

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 March 31, 2019

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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit 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

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

Title of each class	Trading symbol	Name of each exchange on which registered
Common stock	CNOB	NASDAQ

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)

35,455,756 shares
(Outstanding as of May 7, 2019)

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Item 1. Financial Statements

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CONDITION

(in thousands, except for share data)	March 31, 2019 (unaudited)	December 31, 2018
ASSETS		
Cash and due from banks	\$ 54,520	\$ 39,161
Interest-bearing deposits with banks	118,028	133,205
Cash and cash equivalents	172,548	172,366
Securities available-for-sale	516,539	412,034
Equity securities	11,564	11,460
Loans held-for-sale	368	-
Loans receivable	4,972,651	4,541,092
Less: Allowance for loan losses	36,858	34,954
Net loans receivable	4,935,793	4,506,138
Investment in restricted stock, at cost	31,727	31,136
Bank premises and equipment, net	20,150	19,062
Accrued interest receivable	21,198	18,214
Bank owned life insurance	125,300	113,820
Right of use operating lease assets	15,311	-
Goodwill	156,243	145,909
Core deposit intangibles	6,504	1,737
Other assets	35,731	30,216
Total assets	\$ 6,048,976	\$ 5,462,092
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 833,090	\$ 768,584
Interest-bearing	3,760,908	3,323,508
Total deposits	4,593,998	4,092,092
Borrowings	603,412	600,001
Operating lease liabilities	16,719	-
Subordinated debentures (net of debt issuance costs of \$1,517 and \$1,599, respectively)	128,638	128,556
Other liabilities	23,814	27,516
Total liabilities	5,366,581	4,848,165
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Preferred Stock:		
Authorized 5,000,000 shares	-	-
Common stock, no par value:		
Authorized 50,000,000 shares; issued 37,520,855 shares at March 31, 2019 and 34,392,464 shares at December 31, 2018; outstanding 35,443,933 shares at March 31, 2019 and 32,328,542 at December 31, 2018	468,571	412,546
Additional paid-in capital	16,513	15,542
Retained earnings	219,558	211,345
Treasury stock, at cost (2,076,922 common shares at March 31, 2019 and 2,063,922 at December 31, 2018)	(16,967)	(16,717)

Accumulated other comprehensive loss	(5,280)	(8,789)
Total stockholders' equity	682,395	613,927
Total liabilities and stockholders' equity	\$ 6,048,976	\$ 5,462,092

See accompanying notes to unaudited consolidated financial statements.

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

(dollars in thousands, except for per share data)	Three Months Ended March 31,	
	2019	2018
Interest income		
Interest and fees on loans	\$ 60,326	\$ 47,025
Interest and dividends on investment securities:		
Taxable	2,942	1,887
Tax-exempt	1,127	814
Dividends	457	485
Interest on federal funds sold and other short-term investments	357	264
Total interest income	65,209	50,475
Interest expense		
Deposits	15,351	7,688
Borrowings	4,906	4,640
Total interest expense	20,257	12,328
Net interest income	44,952	38,147
Provision for loan losses	4,500	17,800
Net interest income after provision for loan losses	40,452	20,347
Noninterest income		
Income on bank owned life insurance	822	774
Net gains on sale of loans held-for-sale	19	17
Deposit, loan and other income	786	616
Net gains (losses) on equity securities	103	(120)
Net gains on sales of securities available-for-sale	8	-
Total noninterest income	1,738	1,287
Noninterest expenses		
Salaries and employee benefits	11,954	9,672
Occupancy and equipment	2,495	2,143
FDIC insurance	755	850
Professional and consulting	1,209	723
Marketing and advertising	210	207
Data processing	1,155	1,148
Merger expenses	7,562	-
Amortization of core deposit intangibles	364	169
Other components of net periodic pension expense	29	7
Other expenses	2,329	2,020
Total noninterest expenses	28,062	16,939
Income before income tax expense	14,128	4,695
Income tax expense	2,493	444
Net income	\$ 11,635	\$ 4,251
Earnings per common share		
Basic	\$ 0.33	\$ 0.13
Diluted	0.33	0.13
Dividends per common share	\$ 0.090	\$ 0.075

See accompanying notes to unaudited consolidated financial statements.

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

(in thousands)	Three Months Ended March 31,	
	2019	2018
Net income	\$ 11,635	\$ 4,251
Other comprehensive income (loss):		
Unrealized gains and losses on securities:		
Unrealized holding gains (losses) on available-for-sale securities arising during the period	5,558	(5,019)
Tax effect	(1,422)	1,292
Net of tax	4,136	(3,727)
Reclassification adjustment for realized gains included in net income		
	(8)	-
Tax effect	2	-
Net of tax	(6)	-
Unrealized (losses) gains on cash flow hedge	(391)	916
Tax effect	110	(258)
Net of tax	(281)	658
Unrealized pension plan (losses) gains:		
Unrealized pension plan (losses) gains before reclassifications	(562)	236
Tax effect	158	(67)
Net of tax	(404)	169
Reclassification adjustment for realized losses included in net income		
	89	91
Tax effect	(25)	(25)
Net of tax	64	66
Total other comprehensive income (loss)	3,509	(2,834)
Total comprehensive income	\$ 15,144	\$ 1,417

See accompanying notes to unaudited consolidated financial statements.

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

(dollars in thousands, except for per share data)	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive (Loss) Income	Total Stockholders' Equity
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)	-	-	-	709	-	(709)	-
Cumulative effect of adopting ASU 2016-01	-	-	-	(55)	-	55	-
Net income	-	-	-	4,251	-	-	4,251
Other comprehensive loss, net of tax	-	-	-	-	-	(2,834)	(2,834)
Cash dividends declared on common stock (\$0.075 per share)	-	-	-	(2,420)	-	-	(2,420)
Exercise of stock options (38,697 shares)	-	-	202	-	-	-	202
Restricted stock grants (22,004 shares)	-	-	-	-	-	-	-
Net performance units issued (42,672 shares)	-	-	(819)	-	-	-	(819)
Stock-based compensation	-	-	449	-	-	-	449
Balance as of March 31, 2018	<u>\$ -</u>	<u>\$ 412,546</u>	<u>\$ 13,434</u>	<u>\$ 162,510</u>	<u>\$ (16,717)</u>	<u>\$ (7,507)</u>	<u>\$ 564,266</u>
Balance as of December 31, 2018	\$ -	\$ 412,546	\$ 15,542	\$ 211,345	\$ (16,717)	\$ (8,789)	\$ 613,927
Net income	-	-	-	11,635	-	-	11,635
Other comprehensive income, net of tax	-	-	-	-	-	3,509	3,509
Cash dividends declared on common stock (\$0.090 per share)	-	-	-	(3,422)	-	-	(3,422)
Exercise of stock options (21,991 shares)	-	-	143	-	-	-	143
Restricted stock grants (43,483 shares)	-	-	-	-	-	-	-
Restricted stock units (4,904 shares)	-	-	-	-	-	-	-
Net performance units issued (26,517 shares)	-	-	196	-	-	-	196
Repurchase of treasury stock (13,000 shares)	-	-	-	-	(250)	-	(250)
Stock issued (3,032,496 shares) in acquisition of Greater Hudson							
Bank	-	56,025	-	-	-	-	56,025
Stock-based compensation	-	-	632	-	-	-	632
Balance as of March 31, 2019	<u>\$ -</u>	<u>\$ 468,571</u>	<u>\$ 16,513</u>	<u>\$ 219,558</u>	<u>\$ (16,967)</u>	<u>\$ (5,280)</u>	<u>\$ 682,395</u>

See accompanying notes to unaudited consolidated financial statements.

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

(in thousands)	Three Months Ended March 31,	
	2019	2018
<u>Cash flows from operating activities</u>		
Net income	\$ 11,635	\$ 4,251
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	814	775
Provision for loan losses	4,500	17,800
Amortization of intangibles	364	169
Net accretion of loans	(963)	(179)
Accretion on bank premises	(21)	(16)
Accretion on deposits	(328)	(15)
Amortization (accretion) on borrowings, net	58	(45)
Stock-based compensation	828	(370)
Gains on sales of securities available-for-sale, net	(8)	-
(Gains) losses on equity securities, net	(103)	121
Gains on sale of loans held-for-sale, net	(19)	(17)
Loans originated for resale	(1,497)	(1,045)
Proceeds from sale of loans held-for-sale	1,148	1,145
Increase in cash surrender value of bank owned life insurance	(822)	(189)
Amortization of premiums and accretion of discounts on securities available-for-sale	683	1,045
Amortization of subordinated debt issuance costs	82	86
Increase in accrued interest receivable	(550)	(550)
Net change in operating leases	1,408	-
Decrease (increase) in other assets	3,723	(2,269)
Decrease in other liabilities	(7,933)	(464)
Net cash provided by operating activities	<u>12,999</u>	<u>20,233</u>
<u>Cash flows from investing activities</u>		
Securities available-for-sale:		
Purchases	(107,405)	(46,333)
Sales	94,075	-
Maturities, calls and principal repayments	35,371	39,503
Net purchases of restricted investment in bank stocks	(591)	(1,125)
Payments on loans held-for-sale	-	112
Net increase in loans	(70,278)	(69,837)
Purchases of premises and equipment	(257)	(139)
Cash and cash equivalents acquired in acquisition	13,741	-
Net cash used in investing activities	<u>(35,344)</u>	<u>(77,819)</u>
<u>Cash flows from financing activities</u>		
Net increase (decrease) in deposits	86,124	(45,526)
Increase in subordinated debentures	-	73,525
Advances of Federal Home Loan Bank (“FHLB”) borrowings	420,000	435,000
Repayments of FHLB borrowings	(480,833)	(410,000)
Cash dividends paid on common stock	(2,657)	(2,410)
Repurchase of treasury stock	(250)	-
Proceeds from exercise of stock options	143	202
Net cash provided by financing activities	<u>22,527</u>	<u>50,791</u>
Net change in cash and cash equivalents	182	(6,795)

