |
| Loans receivable | 4,462,487 | 4,171,456 |
| Less: Allowance for loan losses | 34,749 | 31,748 |
| Net loans receivable | 4,427,738 | 4,139,708 |
| Investment in restricted stock, at cost | 32,486 | 33,497 |
| Bank premises and equipment, net | 20,998 | 21,659 |
| Accrued interest receivable | 17,690 | 15,470 |
| Bank owned life insurance | 113,026 | 111,311 |
| Other real estate owned | - | 538 |
| Goodwill | 145,909 | 145,909 |
| Core deposit intangibles | 1,881 | 2,364 |
| Other assets | 31,353 | 28,275 |
| Total assets | \$ 5,368,641 | \$ 5,108,442 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing | \$ 758,213 | \$ 776,843 |
| Interest-bearing | 3,230,552 | 3,018,285 |
| Total deposits | 3,988,765 | 3,795,128 |
| Borrowings | 629,979 | 670,077 |
| Subordinated debentures (net of debt issuance costs of \$1,681 and \$456, respectively) | 128,474 | 54,699 |
| Other liabilities | 26,552 | 23,101 |
| Total liabilities | 4,773,770 | 4,543,005 |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY | | |
| Preferred stock, authorized 5,000,000 shares; issued -0- shares of Series B preferred stock at September 30, 2018 and December 31, 2017; outstanding -0- shares at September 30, 2018 and December 31, 2017; liquidation value of \$-0- at September 30, 2018 and December 31, 2017 | - | - |
| Common stock, no par value, authorized 50,000,000 shares; issued 34,303,850 shares at September 30, 2018 and 34,135,782 at December 31, 2017; outstanding 32,239,928 shares at September 30, 2018 and 32,071,860 at December 31, 2017 | 412,546 | 412,546 |
| Additional paid-in capital | 14,625 | 13,602 |
| Retained earnings | 195,101 | 160,025 |

| | | |
|-----------------------------------------------------------------------------------------------|---------------------|---------------------|
| Treasury stock, at cost (2,063,922 common shares at September 30, 2018 and December 31, 2017) | (16,717) | (16,717) |
| Accumulated other comprehensive loss | (10,684) | (4,019) |
| Total stockholders' equity | <u>594,871</u> | <u>565,437</u> |
| Total liabilities and stockholders' equity | <u>\$ 5,368,641</u> | <u>\$ 5,108,442</u> |

See accompanying notes to unaudited consolidated financial statements.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(unaudited)

| (in thousands, except for per share data) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------------------------------------|-------------------------------------|-----------|------------------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Interest income | | | | |
| Interest and fees on loans | \$ 51,699 | \$ 43,241 | \$ 148,218 | \$ 121,879 |
| Interest and dividends on investment securities: | | | | |
| Taxable | 2,154 | 1,695 | 6,191 | 5,042 |
| Tax-exempt | 785 | 870 | 2,377 | 2,655 |
| Dividends | 530 | 362 | 1,517 | 982 |
| Interest on federal funds sold and other short-term investments | 183 | 170 | 607 | 555 |
| Total interest income | 55,351 | 46,338 | 158,910 | 131,113 |
| Interest expense | | | | |
| Deposits | 10,681 | 6,113 | 27,538 | 16,717 |
| Borrowings | 4,708 | 3,206 | 14,318 | 9,135 |
| Total interest expense | 15,389 | 9,319 | 41,856 | 25,852 |
| Net interest income | 39,962 | 37,019 | 117,054 | 105,261 |
| Provision for loan losses | 1,100 | 1,450 | 20,000 | 4,000 |
| Net interest income after provision for loan losses | 38,862 | 35,569 | 97,054 | 101,261 |
| Noninterest income | | | | |
| Annuities and insurance commissions | - | - | - | 39 |
| Income on bank owned life insurance | 751 | 985 | 2,300 | 2,402 |
| Net gains on sale of loans held-for-sale | 2 | 50 | 31 | 120 |
| Deposit, loan and other income | 676 | 721 | 1,893 | 2,023 |
| Net gains on sales of securities available-for-sale | - | - | - | 1,596 |
| Total noninterest income | 1,429 | 1,756 | 4,224 | 6,180 |
| Noninterest expenses | | | | |
| Salaries and employee benefits | 10,174 | 8,810 | 29,575 | 25,521 |
| Occupancy and equipment | 2,137 | 1,969 | 6,311 | 6,215 |
| FDIC insurance | 735 | 840 | 2,350 | 2,550 |
| Professional and consulting | 891 | 740 | 2,439 | 2,192 |
| Marketing and advertising | 192 | 225 | 736 | 770 |
| Data processing | 1,102 | 1,176 | 3,341 | 3,474 |
| Merger expenses | 375 | - | 399 | - |
| Amortization of core deposit intangible | 145 | 169 | 483 | 555 |
| Other components of net periodic pension expense | 7 | 62 | 21 | 189 |
| Increase in valuation allowance, loans held-for-sale | - | 3,000 | - | 15,325 |
| Change in fair value of equity securities | 157 | - | 325 | - |
| Other expenses | 2,372 | 1,650 | 6,474 | 5,402 |
| Total noninterest expenses | 18,287 | 18,641 | 52,454 | 62,193 |
| Income before income tax expense | 22,004 | 18,684 | 48,824 | 45,248 |
| Income tax expense | 2,102 | 5,607 | 7,144 | 12,608 |
| Net income | \$ 19,902 | \$ 13,077 | \$ 41,680 | \$ 32,640 |
| Earnings per common share: | | | | |
| Basic | \$ 0.62 | \$ 0.41 | \$ 1.30 | \$ 1.02 |
| Diluted | 0.61 | 0.41 | 1.29 | 1.01 |
| Dividends per common share | \$ 0.075 | \$ 0.075 | \$ 0.225 | \$ 0.225 |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited)

| (in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------------------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Net income | \$ 19,902 | \$ 13,077 | \$ 41,680 | \$ 32,640 |
| Other comprehensive income: | | | | |
| Unrealized gains and losses: | | | | |
| Unrealized holding (losses) gains on available-for-sale securities arising during the period | (2,840) | 415 | (9,639) | 1,332 |
| Tax effect | 729 | (165) | 2,466 | (525) |
| Net of tax | (2,111) | 250 | (7,173) | 807 |
| Reclassification adjustment for realized gains included in net income | - | - | - | (1,596) |
| Tax effect | - | - | - | 579 |
| Net of tax | - | - | - | (1,017) |
| Unrealized gains on cash flow hedges | 14 | 119 | 1,108 | 76 |
| Tax effect | (5) | (48) | (312) | (31) |
| Net of tax | 9 | 71 | 796 | 45 |
| Unrealized pension plan gains (losses): | | | | |
| Unrealized pension plan gains (losses) before reclassifications | - | - | 236 | (2) |
| Tax effect | - | - | (67) | 1 |
| Net of tax | - | - | 169 | (1) |
| Reclassification adjustment for amortization included in net income | 91 | 103 | 274 | 309 |
| Tax effect | (26) | (42) | (77) | (126) |
| Net of tax | 65 | 61 | 197 | 183 |
| Total other comprehensive (loss) income | (2,037) | 382 | (6,011) | 17 |
| Total comprehensive income | \$ 17,865 | \$ 13,459 | \$ 35,669 | \$ 32,657 |

See accompanying notes to unaudited consolidated financial statements.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(unaudited)

| | Preferred | Common | Additional | Retained | Treasury | Accumulated | Total |
|---------------------------------------------------------------------|-------------|-------------------|------------------|-------------------|--------------------|--------------------|-------------------|
| | Stock | Stock | Paid-In | Earnings | Stock | Other | Stockholders' |
| (dollars in thousands, except for per share data) | | | Capital | | | Comprehensive | Equity |
| | | | | | | (Loss) Income | |
| Balance as of December 31, 2016 | \$ - | \$ 412,726 | \$ 11,407 | \$ 126,462 | \$ (16,717) | \$ (2,846) | \$ 531,032 |
| Net income | - | - | - | 32,640 | - | - | 32,640 |
| Other comprehensive income, net of tax | - | - | - | - | - | 17 | 17 |
| Cash dividends declared on common stock (\$0.225 per share) | - | - | - | (7,251) | - | - | (7,251) |
| Stock issuance costs | - | (180) | - | - | - | - | (180) |
| Exercise of stock options (10,846 shares) | - | - | 118 | - | - | - | 118 |
| Restricted stock grants (57,164 shares) | - | - | - | - | - | - | - |
| Stock-based compensation expense | - | - | 1,315 | - | - | - | 1,315 |
| Balance as of September 30, 2017 | <u>\$ -</u> | <u>\$ 412,546</u> | <u>\$ 12,840</u> | <u>\$ 151,851</u> | <u>\$ (16,717)</u> | <u>\$ (2,829)</u> | <u>\$ 557,691</u> |
| Balance as of December 31, 2017 | \$ - | \$ 412,546 | \$ 13,602 | \$ 160,025 | \$ (16,717) | \$ (4,019) | \$ 565,437 |
| Reclassification of stranded tax effects (ASU 2018-02) (see Note 8) | - | - | - | 709 | - | (709) | - |
| Cumulative effect of adopting ASU 2016-01 (see Note 8) | - | - | - | (55) | - | 55 | - |
| Net income | - | - | - | 41,680 | - | - | 41,680 |
| Other comprehensive loss, net of tax | - | - | - | - | - | (6,011) | (6,011) |
| Cash dividends declared on common stock (\$0.225 per share) | - | - | - | (7,258) | - | - | (7,258) |
| Exercise of stock options (102,378 shares) | - | - | 524 | - | - | - | 524 |
| Restricted stock grants (23,018 shares) | - | - | - | - | - | - | - |
| Net performance units issued (42,672 shares) | - | - | (819) | - | - | - | (819) |
| Stock-based compensation expense | - | - | 1,318 | - | - | - | 1,318 |
| Balance as of September 30, 2018 | <u>\$ -</u> | <u>\$ 412,546</u> | <u>\$ 14,625</u> | <u>\$ 195,101</u> | <u>\$ (16,717)</u> | <u>\$ (10,684)</u> | <u>\$ 594,871</u> |

See accompanying notes to unaudited consolidated financial statements.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

| (in thousands) | Nine Months Ended September 30, | |
|------------------------------------------------------------------------------------|------------------------------------|-----------|
| | 2018 | 2017 |
| <u>Cash flows from operating activities</u> | | |
| Net income | \$ 41,680 | \$ 32,640 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of premises and equipment | 2,336 | 2,364 |
| Provision for loan losses | 20,000 | 4,000 |
| Increase in valuation allowance | - | 15,325 |
| Amortization of intangibles | 483 | 555 |
| Net accretion of loans | (969) | (1,106) |
| Accretion on bank premises | (46) | (58) |
| Accretion on deposits | (46) | (19) |
| Accretion on borrowings | (98) | (156) |
| Stock-based compensation expense | 499 | 1,315 |
| Gains on sales of investment securities, net | - | (1,596) |
| Change in fair value of equity securities, net | 325 | - |
| Gains on sales of loans held-for-sale, net | (31) | (120) |
| Gains on sales of fixed assets, net | - | (8) |
| Loans originated for resale | (2,206) | (6,790) |
| Proceeds from sale of loans held-for-sale | 2,337 | 12,015 |
| Net loss on sale of other real estate owned | 192 | 82 |
| Net increase in cash surrender value of bank owned life insurance | (1,715) | (2,402) |
| Amortization of premiums and accretion of discounts on investments securities, net | 2,577 | 1,808 |
| Amortization of subordinated debt issuance costs | 250 | 124 |
| Increase in accrued interest receivable | (2,220) | (1,876) |
| Decrease in other assets | 42 | 8,770 |
| Increase in other liabilities | 3,945 | 3,444 |
| Net cash provided by operating activities | 67,335 | 68,311 |
| <u>Cash flows from investing activities</u> | | |
| Investment securities available-for-sale: | | |
| Purchases | (114,457) | (138,945) |
| Sales | - | 29,543 |
| Maturities, calls and principal repayments | 115,757 | 61,700 |
| Net redemptions (purchases) of restricted investment in bank stocks | 1,011 | (5,362) |
| Payments on loans held-for-sale | 159 | 2,841 |
| Net increase in loans | (283,283) | (447,457) |
| Proceeds from sales of fixed assets | - | 8 |
| Purchases of premises and equipment | (1,629) | (2,148) |
| Purchases of bank owned life insurance | - | (10,000) |
| Proceeds from sale of other real estate owned | 884 | 1,124 |
| Net cash used in investing activities | (281,558) | (508,696) |
| <u>Cash flows from financing activities</u> | | |
| Net increase in deposits | 193,683 | 279,517 |
| Increase in subordinated debentures | 73,525 | - |
| Advances of Federal Home Loan Bank (“FHLB”) borrowings | 1,256,000 | 780,000 |
| Repayments of FHLB borrowings | (1,296,000) | (656,000) |
| Repayment of repurchase agreement | - | (15,000) |
| Cash dividends paid on common stock | (7,243) | (7,207) |
| Common stock issuance costs | - | (180) |

| | | |
|--------------------------------------------------|------------|------------|
| Proceeds from exercise of stock options | 524 | 118 |
| Net cash provided by financing activities | 220,489 | 381,248 |
| Net change in cash and cash equivalents | 6,266 | (59,137) |
| Cash and cash equivalents at beginning of period | 149,582 | 200,399 |
| Cash and cash equivalents at end of period | \$ 155,848 | \$ 141,262 |

Supplemental disclosures of cash flow information

Cash payments for:

| | | |
|------------------------------------------|-----------|-----------|
| Interest paid on deposits and borrowings | \$ 40,200 | \$ 25,807 |
| Income taxes | 2,507 | 4,670 |

Supplemental disclosures of noncash investing activities

| | | |
|--------------------------------------------------------------|--------|--------|
| Transfer of loans to other real estate owned | \$ 538 | \$ 580 |
| Transfer of loans held-for-investment to loans held-for-sale | 21,236 | 34,652 |
| Transfer of loans held-for-sale to held-for-investment | 45,552 | - |

See accompanying notes to unaudited consolidated financial statements.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 1. Nature of Operations and Principles of Consolidation

ConnectOne Bancorp, Inc. (the “Parent Corporation”) is incorporated under the laws of the State of New Jersey and is a registered bank holding company. The Parent Corporation’s business currently consists of the operation of its wholly-owned subsidiary, ConnectOne Bank (the “Bank” and, collectively with the Parent Corporation and the Parent Corporation’s subsidiaries, the “Company”). The Bank’s subsidiaries include Union Investment Co. (a New Jersey investment company), Twin Bridge Investment Co. (a Delaware investment company), ConnectOne Preferred Funding Corp. (a New Jersey real estate investment trust), Center Financial Group, LLC (a New Jersey financial services company), Center Advertising, Inc. (a New Jersey advertising company), Morris Property Company, LLC, (a New Jersey limited liability company), Volosin Holdings, LLC, (a New Jersey limited liability company), and NJCB Spec-1, LLC (a New Jersey limited liability company).

The Bank is a community-based, full-service New Jersey-chartered commercial bank that was founded in 2005. The Bank operates from its headquarters located at 301 Sylvan Avenue in the Borough of Englewood Cliffs, Bergen County, New Jersey and through its twenty-one other banking offices. Substantially all loans are secured with various types of collateral, including business assets, consumer assets and commercial/residential real estate. Each borrower’s ability to repay its loans is dependent on the conversion of assets, cash flows generated from the borrower’s business, real estate rental and consumer wages.

The preceding unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, and, accordingly, do not include all of the information and footnotes required by GAAP for complete financial statements. However, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2018 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2018, or for any other interim period. The Company’s 2017 Annual Report on Form 10-K should be read in conjunction with these consolidated financial statements.

In preparing the consolidated financial statements, management has made estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the consolidated statements of condition and that affect the results of operations for the periods presented. Actual results could differ significantly from those estimates.

The consolidated financial statements have been prepared in conformity with GAAP. Some items in the prior year consolidated financial statements were reclassified to conform to current presentation. Reclassifications had no effect on prior year net income or stockholders’ equity.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 2. New Authoritative Accounting Guidance

ASU 2018-15, “*Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract.*” These amendments align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by these amendments. ASU 2018-15 is effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2019. We believe the adoption of this standard will not have a significant impact on our consolidated financial statements.

ASU 2018-14, “*Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans.*” These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. ASU 2018-14 is effective for fiscal years ending after December 15, 2020. We believe the adoption of this standard will not have a significant impact on our consolidated financial statements.

ASU 2018-13, “*Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement.*” The amendments in this update modify disclosure requirements on fair value measurements by removing, modifying and adding certain disclosure requirements. The amendments primarily pertain to Level 3 fair value measurements and depending on the amendment are applied either prospectively or retrospectively. ASU 2018-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. We believe the adoption of this standard will not have a significant impact on our consolidated financial statements.

ASU 2018-10, “*Codification Improvements to Topic 842, Leases.*” These amendments affect narrow aspects of the guidance issued in the amendments in ASU 2016-02 including those regarding residual value guarantees, rate implicit in the lease, lessee reassessment of lease classification, lessor reassessment of lease term and purchase option, variable lease payments that depend on an index or a rate, investment tax credits, lease term and purchase option, transition guidance for amounts previously recognized in business combinations, certain transition adjustments, transition guidance for leases previously classified as capital leases under Topic 840, transition guidance for modifications to leases previously classified as direct financing or sales-type leases under Topic 840, transition guidance for sale and leaseback transactions, impairment of net investment in the lease, unguaranteed residual asset, effect of initial direct costs on rate implicit in the lease, and failed sale and leaseback transactions. We believe the adoption of this standard will not have a significant impact on our consolidated financial statements.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 2. New Authoritative Accounting Guidance – (continued)

ASU 2018-01, “*Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842.*” ASU 2018-01 provides an optional transition practical expedient for the adoption of ASU 2016-02 that, if elected, would not require an organization to reconsider their accounting for existing land easements that are not currently accounted for under the old leases standard; and clarify that new or modified land easements should be evaluated under ASU 2016-02, once an entity has adopted the new standard. ASU 2018-01 is effective for fiscal years beginning after December 15, 2018. We believe the adoption of this standard will not have a significant impact on our consolidated financial statements.

ASU No. 2017-12, “*Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.*” ASU No. 2017-12 refines and expands hedge accounting for both financial (e.g., interest rate) and commodity risks. Its provisions create more transparency around how economic results are presented, both on the face of the financial statements and in the footnotes. It also makes certain targeted improvements to simplify the application of hedge accounting guidance. ASU 2017-12 will be effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Although management continues to evaluate the potential impact of ASU 2017-12 on our consolidated financial statements, at this time, we believe the adoption of this standard will not have a significant impact on our consolidated financial statements.

ASU No. 2017-08, “*Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.*” ASU No. 2017-08 shortens the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. ASU 2017-08 will be effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. We are currently evaluating this ASU to determine the impact on our consolidated financial statements.

ASU No. 2017-04, “*Intangibles – Goodwill and Other (Topic 350).*” ASU 2017-04 aims to simplify the subsequent measurement of goodwill. Under these amendments, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. The Board also eliminated the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment. An entity is required to disclose the amount of goodwill allocated to each reporting unit with a zero or negative carrying amount of net assets and still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2019. Although management continues to evaluate the potential impact of ASU 2017-04 on our consolidated financial statements, at this time, we believe the adoption of this standard will not have a significant impact on our consolidated financial statements.

