

Cambridge Bancorp

2016 ANNUAL REPORT



Year at a Glance

Financial Performance

Year End	2012	2013	2014	2015	2016
(Dollars in thousands, except per share data)					
Total Assets	\$1,417,986	\$1,533,710	\$1,573,692	\$1,706,201	\$1,848,999
Total Deposits	\$1,281,333	\$1,409,047	\$1,370,536	\$1,557,224	\$1,686,038
Total Loans	\$ 742,249	\$ 942,451	\$1,080,766	\$1,192,214	\$1,320,154
Non-interest Income	\$ 20,489	\$ 23,181	\$ 24,464	\$ 25,865	\$ 28,661
Net Income	\$ 13,403	\$ 14,140	\$ 14,944	\$ 15,694	\$ 16,896
Diluted Earnings Per Share	\$ 3.45	\$ 3.62	\$ 3.78	\$ 3.93	\$ 4.15
Dividends Declared Per Share	\$ 1.50	\$ 1.59	\$ 1.68	\$ 1.80	\$ 1.84
Book Value Per Share	\$ 27.21	\$ 28.13	\$ 29.50	\$ 31.26	\$ 33.36
Net Interest Margin	3.58%	3.35%	3.33%	3.27%	3.18%
Return/Average Assets	1.00%	0.99%	0.98%	0.95%	0.95%
Return/Average Equity	13.39%	13.63%	12.87%	12.91%	12.77%

Wealth Management

Year	Gross Revenues (in thousands)	Managed Assets (in millions)
2012	\$ 14,110	\$ 1,795
2013	\$ 16,265	\$ 2,140
2014	\$ 17,954	\$ 2,290
2015	\$ 19,242	\$ 2,329
2016	\$ 20,389	\$ 2,573

Asset Quality

Year End	2012	2013	2014	2015	2016
(Dollars in thousands)					
Non-Performing Loans	\$ 1,570	\$ 1,703	\$ 1,629	\$ 1,481	\$ 1,676
Non-Performing Loans/Total Loans	0.21%	0.18%	0.15%	0.12%	0.13%
Net Charge-Offs/(Recoveries)	\$ 11	\$ (260)	\$ (11)	\$ 153	\$ 62
Allowance/Total Loans	1.47%	1.35%	1.32%	1.27%	1.16%

2016 President's Letter

Living in the New England area, we can regularly see visible signs of the basic good health of our communities. As those of you who have visited us in the past year already know, there is growth and renewal taking place all around us, particularly in the neighborhood of our main office. We have also seen growth in the ways that our communities have come together to help one another, as in the wake of last December's fire in East Cambridge.

Here at the Bank, we are constantly engaged in the pursuit of financial growth for our clients. The best way to sustain the conditions under which even further growth can occur is for us to grow as a company. We grow in order to be better, not for the purpose of being bigger. That means growing with care. Visible growth marks success in the unseen factors that made it possible, especially the care that we have taken to shape our growth in a way that is consistent with our traditions.

I am pleased to report the evidence that we have been growing with care over the past year. 2016 represented another year of progress and strong financial performance at Cambridge Bancorp. It also represented a year of significant change, with a number of director and executive retirements and, more broadly, significant industry-wide shifts in client behavior and preferences. Cambridge Bancorp welcomes the opportunity to adapt to these changes while maintaining the best of our traditions. As we make and execute decisions, we keep every client's interest and service foremost in our thoughts and actions.



Financial Performance

In 2016, Cambridge Bancorp reported net income of \$16.9 million, which represents an increase of 7.7% over 2015. The Bank's balance sheet experienced strong growth, with total loans growing by 10.7% and total deposits growing at 8.3%. Non-interest income, led by Wealth Management revenue, grew by 11% and amounted to 35% of total revenue. The Company's performance metrics remained strong, with return on average assets and return on average equity amounting to 0.95% and 12.77%, respectively. Simultaneously, we maintained stellar balance sheet quality with adequate capital levels as well as continued low levels of non-performing loans.

\$16.9
million
net income

In last year's letter, I mentioned a number of strategic changes that we have made in order to improve the Bank's ability to weather a rising rate environment. These initiatives continued in 2016 to great effect. First, we shortened the duration of our commercial loan portfolio by using interest rate derivatives. This provides our clients with longer term financing, while providing the Bank with the opportunity to achieve a variable rate of interest on these loans.

Second, we implemented a strategy to sell the majority of our long-term residential mortgages to the secondary market. This offers our clients an opportunity to benefit from long term mortgages, serviced by Cambridge Trust Company when possible, while limiting the Bank's exposure in a rising rate environment.