Cash and cash equivalents at beginning of period	<u>172,366</u>	<u>149,582</u>
Cash and cash equivalents at end of period	<u>\$ 172,548</u>	<u>\$ 142,787</u>

(continued)

Supplemental disclosures of cash flow information

Cash payments for:

Interest paid on deposits and borrowings	\$ 22,340	\$ 10,927
Income taxes	-	1,223

Supplemental disclosures of noncash activities:Investing:

Transfer of loans to other real estate owned	\$ -	\$ 538
Transfer of loans from held-for-investment to held-for-sale	-	24,236

Business combination:

Fair value of assets acquired, net of cash and cash equivalents	\$ 534,166	\$ -
Fair value of liabilities assumed	488,475	-

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), Port Jervis Holdings LLC (a New York 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-eight 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 months ended March 31, 2019 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2019, or for any other interim period. The Company’s 2018 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.

Note 1a. Authoritative Accounting Guidance

Adoption of New Accounting Standards

Effective January 1, 2019, the Company implemented ASU No. 2016-02, “Leases (Topic 842)” (modified by ASU 2018-01 – Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842) and ASU 2018-20 – Leases (Topic 842) Narrow – Scope Improvements for Lessors). ASU 2016-02 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. Effective with the adoption, the Company recognized a “right-of-use-asset” and a “lease liability” for its operating leases and has elected to apply practical expedients pertaining to the ASU. The Company applied a modified retrospective transition approach for the applicable leases. ASU 2016-02 provides for a modified retrospective transition approach requiring lessees to recognize and measure leases on the balance sheet at the beginning of either the earliest period presented or as of the beginning of the period of adoption. The Company elected to apply ASU 2016-02 as of the beginning of the period of adoption (January 1, 2019) and will not restate comparative periods. The Company has also elected to use the practical expedient to make an accounting policy election for property leases to include both lease and non-lease components as a single component and account for it as a lease. The adoption of ASU 2016-02 resulted in the recognition of \$15.3 million of “right-of-use assets” and \$16.7 million of lease liabilities as of the date of the adoption. This adoption did not materially impact the Company’s Consolidated Statement of Income for the first quarter ended March 31, 2019 and it is not expected to have a material impact on the Consolidated Statement of Income in future periods. See Note 9 – Premises and Equipment for additional disclosures related to leases.

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

Note 1a. Authoritative Accounting Guidance

Newly Issued, But Not Yet Effective Accounting Standards

SU No. 2016-13, “*Financial Instruments – Credit Losses (Topic 326): Assets Measured at Amortized Cost.*” (modified by ASU 2018-19 – *Codification Improvements to Topic 326, Financial Instruments – Credit Losses*). 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, 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 which has assessed our data and system needs. The Company has engaged third-party vendors to assist in analyzing our data and developing a CECL model. The Company, in conjunction with these vendors, has researched and analyzed 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.

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 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 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.

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

Note 2. Business Combination

On July 11, 2018, the Company entered into an Agreement and Plan of Merger with Greater Hudson Bank (“GHB”), under which GHB would merge with and into ConnectOne Bank, with ConnectOne Bank as the surviving bank. This transaction was completed effective January 2, 2019 (“Merger date”). As part of this merger, the Company acquired seven branch offices located in Rockland, Orange and Westchester Counties, New York. Pursuant to the merger agreement, holders of GHB common stock received 0.245 shares of common stock of ConnectOne with cash paid in lieu of fractional shares.

The acquisition of GHB was accounted for using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration paid were recorded at their estimated fair values as of the acquisition date. The application of the acquisition method of accounting resulted in the recognition of goodwill of \$10.3 million and a core deposit intangible of \$5.1 million. The assets acquired and liabilities assumed and consideration paid in the acquisition of GHB were recorded at their estimated fair values based on management’s best estimates using information available at the date of the acquisition and are subject to adjustment for up to one year after the closing date of the acquisition. While the fair values are not expected to be materially different from the estimates, accounting guidance provides that an acquirer must recognize adjustments to provisional amounts that are identified during the measurement period, which runs through January 2, 2020, in the measurement period in which the adjustment amounts are determined. The acquirer must record in the financial statements, the effect on earnings of changes in depreciation, amortization or other income effects, if any, as a result of the changes to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The items most susceptible to adjustment are the credit fair value adjustments on loans, core deposit intangible and the deferred income tax assets resulting from the acquisition.

In connection with the acquisition, the consideration paid and the fair value of identifiable assets acquired and liabilities assumed as of the date of acquisition are summarized in the following table:

	Estimated Fair Value at January 2, 2019 (in thousands)
Consideration paid:	
Common stock issued in acquisition	\$ 56,025
Assets acquired:	
Cash and cash equivalents	13,741
Securities available-for-sale	121,672
Loans, net	362,914
Premises and equipment, net	1,624
Accrued interest receivable	2,434
Core deposit intangibles	5,131
Other assets	26,650
Total assets acquired	534,166
Liabilities assumed:	
Deposits	416,110
Borrowings	64,186
Other liabilities	8,179
Total liabilities assumed	488,475
Net assets acquired	45,691
Goodwill recorded in acquisition	\$ 10,334

The amount of goodwill recorded represents the excess purchase price over the estimated fair value of the net assets acquired by ConnectOne and reflects the economies of scale, increased market share and lending capabilities, greater access to best-in-class banking technology, and related synergies that are expected to result from the acquisition.

Loans acquired in the GHB acquisition were recorded at fair value, and there was no carryover related allowance for loan losses. The fair values of loans acquired from GHB were estimated based on the value of the expected cash flows, which were projected based on the contractual terms of the loans, including both maturity and contractual amortization. The monthly principal and interest cash flows were adjusted for expected losses and prepayments, where appropriate. Projected cash flows were then discounted to present value using a discount rate developed based on the relative risk of the cash flows, considering the loan type, liquidity risk, the maturity of the loans, servicing costs and a required return on capital.

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
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Note 2. Business Combination – (continued)

The following is a summary of the loans accounted for in accordance with ASC 310-30 that were acquired in the GHB acquisition as of the Merger date:

	Estimated Fair Value at January 2, 2019 (in thousands)
Contractually required principal and interest acquisition	\$ 19,874
Contractual cash flows not expected to be collected (non-accretable discount)	(12,167)
Expected cash flows at acquisition	7,707
Interest component of expected cash flows (accretable discount)	(1,286)
Fair value of acquired loans	\$ 6,421

Goodwill is not amortized for book purposes; however, it is reviewed at least annually for impairment and is not deductible for tax purposes.

The fair value of retail demand and interest bearing deposit accounts was assumed to approximate the carrying value as those accounts have no stated maturity and are payable on demand. The fair value of time deposits was estimated by discounting the contractual future cash flows using market rates offered for time deposits of similar remaining maturities. The fair value of borrowed funds was estimated by discounting the future cash flows using market rates for similar borrowings.

Direct acquisition and integration costs of the Merger were expensed as incurred. These items were recorded as merger-related expenses on the statement of operations. During the three months ended March 31, 2019, merger expenses were \$7.6 million.

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:

(dollars in thousands, except for per share data)	Three Months Ended March 31,	
	2019	2018
Net income	\$ 11,635	\$ 4,251
Earnings allocated to participating securities	(26)	(12)
Income attributable to common stock	\$ 11,609	\$ 4,239
Weighted average common shares outstanding, including participating securities	35,283	32,116
Weighted average participating securities	(25)	(94)
Weighted average common shares outstanding	35,258	32,022
Incremental shares from assumed conversions of options, performance units and restricted shares	61	274
Weighted average common and equivalent shares outstanding	35,319	32,296
Earnings per common share:		
Basic	\$ 0.33	\$ 0.13
Diluted	0.33	0.13

There were no antidilutive share equivalents as of March 31, 2019 and March 31, 2018.

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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 March 31, 2019 and December 31, 2018. 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 March 31, 2019 and December 31, 2018 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
	(dollars in thousands)			
<u>March 31, 2019</u>				
Securities available-for-sale				
Federal agency obligations	\$ 43,321	\$ 191	\$ (232)	\$ 43,280
Residential mortgage pass-through securities	255,657	381	(2,837)	253,201
Commercial mortgage pass-through securities	6,903	23	(11)	6,915
Obligations of U.S. states and political subdivisions	167,819	2,115	(1,764)	168,170
Corporate bonds and notes	35,245	193	(367)	35,071
Asset-backed securities	8,244	11	(68)	8,187
Certificates of deposit	148	2	-	150
Other securities	1,565	-	-	1,565
Total securities available-for-sale	<u>\$ 518,902</u>	<u>\$ 2,916</u>	<u>\$ (5,279)</u>	<u>\$ 516,539</u>
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in thousands)			
<u>December 31, 2018</u>				
Securities available-for-sale				
Federal agency obligations	\$ 45,509	\$ 51	\$ (605)	\$ 44,955
Residential mortgage pass-through securities	189,721	85	(4,602)	185,204
Commercial mortgage pass-through securities	3,919	-	(45)	3,874
Obligations of U.S. states and political subdivisions	141,496	1,091	(3,402)	139,185
Corporate bonds and notes	26,308	45	(540)	25,813
Asset-backed securities	9,685	22	(16)	9,691
Certificates of deposit	319	3	-	322
Other securities	2,990	-	-	2,990
Total securities available-for-sale	<u>\$ 419,947</u>	<u>\$ 1,297</u>	<u>\$ (9,210)</u>	<u>\$ 412,034</u>

Investment securities having a carrying value of approximately \$141.9 million and \$151.5 million at March 31, 2019 and December 31, 2018, 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 March 31, 2019 and December 31, 2018, 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
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Note 4. Securities Available-for-Sale – (continued)

The following table presents information for investments in securities available-for-sale at March 31, 2019, 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.