ASU No. 2016-13, “*Financial Instruments – Credit Losses (Topic 326): Assets Measured at Amortized Cost.*” ASU 2016-13 requires a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected. The amendments in this update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates and affects loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. For public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company has formed a CECL committee that is assessing our data and system needs. The Company has engaged a third-party vendor to assist in analyzing our data and developing a CECL model. The Company has recently met with the third-party vendor and discussed our data, in terms of what is available and potential gaps. The Company also discussed modeling standards, loan segmentation, as well as potential external inputs to supplement our historical loss history. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the ASU is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the ASU on our consolidated financial statements.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 2. New Authoritative Accounting Guidance – (continued)

ASU No. 2016-02, “Leases (Topic 842)” requires the recognition of a right of use asset and related lease liability by lessees for leases classified as operating leases under current GAAP. Topic 842, which replaces the current guidance under Topic 840, retains a distinction between finance leases and operating leases. The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee also will not significantly change from current GAAP. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize right of use assets and lease liabilities. Topic 842 will be effective for the Company for reporting periods beginning January 1, 2019, with early adoption permitted. The Company must apply a modified retrospective transition approach for the applicable leases existing at, or entered into after, the beginning of the earliest comparative period presented in the consolidated financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. The Company is currently leasing properties as branch locations and is leasing certain office equipment. Currently, the Company is in the process of evaluating all of our leases for compliance for the new ASU. As part of that process, management is developing a systematic approach that can be used to calculate the financial statement impact starting in 2019. The adoption of ASU 2016-02 will result in increases to the Company’s assets and liabilities.

Note 3. Earnings per Common Share

Financial Accounting Standards Board Accounting Standards Codification (“FASB ASC”) No. 260-10-45 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (“EPS”). The restricted stock awards previously granted by the Company contain non-forfeitable rights to dividends and therefore are considered participating securities. The two-class method for calculating basic EPS excludes dividends paid to participating securities and any undistributed earnings attributable to participating securities.

Earnings per common share have been computed based on the following:

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------------------------------------------------------------------------|-------------------------------------------|------------------|-------------------|------------------|
| | September 30, | | September 30, | |
| | (in thousands, except for per share data) | | | |
| | 2018 | 2017 | 2018 | 2017 |
| Income attributable to common stock | \$ 19,860 | \$ 13,035 | \$ 41,582 | \$ 32,534 |
| Earnings allocated to participating securities | 42 | 42 | 98 | 106 |
| Net income | <u>\$ 19,902</u> | <u>\$ 13,077</u> | <u>\$ 41,680</u> | <u>\$ 32,640</u> |
| Weighted average common shares outstanding, including participating securities | 32,167 | 32,015 | 32,127 | 31,999 |
| Weighted average participating securities | (25) | (103) | (34) | (104) |
| Weighted average common shares outstanding | 32,142 | 31,912 | 32,093 | 31,895 |
| Incremental shares from assumed conversions of options, performance units and restricted shares | 177 | 270 | 220 | 272 |
| Weighted average common and equivalent shares outstanding | <u>32,319</u> | <u>32,182</u> | <u>32,313</u> | <u>32,167</u> |
| Earnings per common share: | | | | |
| Basic | \$ 0.62 | \$ 0.41 | \$ 1.30 | \$ 1.02 |
| Diluted | 0.61 | 0.41 | 1.29 | 1.01 |

There were no antidilutive share equivalents as of September 30, 2018 and September 30, 2017.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 4. Securities Available-for-Sale

Securities available-for-sale are reported at fair value with unrealized gains or losses included in stockholders' equity, net of tax. Accordingly, the carrying value of such securities reflects their fair value as of September 30, 2018 and December 31, 2017. Fair value is based upon either quoted market prices, or in certain cases where there is limited activity in the market for a particular instrument, assumptions are made to determine their fair value. See Note 7 of the Notes to Consolidated Financial Statements for a further discussion.

The following table summarizes the amortized cost and fair value of securities available-for-sale at September 30, 2018 and December 31, 2017 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income (loss).

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|-------------------------------------------------------|-------------------|------------------------------|-------------------------------|-------------------|
| September 30, 2018 | | | | |
| (dollars in thousands) | | | | |
| Securities available-for-sale | | | | |
| Federal agency obligations | \$ 48,963 | \$ 14 | \$ (1,443) | \$ 47,534 |
| Residential mortgage pass-through securities | 196,650 | 75 | (6,174) | 190,551 |
| Commercial mortgage pass-through securities | 3,953 | - | (110) | 3,843 |
| Obligations of U.S. states and political subdivisions | 133,564 | 727 | (3,903) | 130,388 |
| Corporate bonds and notes | 26,305 | 96 | (439) | 25,962 |
| Asset-backed securities | 10,317 | 59 | (13) | 10,363 |
| Certificates of deposit | 420 | 3 | - | 423 |
| Other securities | 975 | - | - | 975 |
| Total securities available-for-sale | <u>\$ 421,147</u> | <u>\$ 974</u> | <u>\$ (12,082)</u> | <u>\$ 410,039</u> |
| December 31, 2017 | | | | |
| (dollars in thousands) | | | | |
| Securities available-for-sale | | | | |
| Federal agency obligations | \$ 56,297 | \$ 141 | \$ (416) | \$ 56,022 |
| Residential mortgage pass-through securities | 183,509 | 330 | (1,948) | 181,891 |
| Commercial mortgage pass-through securities | 4,054 | 3 | (3) | 4,054 |
| Obligations of U.S. states and political subdivisions | 130,723 | 1,739 | (1,334) | 131,128 |
| Trust preferred securities | 4,577 | 205 | (111) | 4,671 |
| Corporate bonds and notes | 29,801 | 163 | (271) | 29,693 |
| Asset-backed securities | 12,021 | 66 | (37) | 12,050 |
| Certificates of deposit | 621 | 4 | - | 625 |
| Equity securities | 11,843 | 235 | (350) | 11,728 |
| Other securities | 3,422 | - | - | 3,422 |
| Total securities available-for-sale | <u>\$ 436,868</u> | <u>\$ 2,886</u> | <u>\$ (4,470)</u> | <u>\$ 435,284</u> |

Effective January 1, 2018, the Company implemented ASU 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." Under ASU 2016-01, equity securities, with certain exceptions, are to be measured at fair value with changes in fair value recognized in net income. As of March 31, 2018, the Company began separately presenting equity securities with readily determinable fair values on the Statements of Condition within the "Equity securities" caption. Net unrealized losses recognized on equity securities with readily determinable fair values for the three and nine months ended as of September 30, 2018 were \$157 thousand and \$325 thousand, respectively.

Investment securities having a carrying value of approximately \$157.0 million and \$157.8 million at September 30, 2018 and December 31, 2017, respectively, were pledged to secure public deposits, borrowings, Federal Reserve Discount Window borrowings and Federal Home Loan Bank advances and for other purposes required or permitted by law. As of September 30, 2018 and December 31, 2017, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of stockholders' equity.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 4. Securities Available-for-Sale – (continued)

The following table presents information for investments in securities available-for-sale at September 30, 2018, based on scheduled maturities. Actual maturities can be expected to differ from scheduled maturities due to prepayment or early call options of the issuer. Securities not due at a single maturity date are shown separately.

| | September 30, 2018 | |
|----------------------------------------------|--------------------|-------------------|
| | Amortized | Fair |
| | Cost | Value |
| (dollars in thousands) | | |
| Securities available-for-sale: | | |
| Due in one year or less | \$ 4,429 | \$ 4,425 |
| Due after one year through five years | 36,607 | 36,375 |
| Due after five years through ten years | 28,135 | 28,290 |
| Due after ten years | 150,398 | 145,580 |
| Residential mortgage pass-through securities | 196,650 | 190,551 |
| Commercial mortgage pass-through securities | 3,953 | 3,843 |
| Other securities | 975 | 975 |
| Total securities available-for-sale | \$ 421,147 | \$ 410,039 |

Gross gains and losses from the sales, calls and maturities of securities for periods presented were as follows:

| | Three Months Ended | | Nine Months Ended | |
|----------------------------------------------------|------------------------|-------------|-------------------|-----------------|
| | September 30, | | September 30, | |
| | (dollars in thousands) | | | |
| | 2018 | 2017 | 2018 | 2017 |
| Proceeds | \$ - | \$ - | \$ - | \$ 29,543 |
| Gross gains on sales of securities | - | - | - | 1,596 |
| Gross losses on sales of securities | - | - | - | - |
| Net gains on sales of securities | - | - | - | 1,596 |
| Less: tax provision on net gains | - | - | - | (579) |
| Net gains on sales of securities, after tax | \$ - | \$ - | \$ - | \$ 1,017 |

The Company reviews all securities for potential recognition of other-than-temporary impairment. The Company maintains a watch list for the identification and monitoring of securities experiencing problems that require a heightened level of review. This could include credit rating downgrades.

The Company's assessment of whether an impairment in the portfolio is other-than temporary includes factors such as whether the issuer has defaulted on scheduled payments, announced restructuring and/or filed for bankruptcy, has disclosed severe liquidity problems that cannot be resolved, disclosed deteriorating financial condition or sustained significant losses.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 4. Securities Available-For-Sale – (continued)

Temporarily Impaired Securities

The Company does not believe that any of the unrealized losses, which were comprised of 170 and 112 securities as of September 30, 2018 and December 31, 2017, respectively, represent an other-than-temporary impairment (“OTTI”). The gross unrealized losses associated with U.S. Treasury and agency securities, federal agency obligations, mortgage-backed securities, corporate bonds, tax-exempt securities, asset-backed securities, trust preferred securities, mutual funds and equity securities are not considered to be other-than-temporary because these unrealized losses are related to changes in interest rates and do not affect the expected cash flows of the underlying collateral or issuer.

Factors which may contribute to unrealized losses include credit risk, market risk, changes in interest rates, economic cycles, and liquidity risk. The magnitude of any unrealized loss may be affected by the relative concentration of the Company’s investment in any one issuer or industry. The Company has established policies to reduce exposure through diversification of the securities portfolio including limits on concentrations to any one issuer. The Company believes the securities portfolio is prudently diversified.

The unrealized losses included in the tables below are primarily related to changes in interest rates and credit spreads. All of the Company’s securities are performing and are expected to continue to perform in accordance with their respective contractual terms and conditions. These are largely intermediate duration holdings and, in certain cases, monthly principal payments can further reduce loss exposure resulting from an increase in rates.

The Company evaluates all securities with unrealized losses quarterly to determine whether the loss is other-than-temporary. Unrealized losses in the corporate debt securities category consist primarily of senior unsecured corporate debt securities issued by large financial institutions, insurance companies and other corporate issuers. Single issuer corporate trust preferred securities are also included, and in the case of one holding the market valuation loss is largely based upon the floating rate coupon and corresponding market valuation. Neither that trust preferred issuer, nor any other corporate issuers, have defaulted on interest payments. The unrealized loss in equity securities consists of losses on other bank equities. The decline in fair value is due in large part to the lack of an active trading market for these securities, changes in market credit spreads and rating agency downgrades. Management concluded that these securities were not OTTI at September 30, 2018.

In determining whether or not securities are OTTI, the Company must exercise considerable judgment. Accordingly, there can be no assurance that the actual results will not differ from the Company’s judgments and that such differences may not require the future recognition of OTTI charges that could have a material effect on the Company’s financial position and results of operations. In addition, the value of, and the realization of any loss on, a security is subject to numerous risks as cited above.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 4. Securities Available-For-Sale – (continued)

The following tables indicate gross unrealized losses not recognized in income and fair value, aggregated by investment category and the length of time individual securities have been in a continuous unrealized loss position at September 30, 2018 and December 31, 2017:

| | September 30, 2018 | | | | | |
|-------------------------------------------------------|------------------------|----------------------|---------------------|----------------------|---------------------|----------------------|
| | Total | | Less than 12 Months | | 12 Months or Longer | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (dollars in thousands) | | | | | |
| Investment Securities | | | | | | |
| Available-for-Sale: | | | | | | |
| Federal agency obligation | \$ 45,057 | \$ (1,443) | \$ 21,455 | \$ (513) | \$ 23,602 | \$ (930) |
| Residential mortgage pass-through securities | 185,442 | (6,174) | 106,190 | (2,491) | 79,252 | (3,683) |
| Commercial mortgage pass-through securities | 3,843 | (110) | 3,843 | (110) | - | - |
| Obligations of U.S. states and political subdivisions | 78,481 | (3,903) | 33,733 | (877) | 44,748 | (3,026) |
| Corporate bonds and notes | 15,655 | (439) | 11,008 | (124) | 4,647 | (315) |
| Asset-backed securities | 4,113 | (13) | 2,303 | (8) | 1,810 | (5) |
| Total temporarily impaired securities | <u>\$ 332,591</u> | <u>\$ (12,082)</u> | <u>\$ 178,532</u> | <u>\$ (4,123)</u> | <u>\$ 154,059</u> | <u>\$ (7,959)</u> |

| | December 31, 2017 | | | | | |
|-------------------------------------------------------|------------------------|----------------------|---------------------|----------------------|---------------------|----------------------|
| | Total | | Less than 12 Months | | 12 Months or Longer | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (dollars in thousands) | | | | | |
| Investment Securities | | | | | | |
| Available-for-Sale: | | | | | | |
| Federal agency obligation | \$ 39,813 | \$ (416) | \$ 28,407 | \$ (213) | \$ 11,406 | \$ (203) |
| Residential mortgage pass-through securities | 148,574 | (1,948) | 117,556 | (1,146) | 31,018 | (802) |
| Commercial mortgage pass-through securities | 1,198 | (3) | 1,198 | (3) | - | - |
| Obligations of U.S. states and political subdivisions | 57,685 | (1,334) | 17,909 | (246) | 39,776 | (1,088) |
| Trust preferred securities | 1,469 | (111) | - | - | 1,469 | (111) |
| Corporate bonds and notes | 11,074 | (271) | 1,965 | (21) | 9,109 | (250) |
| Asset-backed securities | 7,428 | (37) | 993 | (2) | 6,435 | (35) |
| Equity securities | 11,116 | (350) | - | - | 11,116 | (350) |
| Total temporarily impaired securities | <u>\$ 278,357</u> | <u>\$ (4,470)</u> | <u>\$ 168,028</u> | <u>\$ (1,631)</u> | <u>\$ 110,329</u> | <u>\$ (2,839)</u> |

Note 5. Derivatives

The Company utilizes interest rate swap agreements as part of its asset liability management strategy to help manage its interest rate risk position. The notional amount of the interest rate swap does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest rate swap agreements.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 5. Derivatives – (continued)

Interest rate swaps were entered into on April 13, 2017, August 24, 2015, December 30, 2014 and October 15, 2014, each with a respective notional amount of \$25 million and were designated as cash flow hedges of a Federal Home Loan Bank (“FHLB”) advance. The swaps were determined to be fully effective during the period presented and therefore no amount of ineffectiveness has been included in net income while the aggregate fair value of the swaps is recorded in other assets (liabilities) with changes in fair value recorded in other comprehensive income (loss). The amount included in accumulated other comprehensive income (loss) would be reclassified to current earnings should the hedges no longer be considered effective. The Company expects the hedges to remain fully effective during the remaining term of the swaps.

Summary information about the interest rate swaps designated as cash flow hedges as of September 30, 2018, December 31, 2017 and September 30, 2017 are presented in the following table.

| | September 30, 2018 | December 31, 2017 | September 30, 2017 |
|--------------------------------|------------------------|----------------------|-----------------------|
| | (dollars in thousands) | | |
| Notional amount | \$ 100,000 | \$ 100,000 | \$ 100,000 |
| Weighted average pay rates | 1.68% | 1.66% | 1.52% |
| Weighted average receive rates | 2.12% | 1.23% | 1.07% |
| Weighted average maturity | 1.7 years | 2.4 years | 2.7 years |
| Fair value | \$ 1,906 | \$ 798 | \$ 164 |

Net interest income recorded on these swap transactions totaled approximately \$173 thousand and \$326 thousand for the three and nine months ended September 30, 2018, respectively, and net interest expense recorded on these swap transactions totaled \$95 thousand and \$326 thousand for the three and nine months ended September 30, 2017, respectively, and is reported as a component of interest expense on FHLB advances.

Cash Flow Hedge

The following table presents the net losses recorded in other comprehensive income and the Consolidated Statements of Income relating to the cash flow derivative instruments for the following periods:

| | Nine Months Ended September 30, 2018 | | |
|-------------------------|---------------------------------------------------------------|------------------------------------------------------------------|--------------------------------------------------------------------------------------|
| | Amount of gain recognized in OCI (Effective Portion) | Amount of gain reclassified from OCI to interest income | Amount of gain recognized in other Noninterest income (Ineffective Portion) |
| | (dollars in thousands) | | |
| Interest rate contracts | \$ 796 | \$ - | \$ - |
| | Nine Months Ended September 30, 2017 | | |
| | Amount of gain recognized in OCI (Effective Portion) | Amount of gain reclassified from OCI to interest income | Amount of gain recognized in other Noninterest income (Ineffective Portion) |
| | (dollars in thousands) | | |
| Interest rate contracts | \$ 45 | \$ - | \$ - |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

The following table reflects the cash flow hedges included in the consolidated statements of condition as of September 30, 2018 and December 31, 2017:

| | September 30, 2018 | | December 31, 2017 | |
|-----------------------------------------------------------------|------------------------|------------|--------------------|------------|
| | Notional Amount | Fair Value | Notional Amount | Fair Value |
| | (dollars in thousands) | | | |
| Interest rate swaps related to FHLB advances included in assets | \$ 100,000 | \$ 1,906 | \$ 100,000 | \$ 798 |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses

Loans Receivable: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs, premiums and discounts related to purchase accounting, and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments.

Loan segments are defined as a group of loans, which share similar initial measurement attributes, risk characteristics, and methods for monitoring and assessing credit risk. Management has determined that the Company has five segments of loans: commercial, commercial real estate, commercial construction, residential real estate (including home equity) and consumer.

The recognition of interest income on commercial, commercial real estate, commercial construction and residential loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. A loan is moved to nonaccrual status in accordance with the Company's policy, typically after 90 days of non-payment.

All interest accrued but not received for loans placed on nonaccrual 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.

The policy of the Company is to generally grant commercial, residential and consumer loans to residents and businesses within our market area. The borrowers' abilities to repay their obligations are dependent upon various factors including the borrowers' income and net worth, cash flows generated by the borrowers' underlying collateral, value of the underlying collateral, and priority of the lender's lien on the property. Such factors are dependent upon various economic conditions and individual circumstances beyond the control of the Company. The Company is therefore subject to risk of loss. The Company believes its lending policies and procedures adequately minimize the potential exposure to such risks and that adequate provisions for loan losses are provided for all known and inherent risks. Collateral and/or personal guarantees are required for a large majority of the Company's loans.

Loans Held-for-Sale: Residential mortgage loans, originated and intended for sale in the secondary market, are carried at the lower of aggregate cost or estimated fair value as determined by outstanding commitments from investors. For these loans originated and intended for sale, gains and losses on loan sales (sale proceeds minus carrying value) are recorded in other income and direct loan origination costs and fees are deferred at origination of the loan and are recognized in other income upon sale of the loan.

Other loans held-for-sale are carried at the lower of aggregate cost or estimated fair value. Fair value of these loans is determined based on the terms of the loan, such as interest rate, maturity date, reset term, as well as sales of similar assets.

Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses. Losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off. The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

A loan is impaired when, based on current information and events, it is probable that the Company 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, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings (“TDRs”) and classified as impaired. As part of the evaluation of impaired loans, the Company individually reviews for impairment all non-homogeneous loans internally classified as substandard or below. Generally, smaller impaired non-homogeneous loans and impaired homogeneous loans are collectively evaluated for impairment.

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.