These strategies have grown out of our focus on strong core deposit relationships with our clients, as well as our commitment to improving our readiness for rising interest rates. We can have confidence in our improved preparedness while remaining attentive to future speed, amount, and volatility in changes to interest rates yet to come.

Wealth Management

Cambridge Trust's Wealth Management division had a terrific year. Assets under management increased by 10% to \$2.6 billion, driven by market performance and record new business generation. With its focus on capital preservation and premium high-quality service for clients, our strategy made a considerable impact in 2016. Wealth Management revenue grew to \$20.4 million, an increase of 6% from 2015.

\$2.6
billion
assets under
management

Of significant note, Mike Duca, Executive Vice President of Wealth Management, retired in early 2017 and has been succeeded by Jennifer Pline. Jennifer will lead the Bank's Wealth Management Group well into the future. She joins us from Harvard Management Company, where she was the Managing Director and Chief Trust and Gifts Officer. Mike and Jennifer have been working closely together to ensure a smooth transition.

Commercial Banking

In 2016, Commercial Banking had a strong year of growth while maintaining outstanding asset quality. Total loans grew by \$122.4 million, or 22%, with commercial real estate representing the majority of that growth – an increase of \$105 million, or 21%.



2016 also brought a renewed focus on building greater diversification in the commercial lending portfolio. We invested in commercial and industrial lending, innovation banking, and, in the latter part of the year, asset-based lending. These lending strategies are reflected in the broad commercial and industrial lending category, which grew by \$17 million, or 41%. We recognize that our initiatives entail different and greater complexity of risk, and are taking the appropriate steps to grow with care, buttressed by strong risk management.

We maintained our focus on growth in business deposits in 2016, which grew by \$84.6 million, or 16%. Total business deposits are \$598.6 million and represent an important 36% of total deposits. We will continue to focus on growth in business deposits as an important funding source for the balance sheet.

Consumer Banking

In 2016, total deposits grew to \$1.69 billion, an increase of \$128.8 million, or 8.3%. We maintained our focus on building deeper core banking relationships with our clients, as demonstrated by growth in total core deposits to \$1.51 billion, or 9.9% in growth.

We deeply value the trust that our clients place in us to manage their resources with care. Our rapidly evolving digital world allows for less personal engagement. Thus, we especially value the time that our clients spend with us. We enjoy listening and learning. Hearing about our client's life-changes and challenges allows us to fine-tune the service and advice that we provide. At Cambridge Trust Company, we are there for our clients when they need us to assist with the financial complexity in their lives. Our commitment to relationships is not just a principle. We take pride in being able to carry it out in practice. This takes the guesswork out of seeking advice. "Life happens," and we can be counted on to offer our best counsel when it does.

My colleagues in consumer lending have been busy with residential loan originations, amounting to \$143.5 million, an increase of \$5.8 million or 4%. \$59 million was sold in the secondary market, generating non-interest revenue of \$0.9 million, an increase of 50% from 2015. The home equity loan portfolio also grew to \$75 million, an increase of 18%.

2017 will see the relocation of our branch in Kendall Square as part of MIT's ambitious development on Main Street. Our new location will provide us with an opportunity to test a new branch model that is better suited to that highly innovative and young community. We are treating this branch as a laboratory in which to try out new ideas. Accordingly, it will look very different from any of our existing branches. The branch will emphasize technology, as well as our legendary personal service. It will also include a number of conference rooms to be made available to business and non-profit clients.

Community

In 2016, we maintained our active commitment to our communities through our volunteer efforts and financial contributions to over 230 non-profits and organizations. We care deeply about our communities, as reflected in our direct financial contributions, community development lending, low-income housing lending, and other modes of community involvement. Among the many examples of community collaboration during the past year, we are especially pleased to have chaired the

**"Our
commitment
to relationships
is not just a
principle. We
take pride in
being able to
carry it out in
practice."**



Cambridge Housing Assistance Fund annual appeal. Along with local banks, real estate agents, real estate developers, and the broader business community, as well as citizens of Cambridge, we raised \$186,000 for this terrific cause.

Stock Registration

As mentioned in my last quarterly report, we are actively looking at the merits of registering Cambridge Bancorp with the Securities and Exchange Commission. The potential benefits of moving our stock listing to a more prominent stock exchange include improved access to capital, as well as greater stock liquidity and valuation over time. While there are financial and distraction costs associated with such a venture, we plan to make a decision based on the best interest of the Bank as a whole. There are no plans to raise capital at this time. If, in the future, we choose to register, this course of action would open new doors through which to create demand for Cambridge Bancorp stock. With respect to transparency, you will note a more detailed proxy statement this year. This includes detail regarding the Bank's executive compensation and the sound practices implemented by the active committees of our Board of Directors. We are proud of these governance practices, and I hope you will agree that they are among the best in class.