	March 31, 2019	
	Amortized Cost	Fair Value
(dollars in thousands)		
Securities available-for-sale:		
Due in one year or less	\$ 6,909	\$ 6,941
Due after one year through five years	46,300	46,324
Due after five years through ten years	32,152	32,634
Due after ten years	169,416	168,959
Residential mortgage pass-through securities	255,657	253,201
Commercial mortgage pass-through securities	6,903	6,915
Other securities	1,565	1,565
Total securities available-for-sale	\$ 518,902	\$ 516,539

Gross gains and losses from the sales of securities for periods presented were as follows (dollars in thousands):

	Three Months Ended March 31,	
	2019	2018
Proceeds	\$ 94,075	\$ -
Gross gains on sales of securities	8	-
Gross losses on sales of securities	-	-
Net gains on sales of securities	8	-
Less: tax provision on net gains	(2)	-
Net gains on sales of securities, after tax	\$ 6	\$ -

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.

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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 131 and 148 securities as of March 31, 2019 and December 31, 2018, 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 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 March 31, 2019.

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.

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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 March 31, 2019 and December 31, 2018:

	March 31, 2019					
	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	\$ 23,900	\$ (232)	\$ 2,005	\$ (7)	\$ 21,895	\$ (225)
Residential mortgage pass-through securities	194,131	(2,837)	60,001	(137)	134,130	(2,700)
Commercial mortgage pass-through securities	3,873	(11)	-	-	3,873	(11)
Obligations of U.S. states and political subdivisions	53,685	(1,764)	531	-	53,154	(1,764)
Corporate bonds and notes	14,547	(367)	7,382	(42)	7,165	(325)
Asset-backed securities	4,536	(68)	2,884	(49)	1,652	(19)
Total temporarily impaired securities	<u>\$ 294,672</u>	<u>\$ (5,279)</u>	<u>\$ 72,803</u>	<u>\$ (235)</u>	<u>\$ 221,869</u>	<u>\$ (5,044)</u>

	December 31, 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	\$ 35,472	\$ (605)	\$ 810	\$ (1)	\$ 34,662	\$ (604)
Residential mortgage pass-through securities	178,365	(4,602)	42,040	(393)	136,325	(4,209)
Commercial mortgage pass-through securities	3,874	(45)	-	-	3,874	(45)
Obligations of U.S. states and political subdivisions	64,367	(3,402)	7,765	(21)	56,602	(3,381)
Corporate bonds and notes	15,534	(540)	7,767	(133)	7,767	(407)
Asset-backed securities	3,957	(16)	2,219	(11)	1,738	(5)
Total Temporarily Impaired Securities	<u>\$ 301,569</u>	<u>\$ (9,210)</u>	<u>\$ 60,601</u>	<u>\$ (559)</u>	<u>\$ 240,968</u>	<u>\$ (8,651)</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.

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Note 5. Derivatives – (continued)

Interest rate swaps were entered into on April 13, 2017, August 24, 2015, and December 30, 2014, each with a respective notional amount of \$25.0 million and were designated as a cash flow hedge of a Federal Home Loan Bank 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 March 31, 2019, December 31, 2018 and March 31, 2018 are presented in the following table.

	March 31, 2019	December 31, 2018	March 31, 2018
	(dollars in thousands)		
Notional amount	\$ 75,000	\$ 75,000	\$ 100,000
Weighted average pay rates	1.80%	1.70%	1.79%
Weighted average receive rates	2.79%	2.19%	1.82%
Weighted average maturity	1.7 years	2.0 years	2.2 years
Fair value	\$ 768	\$ 1,159	\$ 1,714

Net interest income recorded on these swap transactions totaled approximately \$182 thousand during the three months ended March 31, 2019 compared to \$5 thousand during the three months ended March 31, 2018.

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:

	Three Months Ended March 31, 2019		
	Amount of gain (loss) recognized in OCI (Effective Portion)	Amount of gain (loss) reclassified from OCI to interest income	Amount of gain recognized in other Noninterest income (Ineffective Portion)
	(dollars in thousands)		
Interest rate contracts	\$ (209)	\$ (182)	\$ -

	Three Months Ended March 31, 2018		
	Amount of gain (loss) recognized in OCI (Effective Portion)	Amount of gain (loss) reclassified from OCI to interest income	Amount of gain recognized in other Noninterest income (Ineffective Portion)
	(dollars in thousands)		
Interest rate contracts	\$ 921	\$ (5)	\$ -

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The following table reflects the cash flow hedges included in the consolidated statements of condition as of March 31, 2019 and December 31, 2018:

	March 31, 2019		December 31, 2018	
	Notional Amount	Fair Value	Notional Amount	Fair Value
	(dollars in thousands)			
Interest rate swaps related to FHLB advances included in assets	\$ 75,000	\$ 768	\$ 75,000	\$ 1,159

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
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Note 6. Loans and the Allowance for Loan Losses

Loans Receivable - The following table sets forth the composition of the Company's loan portfolio segments, including net deferred fees, as of March 31, 2019 and December 31, 2018:

	March 31, 2019	December 31, 2018
	(dollars in thousands)	
Commercial	\$ 1,051,199	\$ 988,758
Commercial real estate	3,054,196	2,778,167
Commercial construction	548,039	465,389
Residential real estate	319,215	309,991
Consumer	4,156	2,594
Gross loans	4,976,805	4,544,899
Net deferred loan fees	(4,154)	(3,807)
Total loans receivable	<u>\$ 4,972,651</u>	<u>\$ 4,541,092</u>

At March 31, 2019 and December 31, 2018, loan balances of approximately \$2.5 billion and \$2.3 billion, respectively, were pledged to secure borrowings from the FHLB of New York.

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 March 31, 2019 and December 31, 2018.

	March 31, 2019	December 31, 2018
	(dollars in thousands)	
Commercial	\$ 6,159	\$ 2,509
Commercial real estate	1,181	-
Commercial construction	1,649	-
	<u>\$ 8,989</u>	<u>\$ 2,509</u>

For those purchased loans disclosed above, the Company did not increase the allowance for loan losses during either the three months ended March 31, 2019 and March 31, 2018. There were no reversals from the allowance for loan losses during the three months ended March 31, 2019 and March 31, 2018.

The following table presents the accretible yield, or income expected to be collected, on the purchased credit-impaired loans for three months ended March 31, 2019 and March 31, 2018:

	Three Months Ended March 31, 2019	Three Months Ended March 31, 2018
	(dollars in thousands)	
Balance at beginning of period	\$ 1,134	\$ 1,387
New loans purchased	1,286	-
Accretion of income	(146)	(65)
Balance at end of period	<u>\$ 2,274</u>	<u>\$ 1,322</u>

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
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Note 6. Loans and the Allowance for Loan Losses – (continued)

Loans Receivable on Nonaccrual Status - The following tables present nonaccrual loans included in loans receivable by loan class as of March 31, 2019 and December 31, 2018:

	March 31, 2019	December 31, 2018
	(dollars in thousands)	
Commercial	\$ 28,099	\$ 29,340
Commercial real estate	12,159	15,135
Commercial construction	2,934	2,934
Residential real estate	4,488	4,446
Total nonaccrual loans	<u>\$ 47,680</u>	<u>\$ 51,855</u>

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.

Credit Quality Indicators - 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. The following table presents information about the loan credit quality by loan class of gross loans (which exclude net deferred fees) at March 31, 2019 and December 31, 2018:

	March 31, 2019				
	Pass	Special Mention	Substandard	Doubtful	Total
	(dollars in thousands)				
Commercial	\$ 997,975	\$ 17,452	\$ 35,772	\$ -	\$ 1,051,199
Commercial real estate	3,024,553	12,970	16,673	-	3,054,196
Commercial construction	533,105	6,920	8,014	-	548,039
Residential real estate	314,599	-	4,616	-	319,215
Consumer	4,143	-	13	-	4,156
Gross loans	<u>\$ 4,874,375</u>	<u>\$ 37,342</u>	<u>\$ 65,088</u>	<u>\$ -</u>	<u>\$ 4,976,805</u>
	December 31, 2018				
	Pass	Special Mention	Substandard	Doubtful	Total
	(dollars in thousands)				
Commercial	\$ 951,610	\$ 3,371	\$ 33,777	\$ -	\$ 988,758
Commercial real estate	2,742,989	12,574	22,604	-	2,778,167
Commercial construction	453,598	5,515	6,276	-	465,389
Residential real estate	305,414	-	4,577	-	309,991
Consumer	2,576	-	18	-	2,594
Gross loans	<u>\$ 4,456,187</u>	<u>\$ 21,460</u>	<u>\$ 67,252</u>	<u>\$ -</u>	<u>\$ 4,544,899</u>

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

The following table provides an analysis of the impaired loans by class as of March 31, 2019 and 2018.