TDRs are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan’s effective rate at inception. If a TDR is considered to be a collateral dependent loan, impairment of the loan is measured using the fair value of the collateral. For TDRs that subsequently default, the Company determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience, the primary factor, is determined by loan class and is based on the actual loss history experienced by the Bank over an actual three-year rolling calculation. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio category and with the exogenous factor adjustments based on the risks present for each loan category. These exogenous factors include consideration of the following: concentrations of credit; delinquency & nonaccrual trends; economic & business conditions including evaluation of the national and regional economies and industries with significant loan concentrations; external factors including legal, regulatory or competitive pressures that may impact the loan portfolio; changes in the experience, ability, or size of the lending staff, management, or board of directors that may impact the loan portfolio; changes in underwriting standards, collection procedures, charge-off practices, or other changes in lending policies and procedures that may impact the loan portfolio; loss and recovery trends; changes in portfolio size and mix; and trends in problem loans.

Purchased Credit-Impaired Loans: The Company acquires groups of loans in conjunction with mergers, some of which have shown evidence of credit deterioration since origination. These purchased credit-impaired loans are recorded at their estimated fair value, such that there is no carryover of the seller’s allowance for loan losses (“ALLL”). After acquisition, probable incurred credit losses are recognized by an increase in the ALLL.

Such purchased credit-impaired loans (“PCI”) are identified on an individual basis. The Company estimates the amount and timing of expected cash flows for each loan and the expected cash flows in excess of amount paid is recorded as interest income over the remaining life of the loan (accretable yield). The excess of the loan’s contractual principal and interest over expected cash flows is not recorded (nonaccretable difference).

A PCI loan may be resolved either through a sale of the loan, by working with the customer and obtaining partial or full repayment, by short sale of the collateral, or by foreclosure. A gain or loss on resolution would be recognized based on the difference between the proceeds received and the carrying amount of the loan.

PCI loans that met the criteria for nonaccrual may be considered performing, regardless of whether the customer is contractually delinquent, if management can reasonably estimate the timing and amount of the expected cash flows on such loans and if management expects to fully collect the new carrying value of the loans. As such, management may no longer consider the loans to be nonaccrual or nonperforming and may accrue interest on these loans, including the impact of any accretable discount.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

Loans receivable - The following table sets forth the composition of the Company's loan portfolio, including net deferred loan fees, at September 30, 2018 and December 31, 2017:

| | September 30, 2018 | December 31, 2017 |
|-------------------------|------------------------|----------------------|
| | (dollars in thousands) | |
| Commercial | \$ 933,169 | \$ 824,082 |
| Commercial real estate | 2,739,943 | 2,592,909 |
| Commercial construction | 494,206 | 483,216 |
| Residential real estate | 295,948 | 271,795 |
| Consumer | 2,508 | 2,808 |
| Gross loans | 4,465,774 | 4,174,810 |
| Net deferred loan fees | (3,287) | (3,354) |
| Total loans receivable | <u>\$ 4,462,487</u> | <u>\$ 4,171,456</u> |

At September 30, 2018 and December 31, 2017, loan balances of approximately \$2.2 billion and \$1.9 billion, respectively, were pledged to secure borrowings from the FHLB of New York.

Loans held-for-sale - The following table sets forth the composition of the Company's loans held-for-sale portfolio at September 30, 2018 and December 31, 2017:

| | September 30, 2018 | December 31, 2017 |
|-------------------------|------------------------|----------------------|
| | (dollars in thousands) | |
| Commercial real estate | \$ - | \$ 24,475 |
| Residential real estate | 270 | 370 |
| Total carrying amount | <u>\$ 270</u> | <u>\$ 24,845</u> |

Valuation allowance - The following table sets forth the composition of the Company's valuation allowance within the loans held-for-sale portfolio during the three and nine months ended September 30, 2018 and September 30, 2017:

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 |
|---------------------------------|------------------------------------------------|------------------------------------------------|
| | (dollars in thousands) | |
| Balance at July 1, | \$ - | \$ 12,325 |
| Reduction from loans paid off | - | (38) |
| Increase in valuation allowance | - | 3,000 |
| Balance at September 30, | <u>\$ -</u> | <u>\$ 15,287</u> |
| | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
| | (dollars in thousands) | |
| Balance at January 1, | \$ - | \$ - |
| Reduction from loans paid off | - | (38) |
| Increase in valuation allowance | - | 15,325 |

Balance at September 30,

\$ -

\$ 15,287

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

Purchased Credit-Impaired Loans: The Company holds purchased loans for which there was, at their acquisition date, evidence of deterioration of credit quality since their origination and it was probable, at acquisition, that all contractually required payments would not be collected. The recorded investment of those loans is as follows at September 30, 2018 and December 31, 2017.

| | September 30, 2018 | December 31, 2017 |
|------------|------------------------|----------------------|
| | (dollars in thousands) | |
| Commercial | \$ 2,524 | \$ 2,683 |

For those purchased loans disclosed above, the Company did not increase the allowance for loan losses during either the three or nine months ended September 30, 2018 and September 30, 2017. There were no reversals from the allowance for loan losses during the three and nine months ended September 30, 2018 and September 30, 2017.

The following table presents interest income expected to be recognized on the purchased credit-impaired loans and the related activity for the three and nine months ended September 30, 2018 and September 30, 2017:

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 |
|--------------------------|------------------------------------------------|------------------------------------------------|
| | (dollars in thousands) | |
| Balance at July 1, | \$ 1,259 | \$ 2,496 |
| Accretion of income | (63) | (180) |
| Balance at September 30, | \$ 1,196 | \$ 2,316 |

| | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|--------------------------|-----------------------------------------------|-----------------------------------------------|
| | (dollars in thousands) | |
| Balance at January 1, | \$ 1,387 | \$ 2,860 |
| Accretion of income | (191) | (544) |
| Balance at September 30, | \$ 1,196 | \$ 2,316 |

Loans Receivable on Nonaccrual Status - The following table sets forth the composition of the Company's nonaccrual loans as of September 30, 2018 and December 31, 2017:

| | September 30, 2018 | December 31, 2017 |
|-------------------------|------------------------|----------------------|
| | (dollars in thousands) | |
| Commercial | \$ 29,562 | \$ 47,363 |
| Commercial real estate | 15,927 | 12,757 |
| Commercial construction | 2,934 | - |
| Residential real estate | 4,592 | 5,493 |
| Total nonaccrual loans | \$ 53,015 | \$ 65,613 |

Nonaccrual loans and loans 90 days or greater past due and still accruing include both smaller balance homogeneous loans that are collectively evaluated for impairment and loans individually evaluated for impairment.

The decrease in nonaccruals from the year-end 2017 was mainly attributable to a \$17.0 million charge-off, related to the taxi medallion loan

portfolio (which is included in the Commercial loan category) that took place during the first quarter of 2018. The taxi medallion loan portfolio was classified as substandard and impaired as of September 30, 2018 and December 31, 2017.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

The Company continuously monitors the credit quality of its loans receivable. In addition to its internal monitoring, the Company utilizes the services of a third-party loan review firm to periodically validate the credit quality of its loans receivable on a sample basis. Credit quality is monitored by reviewing certain credit quality indicators. Assets classified “Pass” are deemed to possess average to superior credit quality, requiring no more than normal attention. Assets classified as “Special Mention” have generally acceptable credit quality yet possess higher risk characteristics/circumstances than satisfactory assets. Such conditions include strained liquidity, slow pay, stale financial statements, or other conditions that require more stringent attention from the lending staff. These conditions, if not corrected, may weaken the loan quality or inadequately protect the Company’s credit position at some future date. Assets are classified “Substandard” if the asset has a well-defined weakness that requires management’s attention to a greater degree than for loans classified special mention. Such weakness, if left uncorrected, could possibly result in the compromised ability of the loan to perform to contractual requirements. An asset is classified as “Doubtful” if it is inadequately protected by the net worth and/or paying capacity of the obligor or of the collateral, if any, that secures the obligation. Assets classified as doubtful include assets for which there is a “distinct possibility” that a degree of loss will occur if the inadequacies are not corrected. All loans past due 90 days or greater and all impaired loans are included in the appropriate category below.

Credit Quality Indicators - The following table presents information, excluding loans held-for-sale and net deferred loan fees, about the Company’s loan credit quality at September 30, 2018 and December 31, 2017:

| | September 30, 2018 | | | | |
|---------------------------|------------------------|--------------------|------------------|-------------|---------------------|
| | Pass | Special Mention | Substandard | Doubtful | Total |
| | (dollars in thousands) | | | | |
| Commercial ⁽¹⁾ | \$ 887,024 | \$ 12,639 | \$ 33,506 | \$ - | \$ 933,169 |
| Commercial real estate | 2,699,338 | 10,651 | 29,954 | - | 2,739,943 |
| Commercial construction | 481,226 | 5,458 | 7,522 | - | 494,206 |
| Residential real estate | 291,223 | - | 4,725 | - | 295,948 |
| Consumer | 2,484 | - | 24 | - | 2,508 |
| Gross loans | <u>\$ 4,361,295</u> | <u>\$ 28,748</u> | <u>\$ 75,731</u> | <u>\$ -</u> | <u>\$ 4,465,774</u> |
| | December 31, 2017 | | | | |
| | Pass | Special Mention | Substandard | Doubtful | Total |
| | (dollars in thousands) | | | | |
| Commercial | \$ 767,020 | \$ 3,764 | \$ 53,298 | \$ - | \$ 824,082 |
| Commercial real estate | 2,534,973 | 34,335 | 23,601 | - | 2,592,909 |
| Commercial construction | 475,066 | 5,521 | 2,629 | - | 483,216 |
| Residential real estate | 266,163 | - | 5,632 | - | 271,795 |
| Consumer | 2,767 | - | 41 | - | 2,808 |
| Gross loans | <u>\$ 4,045,989</u> | <u>\$ 43,620</u> | <u>\$ 85,201</u> | <u>\$ -</u> | <u>\$ 4,174,810</u> |

⁽¹⁾ Reflects a \$17.0 million charge-off related to the taxi medallion loans classified as “substandard”.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

The following table provides an analysis of the impaired loans by category as of September 30, 2018 and December 31, 2017:

| | September 30, 2018 | | |
|--------------------------------------|------------------------|----------------------|---------------|
| | Recorded | Unpaid | Related |
| | Investment | Principal Balance | Allowance |
| (dollars in thousands) | | | |
| <u>No related allowance recorded</u> | | | |
| Commercial | \$ 31,471 | \$ 92,452 | |
| Commercial real estate | 21,483 | 21,636 | |
| Commercial construction | 10,428 | 10,429 | |
| Residential real estate | 2,237 | 2,533 | |
| Consumer | - | - | |
| Total (no related allowance) | <u>\$ 65,619</u> | <u>\$ 127,050</u> | |
| <u>With an allowance recorded</u> | | | |
| Commercial real estate | \$ 8,529 | \$ 8,529 | \$ 709 |
| Residential real estate | 263 | 266 | 32 |
| Total (with allowance) | <u>\$ 8,792</u> | <u>\$ 8,795</u> | <u>\$ 741</u> |
| <u>Total</u> | | | |
| Commercial | \$ 31,471 | \$ 92,452 | \$ - |
| Commercial real estate | 30,012 | 30,165 | 709 |
| Commercial construction | 10,428 | 10,429 | - |
| Residential real estate | 2,500 | 2,799 | 32 |
| Consumer | - | - | - |
| Total | <u>\$ 74,411</u> | <u>\$ 135,845</u> | <u>\$ 741</u> |
| December 31, 2017 | | | |
| | Recorded | Unpaid | Related |
| | Investment | Principal Balance | Allowance |
| | (dollars in thousands) | | |
| <u>No related allowance recorded</u> | | | |
| Commercial | \$ 49,761 | \$ 101,066 | |
| Commercial real estate | 23,905 | 23,976 | |
| Commercial construction | 6,662 | 6,662 | |
| Residential real estate | 3,203 | 3,442 | |
| Consumer | - | - | |
| Total (no related allowance) | <u>\$ 83,531</u> | <u>\$ 135,146</u> | |
| <u>With an allowance recorded</u> | | | |
| Commercial real estate | \$ 1,133 | \$ 1,133 | \$ 39 |
| <u>Total</u> | | | |
| Commercial | \$ 49,761 | \$ 101,066 | \$ - |
| Commercial real estate | 25,038 | 25,109 | 39 |
| Commercial construction | 6,662 | 6,662 | - |
| Residential real estate | 3,203 | 3,442 | - |
| Consumer | - | - | - |

| | | | |
|-------|------------------|-------------------|--------------|
| Total | <u>\$ 84,664</u> | <u>\$ 136,279</u> | <u>\$ 39</u> |
|-------|------------------|-------------------|--------------|

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

The following table provides an analysis related to the average recorded investment and interest income recognized on impaired loans by category as of and for the three and nine months ended September 30, 2018 and 2017:

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|----------------------------------------------|----------------------------------|----------------------------|-----------------------------|----------------------------|---------------------------------|----------------------------|-----------------------------|----------------------------|
| | 2018 | | 2017 | | 2018 | | 2017 | |
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| (dollars in thousands) | | | | | | | | |
| <u>Impaired loans (no allowance):</u> | | | | | | | | |
| Commercial ⁽¹⁾ | \$ 31,769 | \$ 36 | \$ 3,100 | \$ 34 | \$ 39,132 | \$ 102 | \$ 3,149 | \$ 115 |
| Commercial real estate | 21,557 | 105 | 19,302 | 221 | 21,714 | 475 | 18,813 | 424 |
| Commercial construction | 10,297 | 92 | 4,285 | 63 | 11,718 | 387 | 4,273 | 215 |
| Residential real estate | 2,249 | - | 2,529 | 2 | 2,304 | - | 2,551 | 6 |
| Consumer | - | - | 48 | 1 | - | - | 54 | 2 |
| Total | \$ 65,872 | \$ 233 | \$ 29,264 | \$ 321 | \$ 74,868 | \$ 964 | \$ 28,840 | \$ 762 |
| <u>Impaired loans (allowance):</u> | | | | | | | | |
| Commercial real estate | \$ 8,534 | \$ 11 | \$ 1,645 | \$ 2 | \$ 8,544 | \$ 34 | \$ 1,654 | \$ 39 |
| Residential real estate | 264 | - | - | - | 267 | - | - | - |
| Total | \$ 8,798 | \$ 11 | \$ 1,645 | \$ 2 | \$ 8,811 | \$ 34 | \$ 1,654 | \$ 39 |
| <u>Total impaired loans:</u> | | | | | | | | |
| Commercial ⁽¹⁾ | \$ 31,769 | \$ 36 | \$ 3,100 | \$ 34 | \$ 39,132 | \$ 102 | \$ 3,149 | \$ 115 |
| Commercial real estate | 30,091 | 116 | 20,947 | 223 | 30,258 | 509 | 20,467 | 463 |
| Commercial construction | 10,297 | 92 | 4,285 | 63 | 11,718 | 387 | 4,273 | 215 |
| Residential real estate | 2,513 | - | 2,259 | 2 | 2,571 | - | 2,551 | 6 |
| Consumer | - | - | 48 | 1 | - | - | 54 | 2 |
| Total | \$ 74,670 | \$ 244 | \$ 30,909 | \$ 323 | \$ 83,679 | \$ 998 | \$ 30,494 | \$ 801 |

(1) Reflects the entire taxi medallion portfolio moving back to the loans held-for-investment category from the loans held-for-sale category in November 2017.

Included in impaired loans at September 30, 2018 and December 31, 2017 are loans that are deemed troubled debt restructurings. The recorded investment in loans include accrued interest receivable and other capitalized costs such as real estate taxes paid on behalf of the borrower and loan origination fees, net, when applicable. Cash basis interest and interest income recognized on accrual basis approximate each other.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

The following table provides an analysis of the aging of gross loans (excluding loans held-for-sale) that are past due at September 30, 2018 and December 31, 2017 by segment:

Aging Analysis

| | September 30, 2018 | | | | | | | |
|-------------------------|------------------------|------------------------|---------------------------------------------------------|------------------|-------------------------------------|---------------------|---------------------|-------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due and Still Accruing | | Total Past Due and Nonaccrual | | Current | Gross Loans |
| | | | Nonaccrual | Nonaccrual | Nonaccrual | Nonaccrual | | |
| | (dollars in thousands) | | | | | | | |
| Commercial | \$ 233 | \$ 246 | \$ 1,648 | \$ 29,562 | \$ 31,689 | \$ 901,480 | \$ 933,169 | |
| Commercial real estate | - | 3,190 | - | 15,927 | 19,117 | 2,720,826 | 2,739,943 | |
| Commercial construction | - | - | - | 2,934 | 2,934 | 491,272 | 494,206 | |
| Residential real estate | 6 | - | - | 4,592 | 4,598 | 291,350 | 295,948 | |
| Consumer | 288 | - | - | - | 288 | 2,220 | 2,508 | |
| Total | <u>\$ 527</u> | <u>\$ 3,436</u> | <u>\$ 1,648</u> | <u>\$ 53,015</u> | <u>\$ 58,626</u> | <u>\$ 4,407,148</u> | <u>\$ 4,465,774</u> | |

Included in the 90 days or greater past due and still accruing category as of September 30, 2018 are purchased credit-impaired loan, net of its fair value marks, which accretes income per its valuation at date of acquisition.

| | December 31, 2017 | | | | | | | |
|-------------------------|------------------------|------------------------|---------------------------------------------------------|------------------|-------------------------------------|---------------------|---------------------|-------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due and Still Accruing | | Total Past Due and Nonaccrual | | Current | Gross Loans |
| | | | Nonaccrual | Nonaccrual | Nonaccrual | Nonaccrual | | |
| | (dollars in thousands) | | | | | | | |
| Commercial | \$ 1,708 | \$ 183 | \$ 1,664 | \$ 47,363 | \$ 50,918 | \$ 773,164 | \$ 824,082 | |
| Commercial real estate | 545 | 1,475 | - | 12,757 | 14,777 | 2,578,132 | 2,592,909 | |
| Commercial construction | - | - | - | - | - | 483,216 | 483,216 | |
| Residential real estate | 1,578 | - | - | 5,493 | 7,071 | 264,724 | 271,795 | |
| Consumer | 18 | - | - | - | 18 | 2,790 | 2,808 | |
| Total | <u>\$ 3,849</u> | <u>\$ 1,658</u> | <u>\$ 1,664</u> | <u>\$ 65,613</u> | <u>\$ 72,784</u> | <u>\$ 4,102,026</u> | <u>\$ 4,174,810</u> | |

Included in the 90 days or greater past due and still accruing category as of December 31, 2017 are purchased credit-impaired loan, net of its fair value marks, which accretes income per its valuation at date of acquisition.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