Our People

In 2016 and early 2017, we experienced significant transitions in management and our Board of Directors due to retirements.

The management team saw significant change with the retirement of Noreen Briand, Senior Vice President of Human Resources; Al Rietheimer, Chief Financial Officer; Michael Duca, Executive Vice President of Wealth Management; and Jim Spencer, Chief Investment Officer. They each provided many years of dedicated service to Cambridge Trust Company. I thank them and wish them well in their retirements.

We welcome Pilar Pueyo, Senior Vice President of Human Resources; Michael Carotenuto, Chief Financial Officer; and Jennifer Pline, Executive Vice President of Wealth Management.

Our Board of Directors also experienced change, with the retirements of Robert Bettacchi, Kathryn Willmore, and Byron Woodman, Jr. We are pleased to welcome Edward Jankowski, Cathleen Schmidt, and Susan Windham-Bannister to the Board. I thank Bob, Kathryn and Byron for their dedicated service, counsel, and guidance to the Company, its clients, employees, and shareholders over many years.

We look forward to a great year to come.

Thank you for your ongoing support,



Denis K. Sheahan
President and CEO
March 3, 2017

**“We grow
in order to
be better,
not for the
purpose of
being bigger.
That means
growing
with care.”**



Independent Auditors' Report

The Board of Directors
Cambridge Bancorp:

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Cambridge Bancorp and its subsidiaries (the Company), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cambridge Bancorp and its subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

Report on Other Legal and Regulatory Requirements

We also have audited in accordance with auditing standards generally accepted in the United States of America, Cambridge Trust Company (the Bank)'s internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 27, 2017 expressed an unqualified opinion on the effectiveness of the Bank's internal control over financial reporting.

KPMG LLP

Boston, Massachusetts
February 27, 2017

CAMBRIDGE BANCORP AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2016	2015
	(In thousands)	
ASSETS		
Cash and cash equivalents	\$ 54,050	\$ 24,645
Investment securities:		
Available for sale, at fair value	325,641	347,173
Held to maturity, at amortized cost (fair value \$83,755 in 2016 and \$86,541 in 2015)	82,502	83,063
Total investment securities	408,143	430,236
Loans held for sale, at lower of cost or fair value	6,506	—
Loans:		
Residential mortgage	534,404	546,245
Commercial mortgage	616,140	511,071
Home equity	75,051	63,522
Commercial & Industrial	59,706	42,384
Consumer	34,853	28,992
Total loans	1,320,154	1,192,214
Allowance for loan losses	(15,261)	(15,191)
Net loans	1,304,893	1,177,023
Stock in FHLB of Boston, at cost	4,098	6,465
Bank owned life insurance	30,499	29,887
Banking premises and equipment, net	10,451	11,371
Accrued interest receivable	4,627	4,222
Other assets	25,732	22,352
Total assets	\$1,848,999	\$1,706,201
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Demand	\$ 472,923	\$ 436,998
Interest bearing checking	430,706	370,400
Money market	72,057	73,911
Savings	539,190	497,525
Certificates of deposit	171,162	178,390
Total deposits	1,686,038	1,557,224
Short-term borrowings	—	—
Long-term borrowings	3,746	3,910
Other liabilities	24,544	20,004
Total liabilities	1,714,328	1,581,138
Stockholders' equity:		
Common stock, par value \$1.00; Authorized 10,000,000 shares; Outstanding: 4,036,879 and 4,000,181 shares, respectively	4,037	4,000
Additional paid-in capital	33,253	30,427
Retained earnings	107,262	99,064
Accumulated other comprehensive loss	(9,881)	(8,428)
Total stockholders' equity	134,671	125,063
Total liabilities and stockholders' equity	\$1,848,999	\$1,706,201