	March 31, 2019		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
(dollars in thousands)			
<u>No related allowance recorded</u>			
Commercial	\$ 28,870	\$ 78,844	
Commercial real estate	10,124	18,258	
Commercial construction	6,326	10,443	
Residential real estate	2,185	2,511	
Consumer	-	-	
Total (no related allowance)	<u>\$ 47,505</u>	<u>\$ 110,056</u>	
<u>With an allowance recorded</u>			
Commercial real estate	\$ 4,984	\$ 7,999	\$ 1,035
Residential real estate	256	266	25
Total (with allowance)	<u>\$ 5,240</u>	<u>\$ 8,265</u>	<u>\$ 1,060</u>
<u>Total</u>			
Commercial	\$ 28,870	\$ 78,844	\$ -
Commercial real estate	15,108	26,257	1,035
Commercial construction	6,326	10,443	-
Residential real estate	2,441	2,777	25
Consumer	-	-	-
Total	<u>\$ 52,745</u>	<u>\$ 118,321</u>	<u>\$ 1,060</u>
December 31, 2018			
	Recorded Investment	Unpaid Principal Balance	Related Allowance
(dollars in thousands)			
<u>No related allowance recorded</u>			
Commercial	\$ 29,896	\$ 83,596	
Commercial real estate	16,839	17,935	
Commercial construction	9,240	9,240	
Residential real estate	2,209	2,521	
Consumer	-	-	
Total (no related allowance)	<u>\$ 58,184</u>	<u>\$ 113,292</u>	
<u>With an allowance recorded</u>			
Commercial real estate	\$ 1,488	\$ 1,488	\$ 7
Residential real estate	260	266	29
Total	<u>\$ 1,748</u>	<u>\$ 1,754</u>	<u>\$ 36</u>
<u>Total</u>			
Commercial	\$ 29,896	\$ 83,596	\$ -
Commercial real estate	18,327	19,423	7
Commercial construction	9,240	9,240	-

Residential real estate	2,469	2,787	29
Consumer	-	-	-
Total	<u>\$ 59,932</u>	<u>\$ 115,046</u>	<u>\$ 36</u>

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
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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 class as of and for the three months ended March 31, 2019 and 2018:

	Three Months Ended March 31,			
	2019		2018	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<u>Impaired loans with no related allowance recorded</u>				
Commercial	\$ 29,080	\$ 16	\$ 45,607	\$ 31
Commercial real estate	10,146	47	35,010	243
Commercial construction	10,400	57	6,083	77
Residential real estate	2,194	-	2,613	-
Consumer	-	-	-	-
Total	<u>\$ 51,820</u>	<u>\$ 120</u>	<u>\$ 89,313</u>	<u>\$ 351</u>
<u>Impaired loans with an allowance recorded</u>				
Commercial real estate	\$ 7,084	\$ -	\$ 1,129	\$ 12
Commercial construction	-	-	2,649	42
Residential real estate	258	-	-	-
Total	<u>\$ 7,342</u>	<u>\$ -</u>	<u>\$ 3,778</u>	<u>\$ 54</u>
<u>Total impaired loans</u>				
Commercial	\$ 29,080	\$ 16	\$ 45,607	\$ 31
Commercial real estate	17,230	47	36,139	255
Commercial construction	10,400	57	8,732	119
Residential real estate	2,452	-	2,613	-
Consumer	-	-	-	-
Total	<u>\$ 59,162</u>	<u>\$ 120</u>	<u>\$ 93,091</u>	<u>\$ 405</u>

Included in impaired loans at March 31, 2019 and December 31, 2018 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.

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

Aging Analysis - The following table provides an analysis of the aging of the loans by class, excluding net deferred fees, that are past due at March 31, 2019 and December 31, 2018:

	March 31, 2019						
	30-59 Days	60-89 Days	90 Days or	Total Past		Current	Gross Loans
	Past Due	Past Due	Greater Past	Nonaccrual	Nonaccrual		
			Due and Still				
			Accruing	Nonaccrual	Nonaccrual		
(dollars in thousands)							
Commercial	\$ 1,979	\$ 2,626	\$ 3,799	\$ 28,099	\$ 36,503	\$ 1,014,696	\$ 1,051,199
Commercial real estate	10,213	180	-	12,159	22,552	3,031,644	3,054,196
Commercial construction	648	-	1,649	2,934	5,231	542,808	548,039
Residential real estate	1,591	-	-	4,488	6,079	313,136	319,215
Consumer	12	-	-	-	12	4,144	4,156
Total	\$ 14,443	\$ 2,806	\$ 5,448	\$ 47,680	\$ 70,377	\$ 4,906,428	\$ 4,976,805

Included in the 90 days or greater past due and still accruing category as of March 31, 2019 are purchased credit-impaired loans, net of fair value marks, which accretes income per the valuation at date of acquisition.

	December 31, 2018						
	30-59 Days	60-89 Days	90 Days or	Total Past		Current	Gross Loans
	Past Due	Past Due	Greater Past	Nonaccrual	Nonaccrual		
			Due and Still				
			Accruing	Nonaccrual	Nonaccrual		
Commercial	\$ 1,673	\$ -	\$ 1,647	\$ 29,340	\$ 32,660	\$ 956,098	\$ 988,758
Commercial real estate	6,162	1,840	-	15,135	23,137	2,755,030	2,778,167
Commercial construction	2,496	564	-	2,934	5,994	459,395	465,389
Residential real estate	3,455	119	-	4,446	8,020	301,971	309,991
Consumer	-	-	-	-	-	2,594	2,594
Total	\$ 13,786	\$ 2,523	\$ 1,647	\$ 51,855	\$ 69,811	\$ 4,475,088	\$ 4,544,899

The amount reported 90 days or greater past due and still accruing as of December 31, 2018 are comprised of PCI loans, net of their fair value marks, which are accreting income per their valuation at date of acquisition.

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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 quality, and the related portion of the allowance for loan losses that are allocated to each loan portfolio segment:

	March 31, 2019						
	Commercial	Commercial real estate	Commercial construction	Residential real estate	Consumer	Unallocated	Total
	(dollars in thousands)						
ALL							
Individually evaluated for impairment	\$ -	\$ 1,035	\$ -	\$ 25	\$ -	\$ -	\$ 1,060
Collectively evaluated for impairment	8,460	19,526	4,982	1,141	1	488	34,598
Acquired portfolio	200	1,000	-	-	-	-	1,200
Acquired with deteriorated credit quality	-	-	-	-	-	-	-
Total	\$ 8,660	\$ 21,561	\$ 4,982	\$ 1,166	\$ 1	\$ 488	\$ 36,858
Gross loans							
Individually evaluated for impairment	\$ 28,870	\$ 15,108	\$ 6,326	\$ 2,441	\$ -	\$ -	\$ 52,745
Collectively evaluated for impairment	893,678	2,603,459	498,503	267,903	3,826	-	4,267,369
Acquired portfolio	122,492	434,448	41,561	48,871	330	-	647,702
Acquired with deteriorated credit quality	6,159	1,181	1,649	-	-	-	8,989
Total	\$ 1,051,199	\$ 3,054,196	\$ 548,039	\$ 319,215	\$ 4,156	\$ -	\$ 4,976,805
	December 31, 2018						
	Commercial	Commercial real estate	Commercial construction	Residential real estate	Consumer	Unallocated	Total
	(dollars in thousands)						
Allowance for loan losses							
Individually evaluated for impairment	\$ -	\$ 7	\$ -	\$ 29	\$ -	\$ -	\$ 36
Collectively evaluated for impairment	9,675	17,840	4,519	1,237	2	445	33,718
Acquired portfolio	200	1,000	-	-	-	-	1,200
Acquired with deteriorated credit quality	-	-	-	-	-	-	-
Total	\$ 9,875	\$ 18,847	\$ 4,519	\$ 1,266	\$ 2	\$ 445	\$ 34,954
Gross loans							
Individually evaluated for impairment	\$ 29,896	\$ 18,327	\$ 9,240	\$ 2,469	\$ -	\$ -	\$ 59,932
Collectively evaluated for impairment	949,129	2,500,132	456,149	263,449	2,484	-	4,171,343
Acquired portfolio	7,224	259,708	-	44,073	110	-	311,115
Acquired with deteriorated credit quality	2,509	-	-	-	-	-	2,509
Total	\$ 988,758	\$ 2,778,167	\$ 465,389	\$ 309,991	\$ 2,594	\$ -	\$ 4,544,899

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
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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.