The following tables detail, at the period-end presented, the amount of gross loans (excluding loans held-for-sale) that are evaluated individually, and collectively, for impairment, those acquired with deteriorated credit quality, and the related portion of the allowance for loan losses (“ALLL”) that are allocated to each loan portfolio segment:

| | September 30, 2018 | | | | | | |
|-------------------------------------------|--------------------|---------------------|-------------------|-------------------|-----------------|---------------|---------------------|
| | Commercial | Commercial | Commercial | Residential | Consumer | Unallocated | Total |
| | Commercial | real estate | construction | real estate | | | |
| (dollars in thousands) | | | | | | | |
| ALLL | | | | | | | |
| Individually evaluated for impairment | \$ - | \$ 709 | \$ - | \$ 32 | \$ - | \$ - | \$ 741 |
| Collectively evaluated for impairment | 9,749 | 16,569 | 4,790 | 1,183 | 3 | 564 | 32,858 |
| Acquired portfolio | 200 | 950 | - | - | - | - | 1,150 |
| Acquired with deteriorated credit quality | - | - | - | - | - | - | - |
| Total | \$ 9,949 | \$ 18,228 | \$ 4,790 | \$ 1,215 | \$ 3 | \$ 564 | \$ 34,749 |
| Gross loans | | | | | | | |
| Individually evaluated for impairment | \$ 31,471 | \$ 30,012 | \$ 10,428 | \$ 2,500 | \$ - | | \$ 74,411 |
| Collectively evaluated for impairment | 891,514 | 2,438,638 | 483,778 | 247,211 | 2,123 | | 4,063,264 |
| Acquired portfolio | 7,660 | 271,293 | - | 46,237 | 385 | | 325,575 |
| Acquired with deteriorated credit quality | 2,524 | - | - | - | - | | 2,524 |
| Total | \$ 933,169 | \$ 2,739,943 | \$ 494,206 | \$ 295,948 | \$ 2,508 | | \$ 4,465,774 |
| December 31, 2017 | | | | | | | |
| | Commercial | Commercial | Commercial | Residential | Consumer | Unallocated | Total |
| | Commercial | real estate | construction | real estate | | | |
| (dollars in thousands) | | | | | | | |
| ALLL | | | | | | | |
| Individually evaluated for impairment | \$ - | \$ 39 | \$ - | \$ - | \$ - | \$ - | \$ 39 |
| Collectively evaluated for impairment | 8,032 | 15,472 | 4,747 | 1,051 | 2 | 605 | 29,909 |
| Acquired portfolio | 200 | 1,600 | - | - | - | - | 1,800 |
| Acquired with deteriorated credit quality | - | - | - | - | - | - | - |
| Total | \$ 8,232 | \$ 17,111 | \$ 4,747 | \$ 1,051 | \$ 2 | \$ 605 | \$ 31,748 |
| Gross loans | | | | | | | |
| Individually evaluated for impairment | \$ 49,761 | \$ 25,038 | \$ 6,662 | \$ 3,203 | \$ - | | \$ 84,664 |
| Collectively evaluated for impairment | 757,923 | 2,190,686 | 476,554 | 212,350 | 2,338 | | 3,639,851 |
| Acquired portfolio | 13,715 | 377,185 | - | 56,242 | 470 | | 447,612 |
| Acquired with deteriorated credit quality | 2,683 | - | - | - | - | | 2,683 |
| Total | \$ 824,082 | \$ 2,592,909 | \$ 483,216 | \$ 271,795 | \$ 2,808 | | \$ 4,174,810 |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

The Company's allowance for loan losses is analyzed quarterly. Many factors are considered, including growth in the portfolio, delinquencies, nonaccrual loan levels, and other factors inherent in the extension of credit. There have been no material changes to the allowance for loan losses ("ALLL") methodology as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

A summary of the activity in the ALLL is as follows:

| | Three Months Ended September 30, 2018 | | | | | | |
|-------------------------------|---------------------------------------|------------------|-----------------|-----------------|-------------|---------------|------------------|
| | Commercial | Commercial | Commercial | Residential | Consumer | Unallocated | Total |
| | Commercial | real estate | construction | real estate | Consumer | Unallocated | Total |
| | (dollars in thousands) | | | | | | |
| Balance at June 30, 2018 | \$ 8,960 | \$ 18,221 | \$ 4,812 | \$ 1,167 | \$ 3 | \$ 431 | \$ 33,594 |
| Charge-offs | - | - | - | - | (6) | - | (6) |
| Recoveries | 56 | - | - | - | 5 | - | 61 |
| Provision for loan losses | 933 | 7 | (22) | 48 | 1 | 133 | 1,100 |
| Balance at September 30, 2018 | <u>\$ 9,949</u> | <u>\$ 18,228</u> | <u>\$ 4,790</u> | <u>\$ 1,215</u> | <u>\$ 3</u> | <u>\$ 564</u> | <u>\$ 34,749</u> |

| | Three Months Ended September 30, 2017 | | | | | | |
|-------------------------------|---------------------------------------|------------------|-----------------|-----------------|-------------|---------------|------------------|
| | Commercial | Commercial | Commercial | Residential | Consumer | Unallocated | Total |
| | Commercial | real estate | construction | real estate | Consumer | Unallocated | Total |
| | (dollars in thousands) | | | | | | |
| Balance at June 30, 2017 | \$ 7,238 | \$ 15,389 | \$ 4,241 | \$ 985 | \$ 2 | \$ 546 | \$ 28,401 |
| Charge-offs | - | - | - | - | (1) | - | (1) |
| Recoveries | 17 | 2 | - | - | 1 | - | 20 |
| Provision for loan losses | 461 | 1,443 | (301) | 67 | - | (220) | 1,450 |
| Balance at September 30, 2017 | <u>\$ 7,716</u> | <u>\$ 16,834</u> | <u>\$ 3,940</u> | <u>\$ 1,052</u> | <u>\$ 2</u> | <u>\$ 326</u> | <u>\$ 29,870</u> |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

| | Nine Months Ended September 30, 2018 | | | | | | |
|-------------------------------|--------------------------------------|------------------|-----------------|-----------------|-------------|---------------|------------------|
| | Commercial | Commercial | Commercial | Residential | Consumer | Unallocated | Total |
| | Commercial | real estate | construction | real estate | | | |
| | (dollars in thousands) | | | | | | |
| Balance at December 31, 2017 | \$ 8,233 | \$ 17,112 | \$ 4,747 | \$ 1,050 | \$ 1 | \$ 605 | \$ 31,748 |
| Charge-offs | (17,066) | - | - | (18) | (7) | - | (17,091) |
| Recoveries | 87 | - | - | - | 5 | - | 92 |
| Provision | 18,695 | 1,116 | 43 | 183 | 4 | (41) | 20,000 |
| Balance at September 30, 2018 | <u>\$ 9,949</u> | <u>\$ 18,228</u> | <u>\$ 4,790</u> | <u>\$ 1,215</u> | <u>\$ 3</u> | <u>\$ 564</u> | <u>\$ 34,749</u> |

| | Nine Months Ended September 30, 2017 | | | | | | |
|-------------------------------|--------------------------------------|------------------|-----------------|-----------------|-------------|---------------|------------------|
| | Commercial | Commercial | Commercial | Residential | Consumer | Unallocated | Total |
| | Commercial | real estate | construction | real estate | | | |
| | (dollars in thousands) | | | | | | |
| Balance at December 31, 2016 | \$ 6,632 | \$ 12,583 | \$ 4,789 | \$ 958 | \$ 3 | \$ 779 | \$ 25,744 |
| Charge-offs | - | (71) | - | - | (12) | - | (83) |
| Recoveries | 158 | 50 | - | - | 1 | - | 209 |
| Provision for loan losses | 926 | 4,272 | (849) | 94 | 10 | (453) | 4,000 |
| Balance at September 30, 2017 | <u>\$ 7,716</u> | <u>\$ 16,834</u> | <u>\$ 3,940</u> | <u>\$ 1,052</u> | <u>\$ 2</u> | <u>\$ 326</u> | <u>\$ 29,870</u> |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

Troubled Debt Restructurings: Loans are considered to have been modified in a troubled debt restructuring (“TDRs”) when due to a borrower’s financial difficulties, the Company makes certain concessions to the borrower that it would not otherwise consider. Modifications may include interest rate reductions, principal or interest forgiveness, forbearance, and other actions intended to minimize economic loss and to avoid foreclosure or repossession of collateral. Generally, a nonaccrual loan that has been modified in a TDR remains on nonaccrual status for a period of nine months to demonstrate that the borrower is able to meet the terms of the modified loan. However, performance prior to the modification, or significant events that coincide with the modification, are included in assessing whether the borrower can meet the new terms and may result in the loan being returned to accrual status at the time of loan modification or after a shorter performance period. If the borrower’s ability to meet the revised payment schedule is uncertain, the loan remains on nonaccrual status.

The following table presents a rollforward of TDRs and the related changes to the allowance for loan losses (“ALLL”) that occurred for the periods presented:

| | Nine Months Ended | | Year Ended | |
|-------------------|------------------------|--------------|-------------------|-------------|
| | September 30, 2018 | | December 31, 2017 | |
| | (dollars in thousands) | | | |
| | Recorded | | Recorded | |
| | Investment | ALLL | Investment | ALLL |
| TDRs | | | | |
| Beginning balance | \$ 20,518 | \$ - | \$ 13,818 | \$ - |
| Net additions | 18,913 | 11 | 10,378 | - |
| Payoffs/paydowns | (7,094) | - | (3,098) | - |
| Transfers | - | - | (580) | - |
| Ending balance | <u>\$ 32,337</u> | <u>\$ 11</u> | <u>\$ 20,518</u> | <u>\$ -</u> |

TDRs totaled \$32.3 million at September 30, 2018, of which \$21.1 million were on nonaccrual status and \$11.2 million were performing under restructured terms. At December 31, 2017, TDRs totaled \$20.5 million, of which \$5.6 million were on nonaccrual status and \$14.9 million were performing under restructured terms. TDRs as of September 30, 2018 increased the ALLL during the three and nine months ended September 30, 2018 by \$-0- and \$147 thousand, respectively. During the nine months ended September 30, 2018, one commercial construction loan and one commercial real estate loan showed collateral improvement, resulting in approximately \$136 thousand reduction in specific reserve allocations. There were no charge-offs in connection with a loan modification at the time of modification during the three and nine months ended September 30, 2018. There were no TDRs for which there was a payment default within twelve months following the modification during the three and nine months ended September 30, 2018.

The following table presents loans by class modified as TDRs that occurred during the nine months ended September 30, 2018:

| TDRs | Number of Loans | Pre-Modification | Post-Modification |
|-------------------------|--------------------|---------------------------------------|---------------------------------------|
| | | Outstanding Recorded Investment | Outstanding Recorded Investment |
| | | (dollars in thousands) | |
| Commercial | 31 | \$ 15,737 | \$ 15,737 |
| Commercial real estate | 2 | 209 | 209 |
| Commercial construction | 2 | 1,839 | 1,839 |
| Residential real estate | 2 | 454 | 454 |
| Total | <u>37</u> | <u>\$ 18,239</u> | <u>\$ 18,239</u> |

Included in the commercial loan segment of the troubled debt restructurings are 27 taxi medallion loans totaling \$11.2 million. All 27 taxi medallion loans included above were on nonaccrual status prior to modification, and remain on nonaccrual status post-modification. All loan modifications during the nine months ended September 30, 2018 included interest rate reductions and maturity extensions.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 6. Loans and the Allowance for Loan Losses – (continued)

TDRs totaled \$17.6 million at September 30, 2017, of which \$4.8 million were on nonaccrual status and \$12.8 million were performing under restructured terms. At December 31, 2016, TDRs totaled \$13.8 million, of which \$0.5 million were on nonaccrual status and \$13.3 million were performing under restructured terms. TDRs as of September 30, 2017 did not increase the ALLL during the three and nine months ended September 30, 2017. There were no charge-offs in connection with a loan modification at the time of modification during the three or nine months ended September 30, 2017. There were no TDRs for which there was a payment default within twelve months following the modification during the three and nine months ended September 30, 2017.

The following table presents loans by segment modified as troubled debt restructurings that occurred during the nine months ended September 30, 2017:

| <u>TDRs</u> | <u>Number of Loans</u> | <u>Pre-Modification Outstanding Recorded Investment</u> | <u>Post-Modification Outstanding Recorded Investment</u> |
|-------------------------|----------------------------|---------------------------------------------------------------------|----------------------------------------------------------------------|
| | | (dollars in thousands) | |
| Commercial real estate | 2 | \$ 3,042 | \$ 3,042 |
| Commercial construction | 1 | 2,589 | 2,589 |
| Residential real estate | 1 | 17 | 17 |
| Total | <u>4</u> | <u>\$ 5,648</u> | <u>\$ 5,648</u> |

Note 7. Fair Value Measurements and Fair Value of Financial Instruments

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (for example, supported with little or no market activity).

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 7. Fair Value Measurements and Fair Value of Financial Instruments – (continued)

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following methods and assumptions were used to estimate the fair values of the Company's assets measured at fair value on a recurring basis at September 30, 2018 and December 31, 2017:

Securities Available-for-Sale and Equity Securities: Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 inputs include securities that have quoted prices in active markets for identical assets. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows. Examples of instruments which would generally be classified within Level 2 of the valuation hierarchy include municipal bonds and certain agency collateralized mortgage obligations. In certain cases where there is limited activity in the market for a particular instrument, assumptions must be made to determine the fair value of the instruments and these are classified as Level 3. When measuring fair value, the valuation techniques available under the market approach, income approach and/or cost approach are used. The Company's evaluations are based on market data and the Company employs combinations of these approaches for its valuation methods depending on the asset class.

Derivatives: The fair value of derivatives is based on valuation models using observable market data as of the measurement date (level 2). Our derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore, the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rate, and volatility factors to value the position. The majority of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 7. Fair Value Measurements and Fair Value of Financial Instruments – (continued)

For financial assets and liabilities measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2018 and December 31, 2017 are as follows:

| | September 30, 2018 | | | |
|------------------------------------------------------|-------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|----------|
| | Fair Value Measurements at Reporting Date Using | | | |
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| | (dollars in thousands) | | | |
| Recurring fair value measurements: | | | | |
| Assets | | | | |
| Investment securities: | | | | |
| Available-for-sale: | | | | |
| Federal agency obligations | \$ 47,534 | \$ - | \$ 47,534 | \$ - |
| Residential mortgage pass-through securities | 190,551 | - | 190,551 | - |
| Commercial mortgage pass-through securities | 3,843 | - | 3,843 | - |
| Obligations of U.S. states and political subdivision | 130,388 | - | 120,947 | 9,441 |
| Corporate bonds and notes | 25,962 | - | 25,962 | - |
| Asset-backed securities | 10,363 | - | 10,363 | - |
| Certificates of deposit | 423 | - | 423 | - |
| Other securities | 975 | 975 | - | - |
| Total available-for-sale | \$ 410,039 | \$ 975 | \$ 399,623 | \$ 9,441 |
| Equity securities | 11,403 | 11,403 | - | - |
| Derivatives | 1,906 | - | 1,906 | - |
| Total assets | \$ 423,348 | \$ 12,378 | \$ 401,529 | \$ 9,441 |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 7. Fair Value Measurements and Fair Value of Financial Instruments – (continued)

| | December 31, 2017 | | | |
|------------------------------------------------------|-------------------------------------------------|-------------|--------------|----------|
| | Fair Value Measurements at Reporting Date Using | | | |
| | Quoted Prices | | | |
| | in Active | Significant | | |
| | Markets for | Other | Significant | |
| | Identical | Observable | Unobservable | |
| | Assets | Inputs | Inputs | |
| | (Level 1) | (Level 2) | (Level 3) | |
| | (dollars in thousands) | | | |
| Recurring fair value measurements: | | | | |
| Assets | | | | |
| Investment securities: | | | | |
| Available-for-sale: | | | | |
| Federal agency obligations | \$ 56,022 | \$ - | \$ 56,022 | \$ - |
| Residential mortgage pass-through securities | 181,891 | - | 181,891 | - |
| Commercial mortgage pass-through securities | 4,054 | - | 4,054 | - |
| Obligations of U.S. states and political subdivision | 131,128 | - | 121,496 | 9,632 |
| Trust preferred securities | 4,671 | - | 4,671 | - |
| Corporate bonds and notes | 29,693 | - | 29,693 | - |
| Asset-backed securities | 12,050 | - | 12,050 | - |
| Certificates of deposit | 625 | - | 625 | - |
| Equity securities | 11,728 | 11,728 | - | - |
| Other securities | 3,422 | 3,422 | - | - |
| Total available-for-sale | \$ 435,284 | \$ 15,150 | \$ 410,502 | \$ 9,632 |
| Derivatives | 798 | - | 798 | - |
| Total assets | \$ 436,082 | \$ 15,150 | \$ 411,300 | \$ 9,632 |

There were no transfers between Level 1 and Level 2 during the quarter ended September 30, 2018 and during the year ended December 31, 2017.

Assets Measured at Fair Value on a Nonrecurring Basis

The Company may be required periodically to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from the application of lower of cost or fair value accounting or impairment write-downs of individual assets. The following methods and assumptions were used to estimate the fair values of the Company's assets measured at fair value on a nonrecurring basis at September 30, 2018 and December 31, 2017:

Loans Held-for-Sale: Residential mortgage loans, originated and intended for sale in the secondary market, are carried at the lower of aggregate cost or estimated fair value as determined by outstanding commitments from investors. For these loans originated and intended for sale, gains and losses on loan sales (sale proceeds minus carrying value) are recorded in other income and direct loan origination costs and fees are deferred at origination of the loan and are recognized in other income upon sale of the loan. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions (Level 2).

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 7. Fair Value Measurements and Fair Value of Financial Instruments – (continued)

Impaired Loans: The Company may record adjustments to the carrying value of loans based on fair value measurements, generally as partial charge-offs of the uncollectible portions of these loans. These adjustments also include certain impairment amounts for collateral dependent loans calculated in accordance with GAAP. Impairment amounts are generally based on the fair value of the underlying collateral supporting the loan and, as a result, the carrying value of the loan less the calculated impairment amount applicable to that loan does not necessarily represent the fair value of the loan. Real estate collateral is valued using independent appraisals or other indications of value based on recent comparable sales of similar properties or assumptions generally observable by market participants. However, due to the substantial judgment applied and limited volume of activity as compared to other assets, fair value is based on Level 3 inputs. Estimates of fair value used for collateral supporting commercial loans generally are based on assumptions not observable in the market place and are also based on Level 3 inputs.

For assets measured at fair value on a nonrecurring basis, the fair value measurements at September 30, 2018 and December 31, 2017 are as follows:

| | September 30, 2018 | Fair Value Measurements at Reporting Date Using | | |
|---------------------------------------------------------------|-----------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (dollars in thousands) | | | | |
| <u>Assets measured at fair value on a nonrecurring basis:</u> | | | | |
| Impaired loans: | | | | |
| Commercial real estate | \$ 7,820 | \$ - | \$ - | \$ 7,820 |
| Residential real estate | 231 | | | 231 |

| | December 31, 2017 | Fair Value Measurements at Reporting Date Using | | |
|---------------------------------------------------------------|----------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (dollars in thousands) | | | | |
| <u>Assets measured at fair value on a nonrecurring basis:</u> | | | | |
| Impaired loans: | | | | |
| Commercial real estate | \$ 1,094 | \$ - | \$ - | \$ 1,094 |

Impaired loans – Collateral dependent impaired loans at September 30, 2018 that required a valuation allowance were \$8.8 million with a related valuation allowance of \$0.7 million compared to \$1.1 million with a related valuation allowance of \$39 thousand at December 31, 2017.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 7. Fair Value Measurements and Fair Value of Financial Instruments – (continued)

Assets Measured With Significant Unobservable Level 3 Inputs

Recurring basis

The tables below present a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2018 and for the year ended December 31, 2017:

| | Municipal Securities |
|------------------------------------|-------------------------|
| | (dollars in thousands) |
| Beginning balance, January 1, 2018 | \$ 9,632 |
| Principal paydowns | (191) |
| Ending balance, September 30, 2018 | \$ 9,441 |

| | Municipal Securities |
|------------------------------------|-------------------------|
| | (dollars in thousands) |
| Beginning balance, January 1, 2017 | \$ 18,218 |
| Principal paydowns | (8,586) |
| Ending balance, December 31, 2017 | \$ 9,632 |

The following methods and assumptions were used to estimate the fair values of the Company's assets measured at fair value on a recurring basis at September 30, 2018 and December 31, 2017. The table below provides quantitative information about significant unobservable inputs used in fair value measurements within Level 3 hierarchy.