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

CAMBRIDGE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,	
	2016	2015
	(In thousands, except per share data)	
Interest income:		
Interest on loans	\$ 48,768	\$ 45,358
Interest on taxable investment securities	5,230	5,921
Interest on tax exempt investment securities	2,737	2,766
Dividends on FHLB of Boston stock	179	259
Interest on overnight investments	114	37
Total interest and dividend income	57,028	54,341
Interest expense:		
Interest on deposits	3,260	2,459
Interest on borrowed funds	95	235
Total interest expense	3,355	2,694
Net interest income	53,673	51,647
Provision for loan losses	132	1,075
Net interest income after provision for loan losses	53,541	50,572
Noninterest income:		
Wealth management income	20,389	19,242
Deposit account fees	2,922	2,324
ATM/Debit card income	1,140	1,192
Bank owned life insurance income	612	667
Gain on disposition of investment securities	438	690
Gain on loans held for sale	916	609
Loan related derivative income	1,323	260
Other income	921	881
Total noninterest income	28,661	25,865
Noninterest expense:		
Salaries and employee benefits	34,529	30,838
Occupancy and equipment	9,331	9,024
Data processing	5,024	4,807
Professional services	2,394	2,260
Marketing	1,706	2,380
FDIC Insurance	834	854
Other expenses	2,932	3,029
Total noninterest expense	56,750	53,192
Income before income taxes	25,452	23,245
Income tax expense	8,556	7,551
Net income	\$ 16,896	\$ 15,694
Per share data:		
Basic earnings per common share	\$ 4.19	\$ 3.94
Diluted earnings per common share	\$ 4.15	\$ 3.93
Average shares outstanding - basic	3,990,343	3,938,117
Average shares outstanding - diluted	4,028,944	3,993,599

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

CAMBRIDGE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31,	
	2016	2015
	(In thousands)	
Net income	\$16,896	\$15,694
Other comprehensive income/(loss), net of tax:		
Defined benefit retirement plans:		
Change in unfunded retirement liability	(437)	40
Unrealized gains/(losses) on available for sale securities:		
Unrealized holding gains/(losses) arising during the period	(735)	(980)
Less: reclassification adjustment for gains recognized in net income	(281)	(443)
Other comprehensive loss	(1,453)	(1,383)
Comprehensive income	\$15,443	\$14,311

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

CAMBRIDGE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income/(Loss)</u>	<u>Total Stockholders' Equity</u>
	(In thousands, except per share data)				
Balance at December 31, 2014	\$3,941	\$28,264	\$ 91,098	\$(7,045)	\$116,258
Comprehensive income	—	—	15,694	(1,383)	14,311
Stock based compensation	22	476	—	—	498
Exercise of stock options	36	1,080	—	—	1,116
Stock issued to ESOP and DSP	15	710	—	—	725
Dividends declared (\$1.80 per share)	—	—	(7,178)	—	(7,178)
Stock repurchased	(14)	(103)	(550)	—	(667)
Balance at December 31, 2015	4,000	30,427	99,064	(8,428)	125,063
Comprehensive income	—	—	16,896	(1,453)	15,443
Stock based compensation	12	956	—	—	968
Exercise of stock options	41	1,367	—	—	1,408
Stock issued to ESOP and DSP	16	761	—	—	777
Dividends declared (\$1.84 per share)	—	—	(7,428)	—	(7,428)
Stock repurchased	(32)	(258)	(1,270)	—	(1,560)
Balance at December 31, 2016	<u>\$4,037</u>	<u>\$33,253</u>	<u>\$107,262</u>	<u>\$(9,881)</u>	<u>\$134,671</u>

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

CAMBRIDGE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,	
	2016	2015
	(In thousands)	
Cash flows provided by operating activities:		
Net income	\$ 16,896	\$ 15,694
Adjustments to arrive at net cash provided by operating activities:		
Provision for loan losses	132	1,075
Amortization of deferred charges and fees, net	1,655	1,027
Depreciation and amortization	2,107	1,935
Bank owned life insurance income	(612)	(667)
Gain on disposition of investment securities	(438)	(690)
Compensation expense from stock option, RSU's and restricted stock grants	968	498
Change in loans held for sale	(6,506)	284
Change in accrued interest receivable, deferred taxes, other assets and other liabilities	963	835
Other, net	42	25
Net cash provided by operating activities	15,207	20,016
Cash flows from investing activities:		
Origination of loans	(275,866)	(260,020)
Purchase of:		
Investment securities - AFS	(154,719)	(225,912)
Investment securities - HTM	(11,238)	(9,691)
Maturities, calls and principal payments of:		
Loans	147,282	148,049
Investment securities - AFS	156,272	168,787
Investment securities - HTM	11,450	6,206
Proceeds from sale of investment securities - AFS & HTM	18,070	47,625
Change in FHLB of Boston stock	2,367	1,490
Purchase of banking premises and equipment	(1,187)	(4,939)
Net cash used in investing activities	(107,569)	(128,405)
Cash flows from financing activities:		
Net change in deposits	128,733	186,688
Net change in short-term borrowings	—	(69,000)
Proceeds from long-term borrowings	—	3,950
Repayment of long-term borrowings	(164)	(40)
Proceeds from issuance of common stock	2,186	1,841
Repurchase of common stock	(1,560)	(667)
Cash dividends paid on common stock	(7,428)	(7,178)
Net cash provided by financing activities	121,767	115,594
Net increase in cash and cash equivalents	29,405	7,205
Cash and cash equivalents at beginning of period	24,645	17,440
Cash and cash equivalents at end of period	\$ 54,050	\$ 24,645
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 3,371	\$ 2,644
Cash paid for income taxes	9,205	8,220