A summary of the activity in the allowance for loan losses by loan segment is as follows:

	Three Months Ended March 31, 2019						
	Commercial	Commercial real estate	Commercial construction	Residential real estate	Consumer	Unallocated	Total
	(dollars in thousands)						
Balance at December 31, 2018	\$ 9,875	\$ 18,847	\$ 4,519	\$ 1,266	\$ 2	\$ 445	\$ 34,954
Charge-offs	-	(2,676)	-	-	-	-	(2,676)
Recoveries	71	-	-	2	7	-	80
Provision for loan losses	(1,286)	5,390	463	(102)	(8)	43	4,500
Balance at March 31, 2019	<u>\$ 8,660</u>	<u>\$ 21,561</u>	<u>\$ 4,982</u>	<u>\$ 1,166</u>	<u>\$ 1</u>	<u>\$ 488</u>	<u>\$ 36,858</u>

	Three Months Ended March 31, 2018						
	Commercial	Commercial real estate	Commercial construction	Residential real estate	Consumer	Unallocated	Total
	(dollars in thousands)						
Balance at December 31, 2017	\$ 8,233	\$ 17,112	\$ 4,747	\$ 1,050	\$ 1	\$ 605	\$ 31,748
Charge-offs	(17,020)	-	-	(18)	-	-	(17,038)
Recoveries	19	-	-	-	-	-	19
Provision for loan losses	17,318	323	25	77	1	56	17,800
Balance at March 31, 2018	<u>\$ 8,550</u>	<u>\$ 17,435</u>	<u>\$ 4,772</u>	<u>\$ 1,109</u>	<u>\$ 2</u>	<u>\$ 661</u>	<u>\$ 32,529</u>

CONNECTONE BANCORP, INC. AND SUBSIDIARIES
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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 troubled debt restructuring remains on nonaccrual status for a period of six 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.

At March 31, 2019, there were no commitments to lend additional funds to borrowers whose loans were on nonaccrual status or were contractually past due 90 days or greater and still accruing interest, or whose terms have been modified in troubled debt restructurings.

As of March 31, 2019, TDRs totaled \$30.9 million, of which \$22.7 million were on nonaccrual status and \$8.2 million were performing under their restructured terms. As of December 31, 2018, TDRs totaled \$34.5 million, of which \$23.3 million were on nonaccrual status and \$11.2 million were performing under their restructured terms. The Company has allocated \$-0- and \$147 thousand of specific allowance for the three months ended March 31, 2019 and March 31, 2018, respectively.

There were no loans modified as TDRs during the three months ended March 31, 2019. There were no charge-offs in connection with a loan modification at the time of modification during the three months ended March 31, 2019. There were no TDRs for which there was a payment default within twelve months following the modification during the three months ended March 31, 2019.

The following table presents loans by class modified as TDRs that occurred during the three months ended March 31, 2018 (dollars in thousands):

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Commercial	3	\$ 2,077	\$ 2,077
Commercial real estate	1	60	60
Commercial construction	2	1,839	1,839
Total	6	\$ 3,976	\$ 3,976

These six loan modifications included interest rate reductions and maturity extensions.

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).



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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 March 31, 2019 and December 31, 2018:

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.

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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 March 31, 2019 and December 31, 2018 are as follows:

		March 31, 2019		
		Fair Value Measurements at Reporting Date Using		
	<u>Total Fair Value</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
(dollars in thousands)				
Recurring fair value measurements:				
Assets				
<u>Investment securities:</u>				
<u>Available-for-sale:</u>				
Federal agency obligations	\$ 43,280	\$ -	\$ 43,280	\$ -
Residential mortgage pass-through securities	253,201	-	253,201	-
Commercial mortgage pass-through securities	6,915	-	6,915	-
Obligations of U.S. states and political subdivision	168,170	-	158,859	9,311
Corporate bonds and notes	35,071	-	35,071	-
Asset-backed securities	8,187	-	8,187	-
Certificates of deposit	150	-	150	-
Other securities	1,565	1,565	-	-
Total available-for-sale	<u>\$ 516,539</u>	<u>\$ 1,565</u>	<u>\$ 505,663</u>	<u>\$ 9,311</u>
Equity securities	11,564	11,564	-	-
Derivatives	768	-	768	-
Total assets	<u>\$ 528,871</u>	<u>\$ 13,129</u>	<u>\$ 506,431</u>	<u>\$ 9,311</u>

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

	December 31, 2018			
	Total Fair Value	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	\$ 44,955	\$ -	\$ 44,955	\$ -
Residential mortgage pass-through securities	185,204	-	185,204	-
Commercial mortgage pass-through securities	3,874	-	3,874	-
Obligations of U.S. states and political subdivision	139,185	-	129,808	9,377
Corporate bonds and notes	25,813	-	25,813	-
Asset-backed securities	9,691	-	9,691	-
Certificates of deposit	322	-	322	-
Other securities	2,990	2,990	-	-
Total available-for-sale	\$ 412,034	\$ 2,990	\$ 399,667	\$ 9,377
Equity securities	11,460	11,460	-	-
Derivatives	1,159	-	1,159	-
Total assets	\$ 424,653	\$ 14,450	\$ 400,826	\$ 9,377

There were no transfers between Level 1 and Level 2 during the quarter ended March 31, 2019 and during the year ended December 31, 2018.

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 March 31, 2019 and December 31, 2018:

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 parts of these loans directly from the purchasing financial institutions (Level 2).

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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 March 31, 2019 and December 31, 2018 are as follows:

	March 31, 2019	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)
<u>Assets measured at fair value on a nonrecurring basis:</u>				
Impaired loans:				
		(dollars in thousands)		
Commercial real estate	\$ 3,949	\$ -	\$ -	\$ 3,949
Residential real estate	231			231

	December 31, 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)
<u>Assets measured at fair value on a nonrecurring basis:</u>				
Impaired loans:				
		(dollars in thousands)		
Commercial real estate	\$ 1,481	\$ -	\$ -	\$ 1,481
Residential real estate	231	-	-	231

Impaired loans – Collateral dependent impaired loans at March 31, 2019 that required a valuation allowance were \$5.0 million with a related valuation allowance of \$1.0 million compared to \$1.7 million with a related valuation allowance of \$36 thousand at December 31, 2018.

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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 three months ended March 31, 2019 and for the year ended December 31, 2018:

	Municipal Securities
	(dollars in thousands)
Beginning balance, January 1, 2019	\$ 9,377
Principal paydowns	(66)
Ending balance, March 31, 2019	\$ 9,311

	Municipal Securities
	(dollars in thousands)
Beginning balance, January 1, 2018	\$ 9,632
Principal paydowns	(255)
Ending balance, December 31, 2018	\$ 9,377

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 March 31, 2019 and December 31, 2018. The table below provides quantitative information about significant unobservable inputs used in fair value measurements within Level 3 hierarchy.

March 31, 2019

	Fair Value	Valuation Techniques	Unobservable Input	Range
		(dollars in thousands)		
Securities available-for-sale:				
Municipal securities	\$ 9,311	Discounted cash flows	Discount rate	2.9%

December 31, 2018

	Fair Value	Valuation Techniques	Unobservable Input	Range
		(dollars in thousands)		
Securities available-for-sale:				
Municipal securities	\$ 9,377	Discounted cash flows	Discount rate	2.9%

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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.

<u>March 31, 2019</u>	<u>Fair Value</u>	<u>Valuation Techniques</u>	<u>Unobservable Input</u>	<u>Range</u>
(dollars in thousands)				
Impaired loans:				
Commercial real estate	\$ 3,949	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%]
(dollars in thousands)				
<u>December 31, 2018</u>	<u>Fair Value</u>	<u>Valuation Techniques</u>	<u>Unobservable Input</u>	<u>Range</u>
Impaired loans:				
Commercial real estate	\$ 1,481	Sales comparison approach	Adjustment for differences between the comparable sales	6% - 9% [8%]
Residential real estate	\$ 231	Sales comparison approach	Adjustment for differences between the comparable sales	0% - 10% [5%]

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

As of March 31, 2019 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 March 31, 2019 and December 31, 2018:

	Fair Value Measurements				
	Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(dollars in thousands)					
March 31, 2019					
Financial assets:					
Cash and due from banks	\$ 172,548	\$ 172,548	\$ 172,548	\$ -	\$ -
Securities available-for-sale	516,539	516,539	1,565	505,663	9,311
Investment in restricted stocks	31,727	n/a	n/a	n/a	n/a
Equity securities	11,564	11,564	11,564	-	-
Net loans	4,935,793	4,875,420	-	-	4,875,420
Derivatives	768	768	-	768	-
Accrued interest receivable	21,198	21,198	-	2,759	18,439
Financial liabilities:					
Noninterest-bearing deposits	833,090	833,090	833,090	-	-
Interest-bearing deposits	3,760,908	3,764,654	2,216,661	1,547,993	-
Borrowings	603,412	603,855	-	603,855	-
Subordinated debentures	128,638	134,962	-	134,962	-
Accrued interest payable	4,869	4,869	-	4,869	-
December 31, 2018					
Financial assets:					
Cash and due from banks	\$ 172,366	\$ 172,366	\$ 172,366	\$ -	\$ -
Securities available-for-sale	412,034	412,034	2,990	399,667	9,377
Investment in restricted stocks	31,136	n/a	n/a	n/a	n/a
Equity securities	11,460	11,460	11,460	-	-
Net loans	4,506,138	4,402,878	-	-	4,402,878
Derivatives	1,159	1,159	-	1,159	-
Accrued interest receivable	18,214	18,214	-	2,064	16,150
Financial liabilities:					
Noninterest-bearing deposits	768,584	768,584	768,584	-	-
Interest-bearing deposits	3,323,508	3,320,640	1,957,503	1,363,137	-
Borrowings	600,001	598,598	-	598,598	-
Subordinated debentures	128,556	132,426	-	132,426	-
Accrued interest payable	6,764	6,764	-	6,764	-



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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, changes in fair value of derivatives 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 Consolidated Statements of Income
	Three Months Ended		
	March 31,		
	2019	2018	
Sale of securities available-for-sale	\$ (8)	\$ -	Net gains on sale of securities available-for-sale
	2	-	Income tax expense
	(6)	-	
Amortization of pension plan net actuarial losses	\$ 89	\$ 91	Salaries and employee benefits
	(25)	(25)	Income tax benefit
	64	66	
Total reclassification	\$ 58	\$ 66	

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Note 8. Comprehensive Income – (continued)

Accumulated other comprehensive loss at March 31, 2019 and December 31, 2018 consisted of the following:

	March 31, 2019	December 31, 2018
	(dollars in thousands)	
Investment securities available-for-sale, net of tax	\$ (1,710)	\$ (5,841)
Cash flow hedge, net of tax	555	837
Defined benefit pension and post-retirement plans, net of tax	(4,125)	(3,785)
Total	\$ (5,280)	\$ (8,789)

Note 9. Premises and Equipment

The Company leases certain premises and equipment under operating leases. At March 31, 2019, the Company had lease liabilities totaling \$16.7 million and right-of-use assets totaling \$15.3 million. For the three months ended March 31, 2019, the weighted average remaining lease term for operating leases was 7.3 years and the weighted average discount rate used in the measurement of operating lease liabilities was 3.0%. Total lease costs for the three months ended March 31, 2019 was \$0.8 million.