September 30, 2018

| | Fair Value | Valuation Techniques | Unobservable Input | Range |
|--------------------------------|------------|-------------------------|-----------------------|-------|
| Securities available-for-sale: | | (dollars in thousands) | | |
| Municipal securities | \$ 9,441 | Discounted cash flows | Discount rate | 2.9% |

December 31, 2017

| | Fair Value | Valuation Techniques | Unobservable Input | Range |
|--------------------------------|------------|-------------------------|-----------------------|-------|
| Securities available-for-sale: | | (dollars in thousands) | | |
| Municipal securities | \$ 9,632 | Discounted cash flows | Discount rate | 2.9% |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 7. Fair Value Measurements and Fair Value of Financial Instruments – (continued)

Nonrecurring basis: The following methods and assumptions were used to estimate the fair values of the Company's assets measured at fair value on a nonrecurring basis for the periods presented. The tables below provide quantitative information about significant unobservable inputs used in fair value measurements within Level 3 hierarchy.

September 30, 2018

| | Fair Value | Valuation Techniques | Unobservable Input | Range |
|-------------------------|------------|---------------------------|---------------------------------------------------------|----------------|
| (dollars in thousands) | | | | |
| Impaired loans: | | | | |
| Commercial real estate | \$ 7,820 | Sales comparison approach | Adjustment for differences between the comparable sales | 0% - 20% [10%] |
| Residential real estate | \$ 231 | Sales comparison approach | Adjustment for differences between the comparable sales | 0% - 7% [2%] |

December 31, 2017

| | Fair Value | Valuation Techniques | Unobservable Input | Range |
|------------------------|------------|---------------------------|---------------------------------------------------------|---------------|
| (dollars in thousands) | | | | |
| Impaired loans: | | | | |
| Commercial real estate | \$ 1,094 | Sales comparison approach | Adjustment for differences between the comparable sales | 0% - 10% [5%] |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 7. Fair Value Measurements and Fair Value of Financial Instruments – (continued)

As of September 30, 2018 the fair value measurements presented are consistent with Topic 820, *Fair Value Measurement*, in which fair value represents exit price. The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of September 30, 2018 and December 31, 2017:

| | Carrying Amount | Fair Value | Fair Value Measurements | | |
|-------------------------------|-----------------|------------|----------------------------------------------------------------|-----------------------------------------------|-------------------------------------------|
| | | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (dollars in thousands) | | | | | |
| September 30, 2018 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 155,848 | \$ 155,848 | \$ 155,848 | \$ - | \$ - |
| Securities available-for-sale | 410,039 | 410,039 | 975 | 399,623 | 9,441 |
| Equity Securities | 11,403 | 11,403 | 11,403 | - | - |
| Loans held-for-sale | 270 | 270 | - | - | 270 |
| Net loans | 4,427,738 | 4,304,357 | - | - | 4,304,357 |
| Derivatives | 1,906 | 1,906 | - | 1,906 | - |
| Financial liabilities: | | | | | |
| Noninterest-bearing deposits | 758,213 | 758,213 | 758,213 | - | - |
| Interest-bearing deposits | 3,230,552 | 3,222,141 | 1,907,805 | 1,314,336 | - |
| Borrowings | 629,979 | 626,841 | - | 626,841 | - |
| Subordinated debentures | 128,474 | 129,165 | - | 129,165 | - |
| December 31, 2017 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 149,582 | \$ 149,582 | \$ 149,582 | \$ - | \$ - |
| Securities available-for-sale | 435,284 | 435,284 | 15,150 | 410,502 | 9,632 |
| Loans held-for-sale | 24,845 | 24,845 | - | 370 | 24,475 |
| Net loans | 4,139,708 | 4,118,542 | - | - | 4,118,542 |
| Derivatives | 798 | 798 | - | 798 | - |
| Financial liabilities: | | | | | |
| Noninterest-bearing deposits | 776,843 | 776,843 | 776,843 | - | - |
| Interest-bearing deposits | 3,018,285 | 3,018,285 | 1,842,151 | 1,176,134 | - |
| Borrowings | 670,077 | 669,680 | - | 669,680 | - |
| Subordinated debentures | 54,699 | 57,340 | - | 57,340 | - |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 7. Fair Value Measurements and Fair Value of Financial Instruments – (continued)

The fair value of commitments to originate loans is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair values of letters of credit and lines of credit are based on fees currently charged for similar agreements or on the estimated cost to terminate or otherwise settle the obligations with the counterparties at the reporting date. The fair value of commitments to originate loans is immaterial and not included in the tables above.

Changes in assumptions or estimation methodologies may have a material effect on these estimated fair values.

Fair value estimates are based on existing balance sheet financial instruments, without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. For example, there are certain significant assets and liabilities that are not considered financial assets or liabilities, such as deferred taxes, premises and equipment, and goodwill. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

Management believes that reasonable comparability between financial institutions may not be likely, due to the wide range of permitted valuation techniques and numerous estimates which must be made, given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values.

Note 8. Comprehensive Income

Total comprehensive income includes all changes in equity during a period from transactions and other events and circumstances from nonowner sources. The Company's other comprehensive income (loss) is comprised of unrealized holding gains and losses on securities available-for-sale, obligations for defined benefit pension plan and an adjustment to reflect the curtailment of the Company's defined benefit pension plan, net of taxes.

The following table represents the reclassification out of accumulated other comprehensive (loss) income for the periods presented:

| Details about Accumulated Other Comprehensive Income Components | Amounts Reclassified from Accumulated Other Comprehensive Income | | | | Affected Line item in the Statement Where Net Income is Presented |
|-----------------------------------------------------------------|------------------------------------------------------------------|----------------|-------------------|---------------|---------------------------------------------------------------------------|
| | Three Months Ended | | Nine Months Ended | | |
| | September 30 | | September 30 | | |
| | 2018 | 2017 | 2018 | 2017 | |
| Sale of investment securities available-for-sale | \$ - | \$ - | \$ - | \$ 1,596 | Net gains on sales of securities available-for-sale Income tax expense |
| | - | - | - | (579) | |
| | \$ - | \$ - | \$ - | \$ 1,017 | |
| Amortization of pension plan net actuarial losses | \$ 91 | \$ (103) | \$ 274 | \$ (309) | Other components of net periodic pension expense Income tax expense |
| | (26) | 42 | (77) | 126 | |
| | \$ 65 | \$ (61) | \$ 197 | \$ (183) | |
| Total reclassification | \$ 65 | \$ (61) | \$ 197 | \$ 834 | |

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 8. Comprehensive Income – (continued)

Accumulated other comprehensive loss at September 30, 2018 and December 31, 2017 consisted of the following:

| | September 30, 2018 | December 31, 2017 |
|---------------------------------------------------------------|------------------------|----------------------|
| | (dollars in thousands) | |
| Investment securities available-for-sale, net of tax | \$ (8,208) | \$ (902) |
| Cash flow hedge, net of tax | 1,370 | 472 |
| Defined benefit pension and post-retirement plans, net of tax | (3,846) | (3,589) |
| Total | \$ (10,684) | \$ (4,019) |

Effective January 1, 2018, the Company implemented ASU 2018-02, “*Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.*” Under ASU 2018-02, the FASB amended existing guidance to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (“Tax Act”). In order to comply with this new ASU, the Company recorded an adjustment to the balance sheet on January 1, 2018 of approximately \$709 thousand that increased retained earnings and increased accumulated other comprehensive loss.

Effective January 1, 2018, the Company implemented ASU 2016-01, “*Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.*” Under ASU 2016-01, equity securities, with certain exceptions, are to be measured at fair value with changes in fair value recognized in net income. In order to comply with this new ASU, the Company recorded a cumulative-effect adjustment to the balance sheet of approximately \$55 thousand. As of September 30, 2018, the Company’s equity securities had readily determinable fair values.

Note 9. Stock Based Compensation

Restricted stock, options and restricted stock units typically have a three-year vesting period starting one year after the date of grant with one-third vesting each year. The options generally expire ten years from the date of grant. Restricted stock granted to new employees and board members may be granted with shorter vesting periods. Grants of performance units typically have a cliff vesting after three years or upon a change of control. All issuances are subject to forfeiture if the recipient leaves or is terminated prior to the awards vesting. Restricted shares have the same dividend and voting rights as common stock, while options, performance units and restricted stock units do not.

All awards are issued at fair value of the underlying shares at the grant date. The Company expenses the cost of the awards, which is determined to be the fair market value of the awards at the date of grant, ratably over the vesting period. Forfeiture rates are not estimated but are handled on a case-by-case basis. Compensation expense for the three and nine months ended September 30, 2018 were \$0.6 million and \$1.3 million, respectively, while the compensation expense for the three and nine months ended September 30, 2017 were \$0.5 million and \$1.3 million, respectively.

All awards are issued at fair value of the underlying shares at the grant date. The Company expenses the cost of the awards, which is determined to be the fair market value of the awards at the date of grant, ratably over the vesting period. Forfeiture rates are not estimated but are handled on a case-by-case basis.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 9. Stock-Based Compensation – (continued)

Activity under the Company's options as of and for the nine months ended September 30, 2018 was as follows:

| | Number of Stock Options | Weighted- Average Exercise Price | Weighted- Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|-----------------------------------|-------------------------------|-------------------------------------------|------------------------------------------------------------------------|------------------------------|
| Outstanding at December 31, 2017 | 299,778 | \$ 6.18 | | |
| Granted | - | | | |
| Exercised | (102,378) | 5.12 | | |
| Forfeited/cancelled/expired | (1,323) | 14.24 | | |
| Outstanding at September 30, 2018 | <u>196,077</u> | 6.68 | 1.8 | \$ 3,346,546 |
| Exercisable at September 30, 2018 | <u>196,077</u> | \$ 6.68 | 1.8 | \$ 3,346,546 |

The aggregate intrinsic value of outstanding and exercisable options above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on September 30, 2018 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2018. This amount changes based on the fair market value of the Company's stock.

Activity under the Company's restricted shares as of and for the nine months ended September 30, 2018 was as follows:

| | Nonvested Shares | Weighted- Average Grant Date Fair Value |
|---------------------------------|---------------------|--------------------------------------------------|
| Nonvested at December 31, 2017 | 103,078 | \$ 20.41 |
| Granted | 23,018 | 28.08 |
| Vested | (58,002) | 20.33 |
| Forfeited/cancelled/expired | (666) | 24.25 |
| Nonvested at September 30, 2018 | <u>67,428</u> | 23.07 |

As of September 30, 2018, there was approximately \$920,000 of total unrecognized compensation cost related to nonvested restricted shares granted under the plans. The cost is expected to be recognized over a weighted average period of 1.1 years. A total of 0- and 23,018 restricted shares were granted during the three and nine months ended September 30, 2018, respectively, and 1,000 and 56,164 for the three and nine months ended September 30, 2017, respectively.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 9. Stock-Based Compensation – (continued)

A summary of the status of unearned performance unit awards and the change during the period is presented in the table below:

| | Units (expected) | Units (maximum) | Weighted Average Grant Date Fair Value |
|--------------------------------|---------------------|--------------------|-------------------------------------------------|
| Unearned at December 31, 2017 | 151,194 | | \$ 19.19 |
| Awarded | 19,614 | | 31.35 |
| Change in Estimate | (15,172) | | |
| Vested | (69,627) | | 19.46 |
| Unearned at September 30, 2018 | <u>86,009</u> | <u>151,772</u> | \$ 22.06 |

At September 30, 2018, the specific number of shares related to performance units that were expected to vest was 86,009, determined by actual performance in consideration of the established range of the performance targets, which is consistent with the level of expense currently being recognized over the vesting period. Should this expectation change, additional compensation expense could be recorded in future periods or previously recognized expense could be reversed. At September 30, 2018 the maximum amount of performance units that ultimately could vest if performance targets were exceeded is 151,772.

At September 30, 2018, compensation cost of approximately \$822,000 related to non-vested performance units not yet recognized is expected to be recognized over a weighted-average period of 1.8 years. A total of -0- and 19,614 performance units were awarded during the three and nine months ended September 30, 2018, respectively.

During the nine months ended September 30, 2018, 69,627 shares were issued in satisfaction of earned performance units. The shares issued were calculated based on a net down of 26,955 shares to satisfy tax obligations created by vesting.

A summary of the status of unearned restricted stock units and the change during the period is presented in the table below:

| | Units (expected) | Weighted Average Grant Date Fair Value |
|--------------------------------|---------------------|-------------------------------------------------|
| Unearned at December 31, 2017 | - | \$ - |
| Awarded | 29,423 | 31.35 |
| Forfeited | - | - |
| Vested | - | - |
| Unearned at September 30, 2018 | <u>29,423</u> | \$ 31.35 |

At September 30, 2018, the specific number of shares related to restricted stock units that were expected to vest was approximately 29,423. Any forfeitures would result in previously recognized expense being reversed. A portion of the shares that vest will be repurchased to satisfy the tax obligations of the recipient.

At September 30, 2018, compensation cost of approximately \$756,000 related to non-vested restricted stock units, not yet recognized, is expected to be recognized over a weighted-average period of 2.4 years. A total of 29,423 and -0- restricted stock units were awarded during the nine months ended September 30, 2018 and 2017, respectively.

Effective January 1, 2017, the Company implemented ASU 2016-09, “*Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment.*” Under ASU 2016-09 all excess tax benefits and tax deficiencies related to share-based payment awards should be recognized as income tax expense or benefit in the income statement during the period in which they occur. Included in income tax expense for the nine months ended September 30, 2018 and September 30, 2017 is a benefit of approximately \$887 thousand and \$181 thousand, respectively, which resulted from the effect of implementing ASU 2016-09.



CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 10. Components of Net Periodic Pension Cost

The Company maintained a non-contributory defined benefit pension plan for substantially all of its employees until June 30, 2007, at which time the Company froze the plan. The following table sets forth the net periodic pension cost of the Company's pension plan for the periods indicated.

| | Three Months Ended | | Affected Line Item in the Consolidated Statements of Income |
|------------------------------------|------------------------|--------------|----------------------------------------------------------------|
| | September 30, | | |
| | 2018 | 2017 | |
| | (dollars in thousands) | | |
| Service cost | \$ - | \$ - | |
| Interest cost | 106 | 119 | Other components of net periodic pension expense |
| Expected return on plan assets | (190) | (160) | Other components of net periodic pension expense |
| Net amortization | 91 | 103 | Other components of net periodic pension expense |
| Total periodic pension cost | \$ 7 | \$ 62 | |

| | Nine Months Ended | | Affected Line Item in the Consolidated Statements of Income |
|------------------------------------|------------------------|---------------|----------------------------------------------------------------|
| | September 30, | | |
| | 2018 | 2017 | |
| | (dollars in thousands) | | |
| Service cost | \$ - | \$ - | |
| Interest cost | 320 | 358 | Other components of net periodic pension expense |
| Expected return on plan assets | (573) | (480) | Other components of net periodic pension expense |
| Net amortization | 274 | 309 | Other components of net periodic pension expense |
| Recognized settlement loss | - | 2 | Other components of net periodic pension expense |
| Total periodic pension cost | \$ 21 | \$ 189 | |

Effective January 1, 2018, the Company implemented ASU 2017-07, "Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." Under ASU 2017-07, the FASB requires employers to report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. If a separate line item or items are not used, the line item or items used in the income statement to present the other components of net benefit cost must be disclosed. The table above details the affected line items within the Consolidated Statements of Income related to the net periodic pension costs for the following periods.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 10. Components of Net Periodic Pension Cost – (continued)

This ASU is also required to be applied retrospectively to all periods presented. The following table summarizes the impact of retrospective application to the consolidated statement of condition for the three and nine months ended September 30, 2017:

| | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2017 |
|---------------------------------------------------------|------------------------------------------------|-----------------------------------------------|
| <u>(dollars in thousands)</u> | | |
| Other components of net periodic pension expense | | |
| As previously reported | \$ - | \$ - |
| As reported under the new guidance | 62 | 189 |
| Salaries and employee benefits | | |
| As previously reported | \$ 8,872 | \$ 25,710 |
| As reported under the new guidance | 8,810 | 25,521 |

Contributions

The Company made a \$2.0 million contribution to the Pension Trust during the three months ended March 31, 2018. The Company does not plan on contributing amounts to the Pension Trust for the remainder of 2018. The trust is established to provide retirement and other benefits for eligible employees and their beneficiaries. No part of the trust assets may be applied to any purpose other than providing benefits under the plan and for defraying expenses of administering the plan and the trust.

Note 11. FHLB Borrowings

The Company's FHLB borrowings and weighted average interest rates are summarized below:

| | September 30, 2018 | | December 31, 2017 | |
|-----------------------------------|--------------------|-------|-------------------|-------|
| | Amount | Rate | Amount | Rate |
| <u>(dollars in thousands)</u> | | | | |
| Total FHLB borrowings | <u>\$ 629,979</u> | 2.32% | <u>\$ 670,077</u> | 1.76% |
| By remaining period to maturity: | | | | |
| Less than 1 year | \$ 459,979 | 2.24% | \$ 505,077 | 1.59% |
| 1 year through less than 2 years | 25,000 | 1.85% | 35,000 | 1.60% |
| 2 years through less than 3 years | 95,000 | 2.76% | 85,000 | 2.65% |
| 3 years through less than 4 years | 25,000 | 2.13% | 45,000 | 2.15% |
| 4 years through 5 years | 25,000 | 2.92% | - | - |
| Total FHLB borrowings | <u>\$ 629,979</u> | 2.32% | <u>\$ 670,077</u> | 1.76% |

The FHLB borrowings are secured by pledges of certain collateral including, but not limited to, U.S. government and agency mortgage-backed securities and a blanket assignment of qualifying first lien mortgage loans, consisting of both residential mortgages and commercial real estate loans.

Advances are payable at stated maturity, with a prepayment penalty for fixed rate advances. All FHLB advances are fixed rates. The advances at September 30, 2018 were primarily collateralized by approximately \$1.7 billion of commercial mortgage loans, net of required over collateralization amounts, under a blanket lien arrangement. At September 30, 2018 the Company had remaining borrowing capacity of approximately \$1.0 billion at FHLB.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 12. Revenue Recognition

Effective January 1, 2018, the Company adopted ASU 2014-09 *Revenue from Contracts with Customers* and all subsequent amendments to the ASU (collectively, "ASC 606"), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. The majority of the Company's revenues come from interest income and other sources, including loans, leases, securities, and derivatives that are outside the scope of ASC 606. The Company's services that fall within the scope of ASC 606 are presented within noninterest income and are recognized as revenue as the Company satisfies its obligation to the customer. Services within the scope of ASC 606 include deposit service charges on deposits, interchange income, and the sale of OREO.

The Company, using a modified retrospective transition approach, determined that there will be no cumulative effect adjustment to retained earnings as a result of adopting the new standard, nor will the standard have a material impact on our consolidated financial statements including the timing or amounts of revenue recognized.

All of the Company's revenue from contracts with customers within the scope of ASC 606 is recognized within noninterest income. The following table presents the Company's sources of noninterest income for the three months and nine months ended September 30, 2018 and 2017. Items outside of ASC 606 are noted as such.

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 ^(b) |
|--------------------------------------------|------------------------------------------------|---------------------------------------------------------------|
| (dollars in thousands) | | |
| Noninterest income | | |
| Service charges on deposits | | |
| Overdraft fees | \$ 222 | \$ 228 |
| Other | 186 | 193 |
| Interchange income | 152 | 153 |
| Net gains on sales of loans ^(a) | 2 | 50 |
| Wire transfer fees ^(a) | 73 | 63 |
| Loan servicing fees ^(a) | 16 | 47 |
| Bank owned life insurance ^(a) | 751 | 985 |
| Other | 27 | 37 |
| Total noninterest income | \$ 1,429 | \$ 1,756 |

| | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 ^(b) |
|----------------------------------------------------|-----------------------------------------------|--------------------------------------------------------------|
| (dollars in thousands) | | |
| Noninterest income | | |
| Service charges on deposits | | |
| Overdraft fees | \$ 590 | \$ 587 |
| Other | 482 | 552 |
| Interchange income | 465 | 499 |
| Net gains on sales of loans ^(a) | 31 | 120 |
| Wire transfer fees ^(a) | 222 | 184 |
| Loan servicing fees ^(a) | 64 | 97 |
| Bank owned life insurance ^(a) | 2,300 | 2,402 |
| Net gains on sales of securities ^(a) | - | 1,596 |
| Annuities and insurance commissions ^(a) | - | 39 |
| Other | 70 | 104 |
| Total noninterest income | \$ 4,224 | \$ 6,180 |

-
- (a) Not within scope of ASC 606
 - (b) The Company elected the modified retrospective approach of adoption; therefore, prior period balances are presented under legacy GAAP and may not be comparable to current year presentation.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 12. Revenue Recognition – (continued)

A description of the Company’s revenue streams accounted for under ASC 606 is as follows:

Service Charges on Deposit Accounts: The Company earns fees from deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed at the point in the time the Company fulfills the customer’s request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer’s account balance.