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

CAMBRIDGE BANCORP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2016

1. THE BUSINESS

The accompanying consolidated financial statements include the accounts of Cambridge Bancorp (the “Corporation”) and its wholly owned subsidiary, Cambridge Trust Company (the “Bank”), and the Bank’s subsidiaries, Cambridge Trust Company of New Hampshire, Inc., CTC Security Corporation, CTC Security Corporation II and CTC Security Corporation III. References to the Corporation herein relate to the consolidated group of companies. During 2016, the Corporation closed CTC Security Corporation II. All significant intercompany accounts and transactions have been eliminated in preparation of the consolidated financial statements.

The Corporation is a state chartered, federally registered bank holding company headquartered in Cambridge, Massachusetts, that was incorporated in 1983. The Corporation is closely held and has less than two thousand shareholders of record and, accordingly, is not required to file quarterly, annual or other public reports with the Securities and Exchange Commission (“SEC”). The Corporation is the sole stockholder of the Bank, a Massachusetts trust company chartered in 1890 which is a community-oriented commercial bank. The community banking business, the Corporation’s only reportable operating segment, consists of commercial banking, consumer banking, and trust and investment management services and is managed as a single strategic unit.

The Bank offers a full range of commercial and consumer banking services through its network of 11 full-service banking offices in Massachusetts. The Bank is engaged principally in the business of attracting deposits from the public and investing those deposits. The Bank invests those funds in various types of loans, including residential and commercial real estate, and a variety of commercial and consumer loans. The Bank also invests its deposits and borrowed funds in investment securities and has two wholly-owned Massachusetts Security Corporations, CTC Security Corporation and CTC Security Corporation III, for this purpose. Deposits at the Bank are insured by the Federal Deposit Insurance Corporation (“FDIC”) for the maximum amount permitted by FDIC Regulations.

Trust and investment management services are offered through the Bank’s full-service branches in Massachusetts, a wealth management office located in Boston, and three wealth management offices located in New Hampshire. The Bank also utilizes its non-depository trust company, Cambridge Trust Company of New Hampshire, Inc., in providing wealth management services in New Hampshire. The assets held for wealth management customers are not assets of the Bank and, accordingly, are not reflected in the accompanying consolidated balance sheets. Total assets managed on behalf of wealth management clients were approximately \$2,573,000,000 and \$2,329,000,000 at December 31, 2016 and 2015, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”) and general practices within the financial services industry.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. The allowance for loan losses, the fair values of financial instruments and the valuation of deferred tax assets are particularly subject to change.

Reclassifications

Certain amounts in the prior year's financial statements may have been reclassified to conform with the current year's presentation.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand, amounts due from banks and overnight investments.

Investment Securities

Investment securities are classified as either 'held to maturity' or 'available for sale' in accordance with the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") 320, "Investments – Debt and Equity Securities." Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and are carried at cost, adjusted for the amortization of premiums and the accretion of discounts, using the effective-yield method. U.S. Government Sponsored Enterprise ("GSE") and U.S. Government Agency obligations represent debt securities issued by the Federal Farm Credit Bank ("FFCB"), the Federal Home Loan Banks ("FHLB"), the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). Mortgage-backed securities represent Pass-Through Certificates and Collateralized Mortgage Obligations ("CMOs") either issued by, or collateralized by securities issued by GNMA, FNMA or FHLMC. Mortgage-backed securities are adjusted for amortization of premiums and accretion of discounts, using the effective-yield method over the estimated average lives of the investments.

Debt and equity securities not classified as held to maturity are classified as available for sale and carried at fair value with unrealized after-tax gains and losses reported net as a separate component of stockholders' equity. Stockholders' equity included net unrealized losses of \$2,589,000 and \$1,571,000 at December 31, 2016 and 2015, respectively. These amounts are net of deferred taxes receivable of \$1,496,000 and \$851,000, in each of the respective years. The Corporation classifies its securities based on its intention at the time of purchase.

Declines in the fair value of investment securities below their amortized cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost; (2) the financial condition and near-term prospects of the issuer; and (3) the Corporation's intent to sell the security or whether it is more likely than not that the Corporation will be required to sell the debt security before its anticipated recovery.