Rent expense for the three months ended March 31, 2018, prior to adoption of ASU 2016-02, was \$0.5 million.

There were no sale and leaseback transactions, leveraged leases or lease transactions with related parties during the three months ended March 31, 2019.

At maturity analysis of operating lease liabilities and reconciliation of the undiscounted cash flows to the total operating lease liability is as follows:

	March 31, 2019
	(dollars in thousands)
Lease payments due:	
Less than 1 year	\$ 2,693
1 year through less than 2 years	2,568
2 years through less than 3 years	2,418
3 years through less than 4 years	2,129
4 years through 5 years	2,143
After 5 years	7,030
Total undiscounted cash flows	18,981
Discounted cash flows	(2,262)
Total lease liability	\$ 16,719

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Note 10. Stock Based Compensation

The Company's stockholders approved the 2017 Equity Compensation Plan ("the Plan") on May 23, 2017. The Plan eliminates all remaining issuable shares under previous plans and is the only outstanding plan as of March 31, 2019. The maximum number of shares of common stock or equivalents which may be issued under the Plan, is 750,000. Grants under the Plan can be in the form of stock options (qualified or non-qualified), restricted shares, restricted share units or performance units. Shares available for grant and issuance under the Plan as of March 31, 2019 are approximately 535,300. The Company intends to issue all shares under the Plan in the form of newly issued shares.

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. Stock-based compensation expense for the three months ended March 31, 2019 and March 31, 2018 was \$0.8 million and \$(0.4) million, respectively.

Activity under the Company's options as of and for the three months ended March 31, 2019 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, 2018	108,463	\$ 8.35		
Granted	-	-		
Exercised	(21,991)	7.84		
Forfeited/cancelled/expired	-	-		
Outstanding at March 31, 2019	<u>86,472</u>	8.48	2.9	\$ 970,370
Exercisable at March 31, 2019	<u>86,472</u>	\$ 8.48	2.9	\$ 970,370

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 March 31, 2019 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 March 31, 2019. This amount changes based on the fair market value of the Company's stock.

Activity under the Company's restricted shares for the three months ended March 31, 2019 was as follows:

	Nonvested Shares	Weighted- Average Grant Date Fair Value
Nonvested at December 31, 2018	68,428	\$ 23.04
Granted	42,483	19.88
Vested	(46,352)	21.98
Forfeited/cancelled/expired	-	-
Nonvested March 31, 2019	<u>64,559</u>	\$ 21.77

As of March 31, 2019, there was approximately \$1,340,000 of total unrecognized compensation cost related to nonvested restricted shares granted. The cost is expected to be recognized over a weighted average period of 1.5 years. A total of 42,483 restricted shares were granted during

the quarter ended March 31, 2019.

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Note 10. Stock Based Compensation

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, 2018	86,009		\$ 22.06
Awarded	35,636		20.79
Change in estimate	11,005		17.02
Vested	(52,508)		21.26
Unearned at March 31, 2019	<u>80,142</u>	<u>120,213</u>	\$ 23.98

At March 31, 2019, the specific number of shares related to performance units that were expected to vest was 80,142, 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 March 31, 2019 the maximum amount of performance units that ultimately could vest if performance targets were exceeded is 120,213. A total of 25,991 shares were netted from the vested shares to satisfy tax obligations. The net issuance of performance units issued during the three months ended March 31, 2019 were 26,517 shares.

At March 31, 2019, compensation cost of approximately \$1.4 million 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 35,636 performance units were awarded during the three months ended March 31, 2019.

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, 2018	29,423	\$ 31.35
Awarded	53,454	20.79
Forfeited	-	-
Vested	(9,808)	21.28
Unearned at March 31, 2019	<u>73,069</u>	\$ 23.62

At March 31, 2019, the specific number of shares related to restricted stock units that were expected to vest was approximately 73,069. Any forfeitures would result in previously recognized expense being reversed. A portion of the shares that vest will be netted out to satisfy the tax obligations of the recipient. During the three months ended March 31, 2019 a total of 4,904 shares were netted out to satisfy tax obligations, resulting in net issuance of 4,904 shares.

At March 31, 2019, compensation cost of approximately \$1.7 million related to non-vested restricted stock units, not yet recognized, is expected to be recognized over a weighted-average period of 1.8 years. A total of 53,454 restricted stock units were awarded during the quarter ended March 31, 2019.

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Note 11. 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 March 31,		Affected Line Item in the Consolidated Statements of Income
	2019	2018	
	(dollars in thousands)		
Service cost	\$ -	\$ -	
Interest cost	113	107	Other components of net periodic pension expense
Expected return on plan assets	(174)	(191)	Other components of net periodic pension expense
Net amortization	89	91	Other components of net periodic pension expense
Total periodic pension cost	<u>\$ 28</u>	<u>\$ 7</u>	

Contributions

The Company did not make a contribution to the Pension Trust during the three months ended March 31, 2019. The Company does not plan on contributing amounts to the Pension Trust for the remainder of 2019. 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.

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Note 12. FHLB Borrowings

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

	March 31, 2019		December 31, 2018	
	Amount	Rate	Amount	Rate
	(dollars in thousands)			
Total FHLB borrowings	\$ 603,412	2.60%	\$ 600,001	2.59%
By remaining period to maturity:				
Less than 1 year	\$ 439,159	2.58%	\$ 405,000	2.57%
1 year through less than 2 years	81,000	2.85%	110,000	2.75%
2 years through less than 3 years	46,000	2.15%	60,000	2.27%
3 years through less than 4 years	9,804	2.48%	-	-
4 years through 5 years	25,000	2.92%	25,000	2.92%
After 5 years	2,926	2.43%	-	-
Total FHLB borrowings	603,889	2.60%	600,000	2.59%
Fair value (discount) premium	(477)		1	
FHLB borrowings, net	\$ 603,412		\$ 600,001	

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 March 31, 2019 were primarily collateralized by approximately \$1.9 billion of commercial mortgage loans, net of required over collateralization amounts, under a blanket lien arrangement. At March 31, 2019 the Company had remaining borrowing capacity of approximately \$1.0 billion at FHLB.

Note 13. 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.

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Note 13. Revenue Recognition – (continued)

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 ended March 31, 2019 and 2018. Items outside of ASC 606 are noted as such.

	Three Months Ended March 31, 2019	Three Months Ended March 31, 2018
(dollars in thousands)		
Noninterest income		
Service charges on deposits		
Overdraft fees	\$ 274	\$ 202
Other	180	155
Interchange income	156	143
Net gains on sales of loans ⁽¹⁾	19	17
Net gains (losses) on equity securities ⁽¹⁾	103	(120)
Net gains on sale of securities available-for-sale ⁽¹⁾	8	-
Wire transfer fees ⁽¹⁾	117	72
Loan servicing fees ⁽¹⁾	32	23
Bank owned life insurance ⁽¹⁾	822	774
Other	27	21
Total noninterest income	\$ 1,738	\$ 1,287

⁽¹⁾ Not within scope of ASC 606

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.

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Note 14. 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 March 31, 2019 was 5.60%. 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 March 31, 2019 and December 31, 2018.

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 March 31, 2019, unamortized costs related to this debt issuance were approximately \$227,000.

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 March 31, 2019, unamortized costs related to this debt issuance were approximately \$1,291,000.

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Note 15. 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 March 31, 2019 and December 31, 2018:

	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)						
March 31, 2019						
Assets:						
Interest rate swaps	\$ 768	\$ -	\$ 768	\$ -	\$ -	\$ 768
December 31, 2018						
Assets:						
Interest rate swaps	\$ 1,159	\$ -	\$ 1,159	\$ -	\$ -	\$ 1,159

As of March 31, 2019 and December 31, 2018, 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 March 31, 2019 and December 31, 2018. 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; (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, business combinations, 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.

Business Combinations: We account for business combinations under the acquisition method of accounting. Using this method, assets acquired, liabilities assumed and consideration paid are recorded at their estimated fair values as of the acquisition date. The application of this method of accounting requires the use of significant estimates and assumptions. The application of the acquisition method of accounting usually results in the recognition of goodwill and a core deposit intangible (if the acquiree has deposits). The amount of goodwill recorded represents the excess purchase price over the estimated fair value of the net assets acquired, including any identifiable intangibles, if applicable. Goodwill is not amortized for book purposes; however, it is reviewed at least annually for impairment and is usually not deductible for tax purposes.