Interchange Income: The Company earns interchange fees from debit and credit card holder transactions conducted through various payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided by the cardholder.

Gains/Losses on Sales of OREO: The Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether the collectability of the transaction prices is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.

Note 13. Subordinated Debentures

During 2003, the Company formed a statutory business trust, which exists for the exclusive purpose of (i) issuing Trust Securities representing undivided beneficial interests in the assets of the Trust; (ii) investing the gross proceeds of the Trust securities in junior subordinated deferrable interest debentures (subordinated debentures) of the Company; and (iii) engaging in only those activities necessary or incidental thereto. On December 19, 2003, Center Bancorp Statutory Trust II, a statutory business trust and wholly-owned subsidiary of the Parent Corporation issued \$5.0 million of MMCapS capital securities to investors due on January 23, 2034. The capital securities presently qualify as Tier I capital. The trust loaned the proceeds of this offering to the Company and received in exchange \$5.2 million of the Parent Corporation’s subordinated debentures. The subordinated debentures are redeemable in whole or in part prior to maturity. The floating interest rate on the subordinate debentures is three month LIBOR plus 2.85% and reprices quarterly. The rate at September 30, 2018 was 5.19%. These subordinated debentures and the related income effects are not eliminated in the consolidated financial statements as the statutory business trust is not consolidated in accordance with FASB ASC 810-10. Distributions on the subordinated debentures owned by the subsidiary trust have been classified as interest expense in the Consolidated Statements of Income.

The following table summarizes the mandatory redeemable trust preferred securities of the Company’s Statutory Trust II at September 30, 2018 and December 31, 2017.

| Issuance Date | Securities Issued | Liquidation Value | Coupon Rate | Maturity | Redeemable by Issuer Beginning |
|---------------|-------------------|------------------------------|-------------------------------------------|------------|--------------------------------|
| 12/19/2003 | \$ 5,000,000 | \$1,000 per Capital Security | Floating 3-month LIBOR + 285 Basis Points | 01/23/2034 | 01/23/2009 |

During June 2015, the Parent Corporation issued \$50 million in aggregate principal amount of fixed-to-floating rate subordinated notes (the “Notes”). The Notes are non-callable for five years, have a stated maturity of July 1, 2025, and bear interest at a fixed rate of 5.75% per year, from and including June 30, 2015 to, but excluding July 1, 2020. From and including July 1, 2020 to the maturity date or early redemption date, the interest rate will reset quarterly to a level equal to the then current three month LIBOR rate plus 393 basis points. As of September 30, 2018, unamortized costs related to this debt issuance were approximately \$317,000.

On January 11, 2018, the Parent Corporation issued \$75 million in aggregate principal amount of fixed-to-floating rate subordinated notes (the “Notes”). The Notes bear interest at 5.20% annually from, and including, the date of initial issuance to, but excluding, February 1, 2023, payable semi-annually in arrears. From and including February 1, 2023 through maturity or earlier redemption, the interest rate shall reset quarterly to an interest rate per annum equal to the then current three-month LIBOR rate plus 284 basis points (2.84%) payable quarterly in arrears. If three-month LIBOR is not available for any reason, then the rate for that interest period will be determined by such alternate method as provided in the Supplemental Indenture. Interest on the Notes will be paid on February 1, and August 1, commencing August 1, 2018 to but not including February 1, 2023, and from and including February 1, 2023, on February 1, May 1, August 1, and November 1, of each year to but excluding the stated maturity date, unless in any case previously redeemed. As of September 30, 2018, unamortized costs related to this debt issuance were

approximately \$1,364,000.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 14. Offsetting Assets and Liabilities

Certain financial instrument-related assets and liabilities may be eligible for offset on the consolidated statements of condition because they are subject to master netting agreements or similar agreements. However, the Company does not elect to offset such arrangements on the consolidated financial statements. The Company enters into interest rate swap agreements with financial institution counterparties. For additional detail regarding interest rate swap agreements refer to Note 5 within this section. In the event of default on, or termination of, any one contract, both parties have the right to net settle multiple contracts. Also, certain interest rate swap agreements may require the Company to receive or pledge cash or financial instrument collateral based on the contract provisions. The following table presents information about financial instruments that are eligible for offset as of September 30, 2018 and December 31, 2017:

| | Gross Amounts Recognized | Gross Amounts Offset in the Statement of Financial Condition | Net Amounts of Assets Presented in the Statement of Financial Condition | Gross Amounts Not Offset | | |
|---------------------------|-----------------------------|--------------------------------------------------------------------------|----------------------------------------------------------------------------------------|----------------------------------------|--------------------------------------------------|---------------|
| | | | | Financial Instruments Recognized | Cash or Financial Instrument Collateral | Net Amount |
| (dollars in thousands) | | | | | | |
| September 30, 2018 | | | | | | |
| Assets: | | | | | | |
| Interest rate swaps | \$ 1,906 | \$ - | \$ 1,906 | \$ - | \$ - | \$ 1,906 |
| December 31, 2017 | | | | | | |
| Assets: | | | | | | |
| Interest rate swaps | \$ 798 | \$ - | \$ 798 | \$ - | \$ - | \$ 798 |

As of September 30, 2018 and December 31, 2017, there was no financial collateral pledged to our interest rate swaps. As these swap positions were not within the contractually agreed upon collateral requirement there was no collateral pledged to, or from, the respective counterparties.

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

The purpose of this analysis is to provide the reader with information relevant to understanding and assessing the Company's results of operations for the periods presented herein and financial condition as of September 30, 2018 and December 31, 2017. In order to fully understand this analysis, the reader is encouraged to review the consolidated financial statements and accompanying notes thereto appearing elsewhere in this report.

Cautionary Statement Concerning Forward-Looking Statements

This report includes forward-looking statements within the meaning of Sections 27A of the Securities Act of 1933, as amended, and 21E of the Securities Exchange Act of 1934, as amended, that involve inherent risks and uncertainties. This report contains certain forward-looking statements with respect to the financial condition, results of operations, plans, objectives, future performance and business of ConnectOne Bancorp Inc. and its subsidiaries, including statements preceded by, followed by or that include words or phrases such as "believes," "expects," "anticipates," "plans," "trend," "objective," "continue," "remain," "pattern" or similar expressions or future or conditional verbs such as "will," "would," "should," "could," "might," "can," "may" or similar expressions. There are a number of important factors that could cause future results to differ materially from historical performance and these forward-looking statements. Factors that might cause such a difference include, but are not limited to: (1) competitive pressures among depository institutions may increase significantly; (2) changes in the interest rate environment may reduce interest margins; (3) prepayment speeds, loan origination and sale volumes, charge-offs and loan loss provisions may vary substantially from period to period; (4) general economic conditions may be less favorable than expected; (5) political developments, sovereign debt problems, wars or other hostilities may disrupt or increase volatility in securities markets or other economic conditions; (6) legislative or regulatory changes or actions may adversely affect the businesses in which ConnectOne Bancorp is engaged, including, without limitation, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and regulations issued thereunder; (7) changes and trends in the securities markets may adversely impact ConnectOne Bancorp; (8) a delayed or incomplete resolution of regulatory issues could adversely impact planning by ConnectOne Bancorp; (9) the impact on reputation risk created by the developments discussed above on such matters as business generation and retention, funding and liquidity could be significant; and (10) the outcome of regulatory and legal investigations and proceedings may not be anticipated. Further information on other factors that could affect the financial results of ConnectOne Bancorp is included in Item 1a. of ConnectOne Bancorp's Annual Report on Form 10-K as amended and updated in ConnectOne Bancorp's other filings with the Securities and Exchange Commission. These documents are available free of charge at the Commission's website at <http://www.sec.gov> and/or from ConnectOne Bancorp, Inc.

Critical Accounting Policies and Estimates

The accounting and reporting policies followed by ConnectOne Bancorp, Inc. and its subsidiaries (collectively, the "Company") conform, in all material respects, to GAAP. In preparing the consolidated financial statements, management has made estimates, judgments and assumptions that affect the reported amounts of assets and liabilities as of the dates of the consolidated statements of condition and for the periods indicated in the consolidated statements of operations. Actual results could differ significantly from those estimates.

The Company's accounting policies are fundamental to understanding Management's Discussion and Analysis ("MD&A") of financial condition and results of operations. The Company has identified the determination of the allowance for loan losses, the other-than-temporary impairment evaluation of securities, the evaluation of the impairment of goodwill and the evaluation of deferred tax assets to be critical because management must make subjective and/or complex judgments about matters that are inherently uncertain and could be most subject to revision as new information becomes available. Additional information on these policies is provided below.

Allowance for Loan Losses and Related Provision: The allowance for loan losses ("ALLL") represents management's estimate of probable incurred credit losses inherent in the loan portfolio. Determining the amount of the ALLL is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, individual credit situation and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated statements of condition.

The evaluation of the adequacy of the ALLL includes, among other factors, an analysis of historical loss rates by loan segment applied to current loan totals. However, actual loan losses may be higher or lower than historical trends, which vary. Actual losses on specified problem loans, which also are provided for in the evaluation, may vary from estimated loss percentages, which are established based upon a limited number of potential loss classifications.

The ALLL is established through a provision for loan losses charged to expense. Management believes that the current ALLL will be adequate to absorb loan losses on existing loans that may become uncollectible based on the evaluation of known and inherent risks in the loan portfolio. The evaluation takes into consideration such factors as changes in the nature and size of the portfolio, overall portfolio quality, and specific problem loans and current economic conditions which may affect the borrowers' ability to pay. The evaluation also details historical losses by loan segment and the resulting loan loss rates which are projected for current loan total amounts. Loss estimates for specified problem loans are also detailed. All of the factors considered in the analysis of the adequacy of the ALLL may be subject to change. To the extent actual outcomes differ from management estimates, additional provisions for loan losses may be required that could materially adversely impact earnings in future periods. Additional information can be found in Note 6 of the Notes to Consolidated Financial Statements.

Other-Than-Temporary Impairment of Securities Available-for-Sale: Securities available-for-sale are evaluated on at least a quarterly basis, and more frequently when market conditions warrant such an evaluation, to determine whether a decline in their value is other-than-temporary. FASB ASC 320-10-65 clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management assesses whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery.

In instances when a determination is made that an other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, the other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

Fair Value of Securities: FASB ASC 820-10-35 clarifies the application of the provisions of FASB ASC 820-10-05 in an inactive market and how an entity would determine fair value in an inactive market. The Company applies the guidance in FASB ASC 820-10-35 when determining fair value for the Company's private label collateralized mortgage obligations, pooled trust preferred securities and single name corporate trust preferred securities. See Note 7 of the Notes to Consolidated Financial Statements for further discussion.

FASB ASC 820-10-65 provides additional guidance for estimating fair value in accordance with FASB ASC 820-10-05 when the volume and level of activity for the asset or liability have significantly decreased. This ASC also includes guidance on identifying circumstances that indicate a transaction is not orderly.

Goodwill: The Company adopted the provisions of FASB ASC 350-10, which requires that goodwill be reported separate from other intangible assets in the Consolidated Statements of Condition and not be amortized but rather tested for impairment annually or more frequently if impairment indicators arise.

Income Taxes: The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in the Company's consolidated financial statements or tax returns.

Fluctuations in the actual outcome of these future tax consequences could impact the Company's consolidated financial condition or results of operations. Note 12 of the Notes to Consolidated Financial Statements included in the Company's Form 10-K for the year ended December 31, 2017 includes additional discussion on the accounting for income taxes.

Operating Results Overview

Net income for the three months ended September 30, 2018 amounted to \$19.9 million compared to \$13.1 million for the comparable 2017 three-month period. The Company's diluted earnings per share were \$0.61 for the three months ended September 30, 2018 as compared with diluted earnings per share of \$0.41 for the comparable 2017 three-month period. The increase in net income and diluted earnings per share was primarily attributable to an increase in net interest income (\$2.9 million), a decrease in provision for loan losses (\$0.4 million) and a decrease in income tax expense (\$3.5 million).

Net income for the nine months ended September 30, 2018 amounted to \$41.7 million compared to \$32.6 million for the comparable nine-month period ended September 30, 2017. The Company's diluted earnings per share were \$1.29 for the nine months ended September 30, 2018 as compared with diluted earnings per share of \$1.01 for the comparable nine-month period ended September 30, 2017. The increase in net income and diluted earnings per share was primarily attributable to an increase in net interest income (\$11.8 million), a decrease in provision for loan losses excluding taxi (\$1.0 million) and a decrease in income tax expense (\$5.5 million), partially offset by a net increase in charges related to taxi medallion loans (\$1.7 million), a decrease in noninterest income (\$2.0 million), and an increase in noninterest expenses (\$5.6 million) (excluding taxi charges of \$15.3 million).

Net Interest Income and Margin

Net interest income is the difference between the interest earned on the portfolio of earning assets (principally loans and investments) and the interest paid for deposits and borrowings, which support these assets. Net interest income is presented on a tax-equivalent basis by adjusting tax-exempt income (primarily interest earned on obligations of state and political subdivisions) by the amount of income tax which would have been paid had the assets been invested in taxable issues. Net interest margin is defined as net interest income on a tax-equivalent basis as a percentage of total average interest-earning assets.

Fully taxable equivalent net interest income for the three months ended September 30, 2018 was \$40.4 million, an increase of \$2.5 million, or 6.6%, from the three months ended September 30, 2017, resulting from an increase in average total interest-earning assets of 10.9%, primarily reflecting significant organic loan growth, offset by a contraction of the net interest margin of 14 basis-points to 3.30% for the three months ended September 30, 2018 from 3.44% for the three months ended September 30, 2017. Included in net interest income was accretion and amortization of purchase accounting adjustments of \$0.2 million during the three months ended September 30, 2018 and \$0.3 million during the three months ended September 30, 2017. Excluding these purchase accounting adjustments, the adjusted net interest margin was 3.29% for the three months ended September 30, 2018, contracting by 12 basis-points from 3.41% for the three months ended September 30, 2017. The decrease in the adjusted net interest margin was primarily attributable to a long-term subordinated debt issuance during the first quarter of 2018, the change in the taxable equivalent adjustment due to the Tax Act, increased cost of deposits and lower yields on securities.

Fully taxable equivalent net interest income for the nine months ended September 30, 2018 was \$118.5 million, an increase of \$10.5 million, or 9.7%, from the nine months ended September 30, 2017, resulting from an increase in total average interest-earning assets of 14.8% due to significant organic loan growth. Net interest margin was 3.29% for the nine months ended September 30, 2018, contracting 15 basis-points from 3.44% for the nine months ended September 30, 2017. Included in net interest income was accretion and amortization of purchase accounting adjustments of \$1.1 million and \$1.3 million during the nine months ended September 30, 2018 and 2017, respectively. Excluding these purchase accounting adjustments, the adjusted net interest margin was 3.25% for the nine months ended September 30, 2018, contracting by 15 basis-points from adjusted net interest margin of 3.40% for the nine months ended September 30, 2017. The decrease in the adjusted net interest margin was primarily attributable to a long-term subordinated debt issuance during the first quarter of 2018, the change in the taxable equivalent adjustment due to the Tax Act, increased cost in deposits funding and lower yields on securities.

The following tables, “Average Statements of Condition with Interest and Average Rates”, present for the three and nine months ended September 30, 2018 and 2017, the Company’s average assets, liabilities and stockholders’ equity. The Company’s net interest income, net interest spread and net interest margin are also reflected.

Average Statements of Condition with Interest and Average Rates

| | Three Months Ended September 30, | | | | | |
|-----------------------------------------------------------------|----------------------------------|-------------------------|-----------------------------|---------------------|-------------------------|-----------------------------|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest Income/Expense | Average Rate ⁽⁸⁾ | Average Balance | Interest Income/Expense | Average Rate ⁽⁸⁾ |
| (dollars in thousands) | | | | | | |
| Interest-earning assets: | | | | | | |
| Securities ^{(1) (2)} | \$ 423,566 | \$ 3,147 | 2.95% | \$ 397,077 | \$ 3,033 | 3.03% |
| Loans receivable and loans held-for-sale ^{(2) (3) (4)} | 4,362,905 | 51,973 | 4.73 | 3,898,404 | 43,683 | 4.45 |
| Federal funds sold and interest-bearing with banks | 42,164 | 183 | 1.72 | 53,820 | 170 | 1.25 |
| Restricted investment in bank stocks | 28,043 | 530 | 7.50 | 29,236 | 362 | 4.91 |
| Total interest-earning assets | 4,856,678 | 55,833 | 4.56 | 4,378,537 | 47,248 | 4.28 |
| Noninterest-earning assets: | | | | | | |
| Allowance for loan losses | (33,943) | | | (28,999) | | |
| Other noninterest-earning assets | 363,438 | | | 363,949 | | |
| Total assets | \$ 5,186,173 | | | \$ 4,713,487 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Time deposits | \$ 1,296,165 | \$ 6,477 | 1.98 | \$ 1,005,997 | \$ 3,593 | 1.42 |
| Other interest-bearing deposits | 1,854,763 | 4,204 | 0.90 | 1,816,162 | 2,520 | 0.55 |
| Total interest-bearing deposits | 3,150,928 | 10,681 | 1.34 | 2,822,159 | 6,113 | 0.86 |
| Borrowings | 531,251 | 2,839 | 2.12 | 570,711 | 2,353 | 1.64 |
| Subordinated debentures ⁽⁵⁾ | 128,420 | 1,831 | 5.66 | 54,630 | 813 | 5.90 |
| Capital lease | 2,554 | 38 | 5.90 | 2,688 | 40 | 5.90 |
| Total interest-bearing liabilities | 3,813,153 | 15,389 | 1.60 | 3,450,188 | 9,319 | 1.07 |
| Noninterest-bearing demand deposits | 761,782 | | | 688,707 | | |
| Other liabilities | 21,110 | | | 17,972 | | |
| Total noninterest-bearing liabilities | 782,892 | | | 706,679 | | |
| Stockholders’ equity | 590,128 | | | 556,620 | | |
| Total liabilities and stockholders’ equity | \$ 5,186,173 | | | \$ 4,713,487 | | |
| Net interest income (tax-equivalent basis) | | 40,444 | | | 37,929 | |
| Net interest spread ⁽⁶⁾ | | | 2.96% | | | 3.21% |
| Net interest margin ⁽⁷⁾ | | | 3.30% | | | 3.44% |
| Tax-equivalent adjustment | | (482) | | | (910) | |
| Net interest income | | \$ 39,962 | | | \$ 37,019 | |

(1) Average balances are based on amortized cost and include equity securities.

(2) Interest income is presented on a tax-equivalent basis using 21% and 35% federal tax rates as of September 30, 2018 and September 30, 2017, respectively.

(3) Includes loan fee income.

(4) Total loans include loans held-for-sale and nonaccrual loans.

(5) Average balances are net of debt issuance costs of \$1,735 and \$525 as of September 30, 2018 and September 30, 2017, respectively.

Amortization expense related to debt issuance costs included in interest expense was \$82 and \$41 as of September 30, 2018 and September 30, 2017, respectively.