Loans and the Allowance for Loan Losses

Loans are reported at the amount of their outstanding principal, including deferred loan origination fees and costs, reduced by unearned discounts and the allowance for loan losses. Loan origination fees, net of related direct incremental loan origination costs, are deferred and recognized as income over the contractual lives of the related loans as an adjustment to the loan yield, using a method which approximates the interest method. Unearned discount is recognized as an adjustment to the loan yield, using the interest method over the contractual life of the related loan. When a loan is paid off, the unamortized portion of net fees or unearned discount is recognized as interest income.

Loans are considered delinquent when a payment of principal and/or interest becomes past due 30 days following its scheduled payment due date.

Loans on which the accrual of interest has been discontinued are designated non-accrual loans. Accrual of interest income is discontinued when concern exists as to the collectability of principal or interest, or typically

when a loan becomes over 90 days delinquent. Additionally, when a loan is placed on non-accrual status, all interest previously accrued but not collected is reversed against current period income. Loans are removed from non-accrual when they become less than 90 days past due and when concern no longer exists as to the collectability of principal or interest. Interest collected on non-accruing loans is either applied against principal or reported as income according to management's judgment as to the collectability of principal.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Under certain circumstances, the Corporation may restructure the terms of a loan as a concession to a borrower. These restructured loans are generally also considered impaired loans. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

The provision for loan losses and the level of the allowance for loan losses reflects management's estimate of probable loan losses inherent in the loan portfolio at the balance sheet date. Management uses a systematic process and methodology to establish the allowance for loan losses each quarter. To determine the total allowance for loan losses, an estimate is made by management of the allowance needed for each of the following segments of the loan portfolio: (a) residential mortgage loans, (b) commercial mortgage loans, (c) home equity loans, (d) commercial & industrial loans, and (e) consumer loans. Portfolio segments are further disaggregated into classes of loans. The establishment of the allowance for each portfolio segment is based on a process that evaluates the risk characteristics relevant to each portfolio segment and takes into consideration multiple internal and external factors. Internal factors include (a) historic levels and trends in charge-offs, delinquencies, risk ratings, and foreclosures, (b) level and changes in industry, geographic and credit concentrations, (c) underwriting policies and adherence to such policies, (d) the growth and vintage of the portfolios and (e) the experience of, and any changes in, lending and credit personnel. External factors include (a) conditions and trends in the local and national economy and (b) levels and trends in national delinquent and non-performing loans.

The Bank evaluates certain loans individually for specific impairment. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Loans are selected for evaluation based upon internal risk rating, delinquency status, or non-accrual status. A specific allowance amount is allocated to an individual loan when such loan has been deemed impaired and when the amount of the probable loss is able to be estimated. Estimates of loss may be determined by the present value of anticipated future cash flows, the loan's observable fair market value, or the fair value of the collateral, if the loan is collateral dependent.

Risk characteristics relevant to each portfolio segment are as follows:

Residential mortgage and home equity loans – The Bank generally does not originate loans in these segments with a loan-to-value ratio greater than 80 percent, unless covered by private mortgage insurance, and in all cases not greater than a loan-to-value ratio of 95 percent. The Bank does not grant subprime loans. Loans in these segments are secured by one-to-four family residential real estate and repayment is primarily dependent on the credit quality of the individual borrower.

Commercial mortgage loans – This includes multifamily properties. The Bank generally does not originate loans in this segment with a loan-to-value ratio greater than 75 percent. Loans in this segment are secured by owner-occupied and nonowner-occupied commercial real estate and repayment is primarily dependent on the cash flows of the property (if nonowner-occupied) or of the business (if owner-occupied).

Commercial loans – Loans in this segment are made to businesses and are generally secured by equipment, accounts receivable or inventory, as well as the personal guarantees of the principal owners of the business and repayment is primarily dependent on the cash flows generated by the business.

Consumer loans – Loans in this segment are made to individuals and can be secured or unsecured. Repayment is primarily dependent on the credit quality of the individual borrower.

The majority of the Bank's loans are concentrated in Eastern Massachusetts and therefore the overall health of the local economy, including unemployment rates, vacancy rates, and consumer spending levels, can have a material effect on the credit quality of all of these portfolio segments.

The process to determine the allowance for loan losses requires management to exercise considerable judgment regarding the risk characteristics of the loan portfolio segments and the effect of relevant internal and external factors.

The provision for loan losses charged to operations is based on management's judgment of the amount necessary to maintain the allowance at a level to provide for probable inherent loan losses. When management believes that the collectability of a loan's principal balance, or portions thereof, is unlikely, the principal amount is charged against the allowance for loan losses. Recoveries on loans that have been previously charged off are credited to the allowance for loan losses as received. The allowance is an estimate, and ultimate losses may vary from current estimates. As adjustments become necessary, they are reported in the results of operations through the provision for loan losses in the period in which they become known.