The assets acquired and liabilities assumed and consideration paid in the acquisition are recorded at their estimated fair values based on management's best estimates using information available at the date of the acquisition and are subject to adjustment for up to one year after the closing date of the acquisition. Our estimates are based upon assumptions that we believe to be reasonable and the Company may use an outside servicer provider to assist with the valuations.

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, 2018 includes additional discussion on the accounting for income taxes.

Operating Results Overview

On January 2, 2019, the acquisition of Greater Hudson Bank was completed and first quarter 2019 results reflect the operations of the combined entity. Historical financial information includes only the operations of ConnectOne Bank.

Net income for the three months ended March 31, 2019 was \$11.6 million compared to \$4.3 million for the comparable three-month period ended March 31, 2018. The Company's diluted earnings per share were \$0.33 for the three months ended March 31, 2019 as compared with diluted earnings per share of \$0.13 for the comparable three-month period ended March 31, 2018. The increase in net income and diluted earnings per share was primarily attributable to a decrease in provision for loan losses and an increase in net interest income, partially offset by an increase in noninterest expenses and income tax expenses. The decrease in provision for loan losses was primarily attributable to provisioning related to the taxi medallion portfolio for the three months ended March 31, 2018.

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 March 31, 2019 increased by \$6.9 million, or 17.9%, from the comparable three-month period ended March 31, 2018, resulting from an increase in average interest-earning assets of 15.1%, primarily loans, and a widening of the net interest margin of 8 basis-points to 3.34% from 3.26%. Included in net interest income was accretion and amortization of purchase accounting adjustments of \$1.2 million during the three months ended March 31, 2019 and \$0.2 million during the comparable three-month period ended March 31, 2018. Excluding these purchase accounting adjustments, the adjusted net interest margin was 3.25% in the first quarter of 2019, widening by 1 basis-point from the first quarter of 2018 adjusted net interest margin of 3.24%. The increase in the adjusted net interest margin was primarily attributable to an improved asset-mix, a higher yield earned on interest-earning assets and growth in noninterest-bearing deposits, partially offset by higher funding costs, primarily due to both increases in short-term interest rates and increased deposit competition.

The following tables, “Average Statements of Condition with Interest and Average Rates”, present for the three months ended March 31, 2019 and 2018, 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 March 31,					
	2019		2018			
	Average	Interest	Average	Average	Interest	Average
	Balance	Income/ Expense	Rate ⁽⁸⁾	Balance	Income/ Expense	Rate ⁽⁸⁾
(dollars in thousands)						
Interest-earning assets:						
Securities ^{(1) (2)}	\$ 531,083	\$ 4,369	3.34%	\$ 441,563	\$ 2,917	2.68%
Total loans ^{(2) (3) (4)}	4,907,683	60,597	5.01	4,247,997	47,272	4.51
Federal funds sold and interest-bearing with banks	57,690	357	2.51	78,194	264	1.37
Restricted investment in bank stocks	26,478	457	7.00	31,699	485	6.21
Total interest-earning assets	5,522,934	65,780	4.83	4,799,453	50,938	4.30
Noninterest-earning assets:						
Allowance for loan losses	(35,499)			(32,113)		
Other noninterest-earning assets	421,626			321,483		
Total assets	<u>\$ 5,909,061</u>			<u>\$ 5,088,823</u>		
Interest-bearing liabilities:						
Interest-bearing deposits:						
Time deposits	\$ 1,515,249	8,303	2.22	\$ 1,207,368	4,788	1.61
Other interest-bearing deposits	2,236,630	7,048	1.28	1,815,122	2,900	0.65
Total interest-bearing deposits	3,751,879	15,351	1.66	3,022,490	7,688	1.03
Borrowings	486,687	3,024	2.52	630,117	2,926	1.88
Subordinated debentures ⁽⁵⁾	128,585	1,845	5.82	115,182	1,674	5.89
Finance lease	2,479	37	6.05	2,622	40	6.03
Total interest-bearing liabilities	4,369,630	20,257	1.88	3,770,411	12,328	1.33
Demand deposits	824,115			724,471		
Other liabilities	35,148			18,912		
Total noninterest-bearing liabilities	859,263			743,383		
Stockholders’ equity	680,168			575,029		
Total liabilities and stockholders’ equity	<u>\$ 5,909,061</u>			<u>\$ 5,088,823</u>		
Net interest income (tax-equivalent basis)		45,523			38,610	
Net interest spread ⁽⁶⁾			2.95%			2.97%
Net interest margin ⁽⁷⁾			3.34%			3.26%
Tax-equivalent adjustment		(571)			(463)	
Net interest income		<u>\$ 44,952</u>			<u>\$ 38,147</u>	

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

(2) Interest income is presented on a tax-equivalent basis using a 21% federal tax rate.

(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 \$1,570 and \$1,639 for the three months ended March 31, 2019 and March 31, 2018, respectively. Amortization expense related to debt issuance costs included in interest expense was \$83 and \$86 for the three months ended March 31, 2019 and March 31, 2018, 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.

Noninterest Income

Noninterest income totaled \$1.7 million for the three months ended March 31, 2019, compared with \$1.3 million for the three months ended March 31, 2018. Noninterest income consists of income on bank owned life insurance, net gains on sales of loans held-for-sale, net gains (losses) on equity securities and deposit service fees, loan fees, and other income. The increase from the prior year first quarter was mainly attributable to increases in gains on equity securities and deposit, loan and other income.

Noninterest Expenses

Noninterest expenses totaled \$28.1 million for the three months ended March 31, 2019, compared to \$16.9 million for the three months ended March 31, 2018. Noninterest expenses increased by \$11.1 million from the prior year first quarter due primarily to \$7.6 million in merger expenses, an increase of \$2.3 million in salaries and employee benefits, \$0.5 million in professional and consulting, \$0.4 million in occupancy and equipment and \$0.3 million in other expenses. These increases were all primarily attributable to the expansion of our franchise through the acquisition of Greater Hudson Bank.

Income Taxes

Income tax expense was \$2.5 million for the three months ended March 31, 2019, compared to \$0.4 million for the three months ended March 31, 2018. The increase in income tax expense was primarily the result of an increase in pretax income when compared to the prior year first quarter. The effective tax rate for the three months ended March 31, 2019 and March 31, 2018 was 17.6% and 9.5%, respectively.

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.

	March 31, 2019		December 31, 2018		Amount
	Amount	%	Amount	%	Increase/ (Decrease)
	(dollars in thousands)				
Commercial	\$ 1,051,199	21.1%	\$ 988,758	21.8%	\$ 62,441
Commercial real estate	3,054,196	61.4	2,778,167	61.1	276,029
Commercial construction	548,039	11.0	465,389	10.2	82,650
Residential real estate	319,215	6.4	309,991	6.8	9,224
Consumer	4,156	0.1	2,594	0.1	1,562
Gross loans	<u>\$ 4,976,805</u>	<u>100.0%</u>	<u>\$ 4,544,899</u>	<u>100.0%</u>	<u>\$ 431,906</u>

At March 31, 2019, gross loans totaled \$5.0 billion, an increase of \$432 million, or 9.5%, as compared to December 31, 2018. Net loan growth was primarily attributable to the Greater Hudson Bank acquisition, with increases in commercial real estate (\$276 million), commercial construction (\$83 million), commercial loans (\$62 million), and residential real estate and consumer (\$11 million).

At March 31, 2019, acquired loans within the loan portfolio totaled \$0.7 billion, compared to \$0.3 billion as of December 31, 2018. The increase was attributable to the Greater Hudson Bank acquisition.

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 March 31, 2019, the ALLL was \$36.9 million as compared to \$35.0 million at December 31, 2018. The provision for loan losses for the three months ended March 31, 2019 was \$4.5 million, compared to \$17.8 million for the three months ended March 31, 2018. The decrease in the provision for loan losses was primarily attributable to \$17.0 million of provision related to the taxi medallion loan portfolio for the three months ended March 31, 2018, offset by a \$3.0 million provision related to a single loan secured by a commercial office building for the three months ended March 31, 2019.

There were \$2.6 million in net charge-offs for the three months ended March 31, 2019, compared with \$17.0 million in net loan charge-offs for the three months ended March 31, 2018. Net charge-offs for the three months ended March 31, 2018 were in the taxi medallion loan portfolio, resulting from a decrease 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 0.74% at March 31, 2019 compared to 0.77% at December 31, 2018 and 0.77 % at March 31, 2018.

The level of the allowance for the respective periods of 2019 and 2018 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 March 31, 2019 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 March 31,	
	2019	2018
	(dollars in thousands)	
Average loans receivable at end of period	\$ 4,907,559	\$ 4,223,231
Analysis of the ALLL:		
Balance - beginning of quarter	\$ 34,954	\$ 31,748
Charge-offs:		
Commercial	-	(17,020)
Commercial real estate	(2,676)	-
Residential real estate	-	(18)
Total charge-offs	(2,676)	(17,038)
Recoveries:		
Commercial	71	19
Residential real estate	2	-
Consumer	7	-
Total recoveries	80	19
Net recoveries (charge-offs)	(2,596)	(17,019)
Provision for loan and losses	4,500	17,800
Balance - end of period	\$ 36,858	\$ 32,529
Ratio of annualized net charge-offs during the period to average loans receivable during the period	0.21%	1.63%

Loans receivable	\$ 4,972,651	\$ 4,202,679
ALLL as a percentage of loans receivable	0.74%	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:

	March 31, 2019	December 31, 2018
	(dollars in thousands)	
Nonaccrual loans	\$ 47,680	\$ 51,855
OREO	-	-
Total nonperforming assets ⁽¹⁾	<u>\$ 47,680</u>	<u>\$ 51,855</u>
Performing TDRs	<u>\$ 8,191</u>	<u>\$ 11,165</u>
Loans 90 days or greater past due and still accruing (non-PCI)	<u>\$ 50</u>	<u>\$ -</u>
Loans 90 days or greater past due and still accruing (PCI)	<u>\$ 5,398</u>	<u>\$ 1,647</u>

⁽¹⁾ Nonperforming assets are defined as nonaccrual loans and OREO.