(6) Represents difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities and is presented on a tax-equivalent basis.

(7) Represents net interest income on a tax-equivalent basis divided by average total interest-earning assets.

(8) Rates are annualized.

Average Statements of Condition with Interest and Average Rates

| | Nine Months Ended September 30, | | | | | |
|-----------------------------------------------------------------|---------------------------------|-------------------------|-----------------------------|---------------------|-------------------------|-----------------------------|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest Income/Expense | Average Rate ⁽⁸⁾ | Average Balance | Interest Income/Expense | Average Rate ⁽⁸⁾ |
| (dollars in thousands) | | | | | | |
| Interest-earning assets: | | | | | | |
| Securities ^{(1) (2)} | \$ 432,475 | \$ 9,200 | 2.84% | \$ 384,782 | \$ 9,272 | 3.22% |
| Loans receivable and loans held-for-sale ^{(2) (3) (4)} | 4,294,792 | 148,994 | 4.64 | 3,716,876 | 123,009 | 4.42 |
| Federal funds sold and interest-bearing with banks | 63,506 | 607 | 1.28 | 73,424 | 555 | 1.01 |
| Restricted investment in bank stocks | 30,402 | 1,517 | 6.67 | 26,177 | 982 | 5.02 |
| Total interest-earning assets | 4,821,175 | 160,318 | 4.45 | 4,201,259 | 133,818 | 4.26 |
| Noninterest-earning assets: | | | | | | |
| Allowance for loan losses | (32,915) | | | (27,533) | | |
| Other noninterest-earning assets | 337,509 | | | 358,161 | | |
| Total assets | \$ 5,125,769 | | | \$ 4,531,887 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Time deposits | \$ 1,261,660 | \$ 17,096 | 1.81 | \$ 982,149 | \$ 9,996 | 1.36 |
| Other interest-bearing deposits | 1,811,966 | 10,442 | 0.77 | 1,745,742 | 6,722 | 0.51 |
| Total interest-bearing deposits | 3,073,626 | 27,538 | 1.20 | 2,727,891 | 16,718 | 0.82 |
| Borrowings | 591,348 | 8,856 | 2.00 | 509,625 | 6,581 | 1.73 |
| Subordinated debentures ⁽⁵⁾ | 124,029 | 5,345 | 5.76 | 54,590 | 2,431 | 5.95 |
| Capital lease | 2,588 | 117 | 6.04 | 2,720 | 123 | 6.05 |
| Total interest-bearing liabilities | 3,791,591 | 41,856 | 1.48 | 3,294,826 | 25,853 | 1.05 |
| Noninterest-bearing demand deposits | 735,345 | | | 670,709 | | |
| Other liabilities | 18,728 | | | 17,652 | | |
| Total noninterest-bearing liabilities | 754,073 | | | 688,361 | | |
| Stockholders' equity | 580,105 | | | 548,700 | | |
| Total liabilities and stockholders' equity | \$ 5,125,769 | | | \$ 4,531,887 | | |
| Net interest income (tax-equivalent basis) | | 118,462 | | | 107,965 | |
| Net interest spread ⁽⁶⁾ | | | 2.97% | | | 3.21% |
| Net interest margin ⁽⁷⁾ | | | 3.29% | | | 3.44% |
| Tax-equivalent adjustment | | (1,408) | | | (2,704) | |
| Net interest income | | \$ 117,054 | | | \$ 105,261 | |

(1) Average balances are based on amortized cost and include equity securities.

(2) Interest income is presented on a tax-equivalent basis using 21% and 35% federal tax rates as of September 30, 2018 and September 30, 2017, respectively.

(3) Includes loan fee income.

(4) Total loans include loans held-for-sale and nonaccrual loans.

(5) Average balances are net of debt issuance costs of \$1,730 and \$565 as of September 30, 2018 and September 30, 2017, respectively.

(6) Amortization expense related to debt issuance costs included in interest expense was \$250 and \$124 as of September 30, 2018 and September 30, 2017, respectively.

(7) Represents difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities and is presented on a tax-equivalent basis.

(8) Represents net interest income on a tax-equivalent basis divided by average total interest-earning assets.

(8) Rates are annualized.

Noninterest Income

Noninterest income totaled \$1.4 million for the three months ended September 30, 2018, compared with \$1.8 million for the three months ended September 30, 2017. Noninterest income consists of income on bank owned life insurance (“BOLI”), net gains on sales of loans held-for-sale, deposit service fees, loan fees, and other income. The decrease from the prior year third quarter was mainly attributable to a BOLI death benefit in the prior period.

Noninterest income totaled \$4.2 million for the nine months ended September 30, 2018, compared with \$6.2 million for the nine months ended September 30, 2017. For the nine months ended September 30, 2018 and 2017, there were \$-0- and \$1.6 million of net securities gains, respectively. Excluding the securities gains, noninterest income decreased \$0.4 million from the prior year third quarter due primarily to a BOLI death benefit in the prior period.

Noninterest Expenses

Noninterest expenses totaled \$18.3 million for the three months ended September 30, 2018, compared to \$18.6 million for the three months ended September 30, 2017. Noninterest expenses decreased by \$0.3 million from the prior year third quarter due primarily to a \$3.0 million valuation allowance adjustment on taxi medallion loans held-for-sale that occurred during the prior year third quarter, partially offset by increases in salaries and employee benefits (\$1.4 million), and other expenses (\$0.7 million), both mainly due to increased levels of business and staff resulting from organic growth, changes in fair value of equity securities (\$0.2 million) and merger-related expenses (\$0.4 million).

Noninterest expenses totaled \$52.5 million for the nine months ended September 30, 2018, compared to \$62.2 million for the nine months ended September 30, 2017. Noninterest expenses decreased by \$9.7 million from the prior year nine-month period due primarily to a \$15.3 million valuation allowance adjustment on taxi medallion loans held-for-sale that occurred during the prior year nine-month period, partially offset by increases in salaries and employee benefits (\$4.1 million), other expenses (\$1.1 million), changes in fair value of equity securities (\$0.3 million) and merger-related expenses (\$0.4 million). The increases over the prior year nine-month period (excluding the valuation allowance on the taxi medallions) were mainly the result of increased levels of business and staff resulting from organic growth.

Income Taxes

Income tax expense was \$2.1 million for the three months ended September 30, 2018, compared to \$5.6 million for the three months ended September 30, 2017. The decrease in income tax expense was primarily the result of a reduced Federal tax rate due to the Tax Act, benefits related to Federal and NJ deferred tax asset adjustments and benefits resulting from ASU 2016-09. The effective tax rate for the three months ended September 30, 2018 and September 30, 2017 was 9.6% and 30.0%, respectively.

Income tax expense was \$7.1 million for the nine months ended September 30, 2018, compared to \$12.6 million for the nine months ended September 30, 2017. The decrease in income tax expense was primarily the result of a reduced Federal tax rate due to the Tax Act, benefits related to Federal and NJ deferred tax asset adjustments and benefits resulting from ASU 2016-09. The effective tax rate for the nine months ended September 30, 2018 was 14.6% versus 27.9% for the prior-year period. The effective tax rate, exclusive of income tax expense adjustments, is anticipated to increase to approximately 26% for 2019, due to the recent NJ corporate tax legislation.

Financial Condition

Loan Portfolio

Commercial lending is the Company’s primary business activity. The Company’s loan portfolio consists of commercial, residential and consumer loans, serving a diverse client base in the Company’s market area. The composition of the Company’s portfolio remains relatively constant but can change due to factors such as the economic climate, the level and fluctuations in interest rates, real estate values and employment metrics. Organic growth (i.e., growth other than through mergers and acquisitions) is generated through business development, repeat client requests for new financings, penetration into existing markets and entry into new markets.

The Company seeks to create growth in commercial lending by offering client-focused products, competitive pricing and by capitalizing on the positive trends in its market area. Products offered are designed to meet the financial requirements of the Company’s clients. It is the objective of the Company’s credit policies to diversify the commercial loan portfolio to limit concentrations in any single segment.

The following table sets forth the composition of our loan portfolio, excluding loans held-for-sale and unearned net origination fees and costs, by loan segment at the periods indicated.

| | September 30, 2018 | | December 31, 2017 | | Amount |
|-------------------------|---------------------|---------------|---------------------|---------------|-------------------------|
| | Amount | % | Amount | % | Increase/ (Decrease) |
| (dollars in thousands) | | | | | |
| Commercial | \$ 933,169 | 20.9% | \$ 824,082 | 19.7% | \$ 109,087 |
| Commercial real estate | 2,739,943 | 61.3 | 2,592,909 | 62.1 | 147,034 |
| Commercial construction | 494,206 | 11.1 | 483,216 | 11.6 | 10,990 |
| Residential real estate | 295,948 | 6.6 | 271,795 | 6.5 | 24,153 |
| Consumer | 2,508 | 0.1 | 2,808 | 0.1 | (300) |
| Gross loans | <u>\$ 4,465,774</u> | <u>100.0%</u> | <u>\$ 4,174,810</u> | <u>100.0%</u> | <u>\$ 290,964</u> |

At September 30, 2018, gross loans totaled \$4.5 billion, an increase of \$291 million, or 7.0%, as compared to December 31, 2017. Net loan growth was attributable to increases in commercial real estate (\$147 million), commercial loans (\$109 million), residential real estate and consumer (\$24 million) and commercial construction (\$11 million). Included in the commercial real estate increase was approximately \$25 million of loans previously classified as held-for-sale but now classified as loans held-for-investment.

At September 30, 2018, acquired loans remaining in the loan portfolio totaled \$0.3 billion, compared to \$0.5 billion as of December 31, 2017.

Allowance for Loan Losses and Related Provision

The purpose of the allowance for loan losses (“ALLL”) is to establish a valuation allowance for probable incurred credit losses in the loan portfolio. Additions to the ALLL are made through provisions charged against current operations and through recoveries made on loans previously charged off. The ALLL is maintained at an amount considered adequate by management to provide for probable incurred credit losses inherent in the loan portfolio based upon historical losses and a periodic evaluation of external and portfolio risk factors. In establishing an appropriate ALLL, an assessment of the individual borrowers, a determination of the value of the underlying collateral, a review of historical loss experience and an analysis of the levels and trends of loan segments, delinquencies and problem loans are considered. Such factors as the level and trend of interest rates and current economic conditions and peer group statistics are also reviewed. The Company’s analysis of its ALLL also takes into consideration the potential impact that current trends may have on the Company’s borrower base.

Although management uses the best information available, the level of the ALLL remains an estimate, which is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review the Company’s ALLL. Such agencies may require the Company to increase the ALLL based on their analysis of information available to them at the time of their examination. Furthermore, the majority of the Company’s loans are secured by real estate in the State of New Jersey. Future adjustments to the ALLL may be necessary due to economic factors impacting New Jersey real estate and the economy in general, as well as operating, regulatory and other conditions beyond the Company’s control.

At September 30, 2018, the ALLL was \$34.7 million as compared to \$31.7 million at December 31, 2017. The provision for loan losses for the three months ended September 30, 2018 was \$1.1 million, compared to \$1.5 million for the three months ended September 30, 2017. The decrease in the provision for loan losses was primarily attributable to a decrease in provision allocated to the acquired loan portfolio. The provision for loan losses for the nine months ended September 30, 2018 was \$20.0 million, compared to \$4.0 million for the nine months ended September 30, 2017. The increase in provision for loan losses was primarily attributable to \$17.0 million allocation related to the taxi medallion loan portfolio.

There were \$55 thousand in net recoveries during the three months ended September 30, 2018, compared with \$19 thousand in net recoveries during the three months ended September 30, 2017. There were \$17.0 million in net charge-offs during the nine months ended September 30, 2018, compared to \$126 thousand in net recoveries during the nine months ended September 30, 2017. The increase in charge-offs during the nine months ended September 30, 2018 is attributable to a \$17.0 million charge-off related to the taxi medallion loan portfolio. The \$17.0 million charge-off was a result of decreases in the transfer values of medallions as reported by the New York City Taxi and Limousine Commission, as well as a reduction in the Company’s cash flow valuation model. The ALLL as a percentage of loans receivable amounted to 0.78% at September 30, 2018 compared to 0.76% at December 31, 2017 and 0.77 % at September 30, 2017.

The level of the allowance for the respective periods of 2018 and 2017 reflects the credit quality within the loan portfolio, loan growth, the changing composition of the commercial and residential real estate loan portfolios and other related factors. In management's view, the level of the ALLL at September 30, 2018 is adequate to cover losses inherent in the loan portfolio. Management's judgment regarding the adequacy of the allowance constitutes a "Forward-Looking Statement" under the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from management's analysis, based principally upon the factors considered by management in establishing the allowance.

Changes in the ALLL are presented in the following table for the periods indicated.

| | Three Months Ended September 30, | |
|------------------------------------------------------------------------------------------|-------------------------------------|--------------|
| | 2018 | 2017 |
| (dollars in thousands) | | |
| Average total loans at end of period | \$ 4,362,905 | \$ 3,898,404 |
| Analysis of the ALLL: | | |
| Balance - beginning of quarter | \$ 33,594 | \$ 28,401 |
| Charge-offs: | | |
| Consumer | (6) | (1) |
| Total charge-offs | (6) | (1) |
| Recoveries: | | |
| Commercial | 56 | 17 |
| Commercial real estate | - | 2 |
| Consumer | 5 | 1 |
| Total recoveries | 61 | 20 |
| Net (charge-offs) recoveries | 55 | 19 |
| Provision for loan and losses | 1,100 | 1,450 |
| Balance - end of period | \$ 34,749 | \$ 29,870 |
| Ratio of annualized net charge-offs during the period to average loans during the period | (0.01)% | (0.00)% |
| Loans receivable | \$ 4,462,487 | \$ 3,889,289 |
| ALLL as a percentage of loans receivable | 0.78% | 0.77% |

| | Nine Months Ended September 30, | |
|--------------------------------------|------------------------------------|--------------|
| | 2018 | 2017 |
| (dollars in thousands) | | |
| Average total loans at end of period | \$ 4,294,792 | \$ 3,716,876 |
| Analysis of the ALLL: | | |
| Balance - beginning of quarter | \$ 31,748 | \$ 25,744 |
| Charge-offs: | | |
| Commercial-taxi medallion loans | (17,046) | - |
| Commercial-other | (20) | - |
| Commercial real estate | - | (71) |
| Residential real estate | (18) | - |
| Consumer | (7) | (12) |
| Total charge-offs | (17,091) | (83) |
| Recoveries: | | |
| Commercial-other | 87 | 158 |
| Commercial real estate | - | 50 |
| Consumer | 5 | 1 |
| Total recoveries | 92 | 209 |
| Net (charge-offs) recoveries | (16,999) | 126 |
| Provision for loan and losses | 20,000 | 4,000 |

| | | |
|------------------------------------------------------------------------------------------|--------------|--------------|
| Balance - end of period | \$ 34,749 | \$ 29,870 |
| Ratio of annualized net charge-offs during the period to average loans during the period | 0.53% | (0.00)% |
| Loans receivable | \$ 4,462,487 | \$ 3,889,289 |
| ALLL as a percentage of loans receivable | 0.78% | 0.77% |

Asset Quality

The Company manages asset quality and credit risk by maintaining diversification in its loan portfolio and through review processes that include analysis of credit requests and ongoing examination of outstanding loans, delinquencies, and potential problem loans, with particular attention to portfolio dynamics and mix. The Company strives to identify loans experiencing difficulty early enough to correct the problems, to record charge-offs promptly based on realistic assessments of current collateral values and cash flows, and to maintain an adequate allowance for loan losses at all times.

It is generally the Company's policy to discontinue interest accruals once a loan is past due as to interest or principal payments for a period of ninety days. When a loan is placed on nonaccrual status, interest accruals cease and uncollected accrued interest is reversed and charged against current income. Payments received on nonaccrual loans are generally applied against principal. A loan may be restored to an accruing basis when all past due amounts have been collected. Loans past due 90 days or more which are both well-secured and in the process of collection may remain on an accrual basis.

Nonperforming assets include nonaccrual loans and other real estate owned. Nonaccrual loans represent loans on which interest accruals have been suspended. In general, it is the policy of management to consider the charge-off of uncollectible amounts of loans at the point they become past due 90 days. Performing troubled debt restructured loans represent loans to borrowers experiencing financial difficulties on which a concession was granted, such as a reduction in interest rate below the current market rate for new debt with similar risks or modified repayment terms, and are performing under the restructured terms.

The following table sets forth, as of the dates indicated, the amount of the Company's nonaccrual loans, other real estate owned ("OREO"), performing troubled debt restructurings ("TDRs") and loans past due 90 days or greater and still accruing:

| | September 30, 2018 | December 31, 2017 |
|-------------------------------------------------------------------|------------------------|----------------------|
| | (dollars in thousands) | |
| Nonaccrual loans | \$ 53,015 | \$ 65,613 |
| OREO | - | 538 |
| Total nonperforming assets ⁽¹⁾ | <u>\$ 53,015</u> | <u>\$ 66,151</u> |
| Performing TDRs | <u>\$ 11,243</u> | <u>\$ 14,920</u> |
| Loans 90 days or greater past due and still accruing (non-PCI) | <u>\$ -</u> | <u>\$ -</u> |
| Loans 90 days or greater past due and still accruing (PCI) | <u>\$ 1,648</u> | <u>\$ 1,664</u> |

(1) Nonperforming assets are defined as nonaccrual loans and other real estate owned.

| | | |
|------------------------------------------------------------------------------------------------------------------------|-------|-------|
| Nonaccrual loans to total loans receivable | 1.19% | 1.57% |
| Nonperforming assets to total assets | 0.99% | 1.29% |
| Nonperforming assets, performing TDRs, and loans 90 days or greater past due and still accruing to loans receivable | 1.48% | 1.98% |

The decrease in nonaccruals from the year-end 2018 was mainly attributable to a \$17.0 million charge-off, related to the taxi medallion loan portfolio (which is included in the Commercial loan segment).

Investment Securities

As of September 30, 2018, the principal components of the securities portfolio were federal agency obligations, mortgage-backed securities, obligations of U.S. states and political subdivisions, corporate bonds and notes, asset-backed securities and equity securities. For the quarter ended September 30, 2018, average securities increased \$26.5 million to approximately \$423.6 million, or 8.7% of average total interest-earning assets, from approximately \$397.1 million, or 9.1% of average interest-earning assets, for the comparable period in 2017.

At September 30, 2018, net unrealized losses on securities available-for-sale, which are carried as a component of accumulated other comprehensive income and included in stockholders' equity, net of tax, amounted to \$8.2 million as compared with net unrealized losses of \$0.9 million at December 31, 2017. The increase in unrealized losses is predominately attributable to changes in market conditions and interest rates. The gross unrealized losses associated with agency securities and federal agency obligations, mortgage-backed securities, corporate bonds and tax-exempt securities are not considered to be other-than-temporary 55 because their unrealized losses are related to changes in interest rates and do not affect the expected cash flows of the underlying collateral or issuer.

Interest Rate Sensitivity Analysis

The principal objective of our asset and liability management function is to evaluate the interest-rate risk included in certain balance sheet accounts; determine the level of risk appropriate given our business focus, operating environment, and capital and liquidity requirements; establish prudent asset concentration guidelines; and manage the risk consistent with Board approved guidelines. We seek to reduce the vulnerability of our operations to changes in interest rates, and actions in this regard are taken under the guidance of the Bank's Asset Liability Committee (the "ALCO"). The ALCO generally reviews our liquidity, cash flow needs, maturities of investments, deposits and borrowings, and current market conditions and interest rates.

We currently utilize net interest income simulation and economic value of equity ("EVE") models to measure the potential impact to the Bank of future changes in interest rates. As of September 30, 2018 and December 31, 2017, the results of the models were within guidelines prescribed by our Board of Directors. If model results were to fall outside prescribed ranges, action, including additional monitoring and reporting to the Board, would be required by the ALCO and the Bank's management.