Residential mortgage loans originated and intended for sale in the secondary market are classified as held for sale at the time of their origination and are carried at the lower of cost or fair value on an individual loan basis. Changes in fair value relating to loans held for sale below the loans cost basis are charged against gain on loans held for sale. Gains and losses on the actual sale of the residential loans are recorded in earnings as net gains (losses) on loans held for sale on the consolidated statements of income.

Bank Owned Life Insurance

Bank owned life insurance ("BOLI") represents life insurance on the lives of certain employees who have provided positive consent allowing the Bank to be the beneficiary of such policies. Since the Bank is the primary beneficiary of the insurance policies, increases in the cash value of the policies, as well as insurance proceeds received, are recorded in other noninterest income, and are not subject to income taxes. The cash value of the policies is included in other assets. Applicable regulations generally limit our investment in bank-owned life insurance to 25% of our Tier 1 capital plus our allowance for loan losses. The Bank reviews the financial strength of the insurance carriers prior to the purchase of BOLI and at least annually thereafter.

Banking Premises and Equipment

Land is stated at cost. Buildings, leasehold improvements and equipment are stated at cost, less accumulated depreciation and amortization, which is computed using the straight-line method over the estimated useful lives of the assets or the terms of the leases, if shorter. The cost of ordinary maintenance and repairs is charged to expense when incurred.

Advertising Costs

Advertising costs are expensed as incurred.

Other Real Estate Owned

Other real estate owned ("OREO") consists of properties formerly pledged as collateral to loans, which have been acquired by the Bank through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Upon

transfer of a loan to foreclosure status, an appraisal is obtained and any excess of the loan balance over the fair value, less estimated costs to sell, is charged against the allowance for loan losses. Expenses and subsequent adjustments to the fair value are treated as other operating expense.

Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in a business combination. Goodwill and intangible assets that are not amortized are tested for impairment, based on their fair values, at least annually. Identifiable intangible assets that are subject to amortization are also reviewed for impairment based on their fair value. Any impairment is recognized as a charge to earnings and the adjusted carrying amount of the intangible asset becomes its new accounting basis. The remaining useful life of an intangible asset that is being amortized is also evaluated each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization.

Mortgage servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets with servicing rights retained. The fair value of the servicing rights is determined by estimating the present value of future net cash flows, taking into consideration market loan prepayment speeds, discount rates, servicing costs and other economic factors. For purposes of measuring impairment, the underlying loans are stratified into relatively homogeneous pools based on predominant risk characteristics which include product type (i.e., fixed or adjustable) and interest rate bands. If the aggregate carrying value of the capitalized mortgage servicing rights for a stratum exceeds its fair value, MSR impairment is recognized in earnings through a valuation allowance for the difference. As the loans are repaid and net servicing revenue is earned, the MSR asset is amortized as an offset to loan servicing income. Servicing revenues are expected to exceed this amortization expense. However, if actual prepayment experience or defaults exceed what was originally anticipated, net servicing revenues may be less than expected and mortgage servicing rights may be impaired.

Income Taxes

The Corporation and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and in the state of Massachusetts and other states as required.

The Corporation uses the liability (or balance sheet) method for accounting for income taxes. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Deferred tax assets are reviewed quarterly and reduced by a valuation allowance if, based upon the information available, it is more likely than not that some or all of the deferred tax assets will not be realized.

Interest and penalties related to unrecognized tax benefits, if incurred, are recognized as a component of income tax expense.

Fee Revenue

Wealth management revenues include asset-based revenues (trust and investment advisory fees) that are primarily accrued as earned based upon a percentage of asset values under administration. Also included in wealth management revenues are transaction-based revenues (financial planning fees, commissions and other service fees), which are recognized as revenue to the extent that services have been completed. Fee revenue from deposit service charges is generally recognized when earned.

Pension and Retirement Plans

The Corporation sponsors a defined benefit pension plan and a postretirement health care plan covering substantially all employees hired before May 2, 2011. Benefits for the pension plan are based primarily on years

of service and the employee's average monthly pay during the five highest consecutive plan years of the employee's final ten years. Benefits for the postretirement health care plan are based on years of service. Expense for both of these plans is recognized over the employee's service life utilizing the projected unit credit actuarial cost method. Contributions are periodically made to the pension plan so as to comply with the Employee Retirement Income Security Act ("ERISA") funding standards and the Internal Revenue Code of 1986, as amended.

The Corporation also has a non-qualified retirement plan to provide supplemental retirement benefits to certain executives. Expense for this plan is recognized over the executive's service life utilizing the projected unit credit actuarial cost method.