Nonaccrual loans to total loans receivable	0.96%	1.14%
Nonperforming assets to total assets	0.79%	0.95%
Nonperforming assets, performing TDRs, and loans 90 days or greater past due and still accruing to loans receivable	1.23%	1.42%

Securities Available-For-Sale

As of March 31, 2019, 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 March 31, 2019, average securities increased \$89.5 million to approximately \$531.1 million, or 9.6% of average total interest-earning assets, from approximately \$441.6 million, or 9.2% of average interest-earning assets, for the comparable period in 2018.

At March 31, 2019, net unrealized losses on securities available-for-sale, which are carried as a component of accumulated other comprehensive loss and included in stockholders' equity, net of tax, amounted to \$1.7 million as compared with net unrealized losses of \$5.8 million at December 31, 2018. The decrease 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 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 March 31, 2019 and December 31, 2018, 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 March 31, 2019, 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 2.62%, while a 100 basis-point instantaneous decrease in interest rates would decrease net interest income by 2.00%. As of December 31, 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 0.40%, while a 100 basis-point instantaneous decrease in interest rates would decrease net interest income by 1.21%.

Based on our model, which was run as of March 31, 2019, 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 3.17%, while a 100 basis-point instantaneous decrease in interest rates would decrease net interest income by 2.68%. As of December 31, 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 1.59%, while a 100 basis-point instantaneous decrease in interest rates would decrease net interest income by 2.17%.

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 March 31, 2019, would decline by 9.51% with an instantaneous rate shock of up 200 basis points, and increase by 2.93% with an instantaneous rate shock of down 100 basis points. Our EVE as of December 31, 2018, would decline by 12.01% with an instantaneous rate shock of up 200 basis points, and increase by 3.15% 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 March 31, 2019.

Interest Rates (basis points)	Estimated EVE	Estimated Change in EVE		Interest Rates (basis points)	Estimated NII	Estimated Change in NII	
		Amount	%			Amount	%
+300	\$ 567,668	\$ (99,551)	(14.92)	+300	\$ 186,930	\$ 6,428	3.56
+200	603,775	(63,444)	(9.51)	+200	185,233	4,731	2.62
+100	638,871	(28,348)	(4.25)	+100	183,377	2,875	1.59
0	667,219	-	0.0	0	180,502	-	0.0
-100	686,789	19,570	2.93	-100	176,892	(3,610)	(2.00)

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 requires 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 March 31, 2019, 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 March 31, 2019, liquid assets (cash and due from banks, interest-bearing deposits with banks and unencumbered investment securities) were \$556.0 million, which represented 9.2% of total assets and 10.7% of total deposits and borrowings, compared to \$441.4 million as of December 31, 2018, which represented 8.1% of total assets and 9.4% 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 March 31, 2019, had the ability to borrow \$1.9 billion. In addition, at March 31, 2019, 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 \$7.7 million. At March 31, 2019, the Bank had aggregate available and unused credit of approximately \$1.0 billion, which represents the aforementioned facilities totaling \$1.9 billion net of \$952.7 million in outstanding borrowings and letters of credit. At March 31, 2019, outstanding commitments for the Bank to extend credit were approximately \$954.0 million.

Cash and cash equivalents totaled \$172.5 million at March 31, 2019, increasing by \$0.2 million from \$172.4 million at December 31, 2018. Operating activities provided \$13.0 million in net cash. Investing activities used \$35.3 million in net cash, primarily reflecting an increase in loans and net cash flow from the securities portfolio. Financing activities provided \$22.5 million in net cash, primarily reflecting a net increase in deposits.

Deposits

Total deposits increased by \$502 million, or 12.3%, to \$4.6 billion at March 31, 2019 from December 31, 2018. The increase was primarily attributable the acquisition of Greater Hudson Bank. The following table sets forth the composition of our deposit base by the periods indicated.

	March 31, 2019		December 31, 2018		Amount Increase/ (Decrease) 2019 vs. 2018
	Amount	%	Amount	%	
(dollars in thousands)					
Demand, noninterest-bearing	\$ 833,090	18.1%	\$ 768,584	18.8%	\$ 64,506
Demand, interest-bearing	901,836	19.6	845,424	20.7	56,412
Money market	1,141,898	24.9	951,276	23.2	190,622
Savings	172,927	3.8	160,755	3.9	12,172
Time	<u>1,544,247</u>	<u>33.6</u>	<u>1,366,053</u>	<u>33.4</u>	<u>178,194</u>
Total deposits	<u>\$ 4,593,998</u>	<u>100.0%</u>	<u>\$ 4,092,092</u>	<u>100.0%</u>	<u>\$ 501,906</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 March 31, 2019 was 5.60%.

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 \$682 million at March 31, 2019, an increase of \$68 million from December 31, 2018. The increase in stockholders' equity was primarily attributable to the acquisition of Greater Hudson Bank. As of March 31, 2019, the Company's tangible common equity ratio and tangible book value per share were 8.83% and \$14.67, respectively. As of December 31, 2018, the tangible common equity ratio and tangible book value per share were 8.77% and \$14.42, respectively. Total goodwill and other intangible assets were approximately \$163 million as of March 31, 2019 and \$148 million at December 31, 2018.

	March 31, 2019	December 31, 2018
	(dollars in thousands, except for share and per share data)	
Stockholders' equity	\$ 682,395	\$ 613,927
Less: Goodwill and other intangible assets	162,747	147,646
Tangible common stockholders' equity	<u>\$ 519,648</u>	<u>\$ 466,281</u>
Common stock outstanding at period end	35,443,933	32,328,542
Book value per common share	\$ 19.25	\$ 18.99
Less: Goodwill and other intangible assets	4.59	4.57
Tangible book value per common share	<u>\$ 14.66</u>	<u>\$ 14.42</u>

In March 2019, the Board of Directors of the Company approved a stock repurchase program for up to 1,200,000 shares. The Company may repurchase shares from time to time in the open market, in privately negotiated stock purchases or pursuant to any trading plan that may be adopted in accordance with Rule 10b5-1 of the Securities and Exchange Commission and applicable federal securities laws. The share repurchase plan does not obligate the Company to acquire any particular amount of common stock, and it may be modified or suspended at any time at the Company's discretion. Pursuant to this plan, in March 2019 the Company repurchased 13,000 shares at an average price of \$19.13 per share. As of March 31, 2019, the Company had authorization to repurchase an additional 1,187,000 shares under the plan.

The following table details stock repurchases during the three months ended March 31, 2019:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
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January 1, 2019 through January 31, 2019	-	-	-	-	
February 1, 2019 through February 28, 2019	-	-	-	-	
March 1, 2019 through March 31, 2019	13,000	\$	19.13	13,000	1,187,000

Regulatory Capital and Capital Adequacy

The maintenance of a solid capital foundation is a primary goal for the Company. Accordingly, capital plans, stock repurchases 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 March 31, 2019 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 March 31, 2019	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	\$ 524,089	9.12%	\$ 229,878	4.00%	N/A	N/A
CET I risk-based ratio	518,934	9.68	241,276	4.50	N/A	N/A
Tier 1 risk-based capital	524,089	9.77	321,701	6.00	N/A	N/A
Total risk-based capital	685,947	12.79	428,935	8.00	N/A	N/A

At March 31, 2019	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	\$ 599,115	10.43%	\$ 229,857	4.00%	\$ 287,322	5.00%
CET I risk-based ratio	599,115	11.17	241,269	4.50	348,499	6.50
Tier 1 risk-based capital	599,115	11.17	321,691	6.00	428,922	8.00
Total risk-based capital	668,223	12.46	428,922	8.00	536,152	10.00

N/A - not applicable

As of March 31, 2019, 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. Beginning January 1, 2019, the Company and the Bank are required to maintain a 2.5% capital conservation buffer, above and beyond the capital levels otherwise required under applicable regulation. 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 March 31, 2019 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 1.27% above the minimum buffer ratio and, at the Bank, the lowest ratio was the Total Risk Based Capital Ratio which was 1.96% 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 Operations- 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

The Company is not subject to any legal proceedings, which could have a materially adverse impact on its results of operations and financial condition.

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.

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: May 7, 2019

Date: May 7, 2019

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

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: May 7, 2019

/s/ Frank Sorrentino III

Frank Sorrentino III

Chairman and Chief Executive Officer

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

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: May 7, 2019

/s/ William S. Burns

William S. Burns

Executive Vice President and Chief Financial Officer

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

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 March 31, 2019 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: May 7, 2019

/s/ Frank Sorrentino III

Frank Sorrentino III

Chairman and Chief Executive Officer

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

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 March 31, 2019 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: May 7, 2019

/s/ William S. Burns

William S. Burns
Executive Vice President and Chief Financial Officer

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