The net interest income simulation model attempts to measure the change in net interest income over the next one-year period, and over the next three-year period on a cumulative basis, assuming certain changes in the general level of interest rates.

Based on our model, which was run as of September 30, 2018, we estimated that over the next one-year period a 200 basis-point instantaneous increase in the general level of interest rates would increase our net interest income by 1.28%, while a 100 basis-point instantaneous decrease in interest rates would decrease net interest income by 1.44%. As of December 31, 2017, we estimated that over the next one-year period, a 200 basis-point instantaneous increase in the general level of interest rates would increase our net interest income by 1.31%, while a 100 basis-point instantaneous decrease in interest rates would decrease net interest income by 1.40%.

Based on our model, which was run as of September 30, 2018, we estimated that over the next three years, on a cumulative basis, a 200 basis-point instantaneous increase in the general level of interest rates would increase our net interest income by 1.85%, while a 100 basis-point instantaneous decrease in interest rates would decrease net interest income by 2.17%. As of December 31, 2017, we estimated that over the next three years, on a cumulative basis, a 200 basis-point instantaneous increase in the general level of interest rates would increase our net interest income by 2.16%, while a 100 basis-point instantaneous decrease in interest rates would decrease net interest income by 2.41%.

An EVE analysis is also used to dynamically model the present value of asset and liability cash flows with instantaneous rate shocks of up 200 basis points and down 100 basis points. The economic value of equity is likely to be different as interest rates change. Our EVE as of September 30, 2018, would decline by 13.09% with an instantaneous rate shock of up 200 basis points, and increase by 3.49% with an instantaneous rate shock of down 100 basis points. Our EVE as of December 31, 2017, would decline by 12.83% with an instantaneous rate shock of up 200 basis points, and increase by 4.02% with an instantaneous rate shock of down 100 basis points.

The following table illustrates the most recent results for EVE and one year NII sensitivity as of September 30, 2018.

| Interest Rates (basis points) | Estimated EVE | Estimated Change in EVE | | Interest Rates (basis points) | Estimated NII | Estimated Change in NII | |
|----------------------------------|------------------|----------------------------|---------|----------------------------------|------------------|-------------------------|--------|
| | | Amount | % | | | Amount | % |
| +300 | \$ 474,448 | \$ (117,523) | (19.85) | +300 | \$ 169,179 | \$ 2,826 | 1.70 |
| +200 | 514,454 | (77,517) | (13.09) | +200 | 168,482 | 2,129 | 1.28 |
| +100 | 555,834 | (36,137) | (6.10) | +100 | 167,731 | 1,378 | 0.83 |
| 0 | 591,971 | - | 0.0 | 0 | 166,353 | - | 0.0 |
| -100 | 612,632 | 20,661 | 3.49 | -100 | 163,951 | (2,402) | (1.44) |

Estimates of Fair Value

The estimation of fair value is significant to a number of the Company's assets, including loans held-for-sale and securities available-for-sale. These are all recorded at either fair value or the lower of cost or fair value. Fair values are volatile and may be influenced by a number of factors. Circumstances that could cause estimates of the fair value of certain assets and liabilities to change include a change in prepayment speeds, discount rates, or market interest rates. Fair values for most available-for-sale securities are based on quoted market prices. If quoted market prices are not available, fair values are based on judgments regarding future expected loss experience, current economic condition risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature, involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Impact of Inflation and Changing Prices

The consolidated financial statements and notes thereto presented elsewhere herein have been prepared in accordance with GAAP, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of operations; unlike most industrial companies, nearly all of the Company's assets and liabilities are monetary. As a result, interest rates have a greater impact on performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

Liquidity

Liquidity is a measure of a bank's ability to fund loans, withdrawals or maturities of deposits, and other cash outflows in a cost-effective manner. Our principal sources of funds are deposits, scheduled amortization and prepayments of loan principal, maturities of investment securities, and funds provided by operations. While scheduled loan payments and maturing investments are relatively predictable sources of funds, deposit flow and loan prepayments are greatly influenced by general interest rates, economic conditions and competition.

At September 30, 2018, the amount of liquid assets remained at a level management deemed adequate to ensure that, on a short and long-term basis, contractual liabilities, depositors' withdrawal requirements, and other operational and client credit needs could be satisfied. As of September 30, 2018, liquid assets (cash and due from banks, interest-bearing deposits with banks and unencumbered investment securities) were \$419.4 million, which represented 7.8% of total assets and 9.1% of total deposits and borrowings, compared to \$423.4 million as of December 31, 2017, which represented 8.3% of total assets and 9.5% of total deposits and borrowings.

The Bank is a member of the Federal Home Loan Bank of New York and, based on available qualified collateral as of September 30, 2018, had the ability to borrow \$1.7 billion. In addition, at September 30, 2018, the Bank had in place borrowing capacity of \$25 million through correspondent banks. The Bank also has a credit facility established with the Federal Reserve Bank of New York for direct discount window borrowings with capacity based on pledged collateral of \$8.0 million. At September 30, 2018, the Bank had aggregate available and unused credit of approximately \$1.0 billion, which represents the aforementioned facilities totaling \$1.7 billion net of \$740 million in outstanding borrowings and letters of credit. At September 30, 2018, outstanding commitments for the Bank to extend credit were approximately \$823 million.

Cash and cash equivalents totaled \$155.8 million at September 30, 2018, increasing by \$6.3 million from \$149.6 million at December 31, 2017. Operating activities provided \$67.3 million in net cash. Investing activities used \$281.6 million in net cash, primarily reflecting an increase in loans and net cash flow from the securities portfolio. Financing activities provided \$220.5 million in net cash, primarily reflecting a net increase of \$193.7 million in deposits, increase of subordinated notes of \$73.5 million and net decrease in FHLB advances of \$40.0 million.

Deposits

Total deposits increased by \$194 million, or 5.1%, to \$4.0 billion at September 30, 2018 from December 31, 2017. The increase was attributable to increases in interest-bearing demand and time deposits, offset by decreases in noninterest-bearing demand, money market deposits, and savings. The following table sets forth the composition of our deposit base by the periods indicated.

| | September 30, 2018 | | December 31, 2017 | | Amount Increase/ (Decrease) 2018 vs. 2017 |
|-----------------------------|------------------------|---------------|---------------------|---------------|----------------------------------------------------|
| | Amount | % | Amount | % | |
| | (dollars in thousands) | | | | |
| Demand, noninterest-bearing | \$ 758,213 | 19.0% | \$ 776,843 | 20.5% | \$ (18,630) |
| Demand, interest-bearing | 795,962 | 20.0 | 636,339 | 16.8 | 159,623 |
| Money market | 949,103 | 23.8 | 1,033,525 | 27.2 | (84,422) |
| Savings | 162,740 | 4.1 | 168,452 | 4.4 | (5,712) |
| Time | 1,322,747 | 33.1 | 1,179,969 | 31.1 | 142,778 |
| Total deposits | <u>\$ 3,988,765</u> | <u>100.0%</u> | <u>\$ 3,795,128</u> | <u>100.0%</u> | <u>\$ 193,637</u> |

Subordinated Debentures

During December 2003, Center Bancorp Statutory Trust II, a statutory business trust and wholly-owned subsidiary of the Parent Corporation issued \$5.0 million of MMCapS capital securities to investors due on January 23, 2034. The trust loaned the proceeds of this offering to the Company and received in exchange \$5.2 million of the Parent Corporation's subordinated debentures. The subordinated debentures are redeemable in whole or part prior to maturity. The floating interest rate on the subordinated debentures is three month LIBOR plus 2.85% and re-prices quarterly. The rate at September 30, 2018 was 5.19%.

During June 2015, the Parent Corporation issued \$50 million in aggregate principal amount of fixed-to-floating rate subordinated notes (the "Notes") to certain institutional accredited investors. The net proceeds from the sale of the Notes were used by the Parent Corporation to contribute \$35.0 million of common equity to the Bank and to repay \$11.25 million of SBLF preferred stock issued to the U.S. Treasury on March 11, 2016. Remaining funds were used for general corporate purposes. The Notes are non-callable for five years, have a stated maturity of July 1, 2025, and bear interest at a fixed rate of 5.75% per year, from and including June 30, 2015 to, but excluding July 1, 2020. From and including July 1, 2020 to the maturity date or early redemption date, the interest rate will reset quarterly to a level equal to the then current three month LIBOR rate plus 393 basis points.

During January 2018, the Parent Corporation issued \$75 million in aggregate principal amount of fixed-to-floating rate subordinated notes (the "2018 Notes") to certain accredited investors. The net proceeds from the sale of the 2018 Notes were used for general corporate purposes, which included the Parent Corporation contributing \$65 million of the net proceeds to the Bank in the form of debt and common equity in the first quarter of 2018. The 2018 Notes are non-callable for five years, have a stated maturity of February 1, 2028 and bear interest at a fixed rate of 5.20% per year, from and including January 17, 2018 to, but excluding February 1, 2023. From and including February 1, 2023 to, but excluding the maturity date, or early redemption date, the interest rate will reset quarterly to a level equal to the then current three-month LIBOR rate plus 284 basis points.

Stockholders' Equity

The Company's stockholders' equity was \$595 million at September 30, 2018, an increase of \$29 million from December 31, 2017. The increase in stockholders' equity was primarily attributable to increases in retained earnings of \$35 million, partially offset by increases in accumulated other comprehensive losses of \$7 million. As of September 30, 2018, the Company's tangible common equity ratio and tangible book value per share were 8.56% and \$13.87, respectively. Tangible book value per share increased \$0.49, or 3.7%, from the sequential quarter. As of December 31, 2017, the tangible common equity ratio and tangible book value per share were 8.41% and \$13.01, respectively. Total goodwill and other intangible assets were approximately \$148 million as of September 30, 2018 and December 31, 2017.

| | September 30, 2018 | December 31, 2017 |
|--------------------------------------------|----------------------------------------------------------------|----------------------|
| | (dollars in thousands, except for share and per share data) | |
| Stockholders' equity | \$ 594,871 | \$ 565,437 |
| Less: Goodwill and other intangible assets | 147,791 | 148,273 |
| Tangible common stockholders' equity | <u>\$ 447,080</u> | <u>\$ 417,164</u> |
| Common stock outstanding at period end | 32,239,928 | 32,071,860 |
| Book value per common share | \$ 18.45 | \$ 17.63 |
| Less: Goodwill and other intangible assets | 4.58 | 4.62 |
| Tangible book value per common share | <u>\$ 13.87</u> | <u>\$ 13.01</u> |

Regulatory Capital and Capital Adequacy

The maintenance of a solid capital foundation is a primary goal for the Company. Accordingly, capital plans and dividend policies are monitored on an ongoing basis. The Company's objective with respect to the capital planning process is to effectively balance the retention of capital to support future growth with the goal of providing stockholders with an attractive long-term return on their investment.

The Company and the Bank are subject to regulatory guidelines establishing minimum capital standards that involve quantitative measures of assets, and certain off-balance sheet items, as risk-adjusted assets under regulatory accounting practices.

The following is a summary of regulatory capital amounts and ratios as of September 30, 2018 for the Company and the Bank, compared with minimum capital adequacy requirements and the regulatory requirements for classification as a well-capitalized depository institution.

| At September 30, 2018 | ConnectOne Bancorp, Inc. | | For Capital Adequacy Purposes | | To Be Well-Capitalized Under Prompt Corrective Action Provisions | |
|---------------------------|--------------------------|-------|-------------------------------|-------|------------------------------------------------------------------|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (dollars in thousands) | | | | | |
| Tier 1 leverage capital | \$ 461,570 | 9.15% | \$ 201,813 | 4.00% | N/A | N/A |
| CET I risk-based ratio | 456,415 | 9.50 | 216,108 | 4.50 | N/A | N/A |
| Tier 1 risk-based capital | 461,570 | 9.61 | 288,144 | 6.00 | N/A | N/A |
| Total risk-based capital | 621,319 | 12.94 | 384,192 | 8.00 | N/A | N/A |

| At September 30, 2018 | ConnectOne Bank | | For Capital Adequacy Purposes | | To Be Well-Capitalized Under Prompt Corrective Action Provisions | |
|---------------------------|------------------------|--------|-------------------------------|-------|------------------------------------------------------------------|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (dollars in thousands) | | | | | |
| Tier 1 leverage capital | \$ 536,863 | 10.64% | \$ 201,789 | 4.00% | \$ 252,236 | 5.00% |
| CET I risk-based ratio | 536,863 | 11.18 | 216,113 | 4.50 | 312,163 | 6.50 |
| Tier 1 risk-based capital | 536,863 | 11.18 | 288,150 | 6.00 | 384,200 | 8.00 |
| Total risk-based capital | 603,862 | 12.57 | 384,200 | 8.00 | 480,251 | 10.00 |

N/A - not applicable

As of September 30, 2018, management believes that each of the Bank and the Company meet all capital adequacy requirements to which they are subject. Basel III rules require a "capital conservation buffer" for both the Company and the Bank. When fully phased in on January 1, 2019, each of the Company and the Bank will be required to maintain a 2.5% capital conservation buffer, above and beyond the capital levels otherwise required under applicable regulation. The implementation of this capital conservation buffer began on January 1, 2016 at a level of 0.625%, and will increase by 0.625% on each subsequent January 1 until it reaches 2.5% on January 1, 2019. Under this guidance banking institutions with a CET1, Tier 1 Capital Ratio and Total Risk Based Capital Ratio above the minimum regulatory adequate capital ratios but below the capital conservation buffer will face constraints on their ability to pay dividends, repurchase equity and pay discretionary bonuses to executive officers, based on the amount of the shortfall.

As of September 30, 2018 both the Company and Bank satisfy the capital conservation buffer requirements applicable to them. The lowest ratio at the Company is the Tier 1 Risk Based Ratio which was 1.74% above the minimum buffer ratio and, at the Bank, the lowest ratio was the Total Risk Based Capital Ratio which was 2.70% above the minimum buffer ratio.

Item 3. Qualitative and Quantitative Disclosures about Market Risks

Market Risk

Interest rate risk management is our primary market risk. See "Item 2- Management's Discussion and Analysis of Financial Condition and Results of Operation- Interest Rate Sensitivity Analysis" herein for a discussion of our management of our interest rate risk.

Item 4. Controls and Procedures

a) *Disclosure controls and procedures.* As of the end of the Company's most recently completed fiscal quarter covered by this report, the Company carried out an evaluation, with the participation of the Company's management, including the Company's chief executive officer and chief financial officer, of the effectiveness of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15. Based upon that evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms and are operating in an effective manner and that such information is accumulated and communicated to management, including the Company's chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

b) *Changes in internal controls over financial reporting.* There have been no changes in the Company's internal controls over financial reporting that occurred during the Company's last fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Other than as set forth below, the Company is not subject to any legal proceedings, which could have a materially adverse impact on its results of operations and financial condition.

Two complaints have been filed in the Supreme Court of the State of New York in connection with our previously announced merger with Greater Hudson Bank. Each seeks class action status and asserts that Greater Hudson Bank and the members of its Board violated their duties to Greater Hudson Bank shareholders in connection with the proposed merger. One of these complaints also alleges that ConnectOne Bancorp, Inc. has aided and abetted the individual defendants in their alleged breaches of fiduciary duties.

The asserted factual bases for the allegations of breach of duty include, generally that Greater Hudson Bank and its Board failed in its duty to disclose all material facts in this proxy statement in order to allow Greater Hudson's shareholders to make an informed decision as to whether to vote in favor of the merger agreement, including failure to adequately disclose: (i) alleged conflicts of interest of the special committee of Greater Hudson's Board with respect to the transaction; (ii) the purported sale process Board engaged; and (iii) the details of the analyses underlying the opinion prepared by the Greater Hudson's financial advisor that the consideration is fair to Greater Hudson shareholders.

Both we and Greater Hudson Bank are evaluating the complaints, and we intend to vigorously defend the allegations contained in the complaints.

Item 1a. Risk Factors

There have been no changes to the risks inherent in our business from those described under Item 1A – Risk Factors of our Annual Report on Form 10-K as supplemented by our form 10-Q for the quarter ended June 30, 2018.

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

Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Mine Safety Disclosures

Not applicable

Item 5 Other Information

Not applicable

Item 6. Exhibits

| Exhibit No. | Description |
|--------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|
| <u>2.1</u> | <u>Agreement and Plan of Merger, dated as of July 11, 2018, by and between ConnectOne Bancorp, Inc., ConnectOne Bank and Greater Hudson Bank*</u> |
| <u>10.1</u> | <u>Form of Voting Agreement executed by all directors and executive officers of Greater Hudson Bank.*</u> |
| <u>10.2</u> | <u>Voting and Sell Down Agreement with Kenneth J. Torsoe*</u> |
| <u>10.3</u> | <u>Registration Rights Agreement with Kenneth J. Torsoe*</u> |
| <u>31.1</u> | <u>Certification of the Chief Executive Officer of the Parent Corporation Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>31.2</u> | <u>Certification of the Chief Financial Officer of the Parent Corporation Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.1</u> | <u>Certification of the Chief Executive Officer of the Parent Corporation Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.2</u> | <u>Certification of the Chief Financial Officer of the Parent Corporation Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | Definition Taxonomy Extension Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

* Incorporated by reference to exhibits 10.1, 10.2 and 10.3 to the Registrant's Current Report on Form 8-k filed on July 12, 2018.

SIGNATURES

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

CONNECTONE BANCORP, INC.
(Registrant)

By: /s/ Frank Sorrentino III
Frank Sorrentino III
Chairman and Chief Executive Officer

By: /s/ William S. Burns
William S. Burns
Executive Vice President and Chief Financial Officer

Date: November 2, 2018

Date: November 2, 2018

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

Section 2: EX-31.1 (CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER)

EXHIBIT 31.1

CERTIFICATION

I, Frank Sorrentino III, certify that:

1. I have reviewed this quarterly report on Form 10-Q of ConnectOne Bancorp, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;

4. The Registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting.

5. The Registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent

functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: November 2, 2018

/s/ Frank Sorrentino III

Frank Sorrentino III

Chairman and Chief Executive Officer

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

Section 3: EX-31.2 (CERTIFICATION OF THE CHIEF FINANCIAL OFFICER)

EXHIBIT 31.2

CERTIFICATION

I, William S. Burns, certify that:

1. I have reviewed this quarterly report on Form 10-Q of ConnectOne Bancorp, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;

4. The Registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting.

5. The Registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal

control over financial reporting.

Date: November 2, 2018

/s/ William S. Burns

William S. Burns

Executive Vice President and Chief Financial Officer

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

Section 4: EX-32.1 (CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER)

EXHIBIT 32.1

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with this Quarterly Report of ConnectOne Bancorp, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2018 filed with the Securities and Exchange Commission (the "Report"), I, Frank Sorrentino III, Chairman and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

1. The Report fully complies with the requirements of Section 13 (a) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the consolidated financial condition of the Company as of the dates presented and the consolidated results of operations of the Company for the periods presented.

Date: November 2, 2018

/s/ Frank Sorrentino III

Frank Sorrentino III

Chairman and Chief Executive Officer

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

Section 5: EX-32.2 (CERTIFICATION OF THE CHIEF FINANCIAL OFFICER)

EXHIBIT 32.2

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with this Quarterly Report of ConnectOne Bancorp, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2018 filed with the Securities and Exchange Commission (the "Report"), I, William S. Burns, Executive Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

1. The Report fully complies with the requirements of Section 13 (a) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the consolidated financial condition of the Company as of the dates presented and the consolidated results of operations of the Company for the periods presented.

Date: November 2, 2018

/s/ William S. Burns

William S. Burns

Executive Vice President and Chief Financial Officer

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