Stock-Based Compensation

Stock-based compensation plans provide for awards of stock options and other equity incentives, including nonvested share units and nonvested performance share units.

Compensation expense for awards is recognized over the service period based on the fair value at the date of grant. Awards of nonvested share units and nonvested performance share units are valued at the fair market value of the Corporation's common stock as of the award date. Nonvested performance share unit compensation expense is based on the most recent performance assumption available and is adjusted as assumptions change. If the goals are not met, vesting does not occur and no compensation cost will be recognized and any recognized compensation costs will be reversed. Stock-based awards that do not require future service are expensed immediately. The Corporation estimates expected forfeitures in determining compensation expense.

Derivative Instruments and Hedging Activities

Derivative instruments related to commercial loan swaps, mirror swaps with counterparties and risk participation agreements are considered "derivatives".

Derivatives are recognized as either assets or liabilities on the balance sheet and are measured at fair value. The accounting for changes in the fair value of such derivatives depends on the intended use of the derivative and resulting designation.

For derivatives designated as fair value hedges, changes in the fair value of such derivatives are recognized in earnings together with the changes in the fair value of the related hedged item. The net amount, if any, represents hedge ineffectiveness and is reflected in earnings.

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is recorded in other comprehensive income (loss) and recognized in earnings when the hedged transaction affects earnings. The ineffective portion of changes in the fair value of cash flow hedges is recognized directly in earnings.

For derivatives not designated as hedges, changes in fair value of the derivative instruments are recognized in earnings, in noninterest income.

The accrued net settlements on derivatives that qualify for hedge accounting are recorded in interest income or interest expense based on the item being hedged. Changes in fair value of such derivatives including accrued net settlements that do not qualify for hedge accounting are reported in noninterest income.

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company measures the fair values of its

financial instruments in accordance with accounting guidance that requires an entity to base fair value on exit price, and maximize the use of observable inputs and minimize the use of unobservable inputs to determine the exit price.

ASC 820, “*Fair Value Measurements and Disclosures*” establishes a fair value hierarchy that gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data and requires fair value measurements to be disclosed by level within the hierarchy. The three broad levels defined by the fair value hierarchy are as follows:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reported date. The type of financial instruments included in Level 1 are highly liquid cash instruments with quoted prices such as government or agency securities, listed equities and money market securities, as well as listed derivative instruments.

Level 2 – Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these financial instruments includes cash instruments for which quoted prices are available but traded less frequently, derivative instruments whose fair value has been derived using a model where inputs to the model are directly observable in the market, or can be derived principally from or corroborated by observable market data, and instruments that are fair valued using other financial instruments, the parameters of which can be directly observed. Instruments which are generally included in this category are corporate bonds and loans, mortgage whole loans, municipal bonds and over-the-counter derivatives.

Level 3 – Instruments that have little to no pricing observability as of the reported date. These financial instruments do not have two-way markets and are measured using management’s best estimate of fair value, where the inputs into the determination of fair value require significant management judgment to estimation. Instruments that are included in this category generally include certain commercial mortgage loans, certain private equity investments, distressed debt, non-investment grade residual interests in securitizations, as well as certain highly structured over-the-counter derivative contracts.

Earnings per Common Share

Earnings per common share is computed using the two-class method prescribed under ASC Topic 260, “Earnings Per Share.” ASC Topic 260 provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. We have determined that our outstanding non-vested stock awards are participating securities.

Under the two-class method, basic earnings per common share is computed by dividing net earnings allocated to common stock by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of common stock equivalents. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 21 – Earnings Per Common Share.

Subsequent Events

Management has reviewed events occurring through February 27, 2017, the date the consolidated financial statements were issued and determined that no subsequent events occurred requiring accrual or disclosure.

3. RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, “Revenue from Contracts with Customers (Topic 606)” (“ASU 2014-09”). This issuance was part of the joint project between the FASB and the International Accounting Standards Board to clarify the principles of recognizing revenue and to develop a common revenue standard for GAAP and International Financial Reporting Standards. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. The impact of ASU 2014-09 on the Corporation’s consolidated financial statements is not yet known. Additionally, in August 2015, the FASB issued Accounting Standards Update No. 2015-14, “Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date” (“ASU 2015-14”) which defers adoption of ASU 2014-09 to annual reporting periods beginning after December 15, 2017.

Accounting Standards Update No. 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities” (“ASU 2016-01”), was issued in January 2016 and provides revised guidance related to the accounting for and reporting of financial instruments. Some of the main provisions include: requiring most equity securities to be reported at fair value with unrealized gains and losses reported in the income statement; requiring separate presentation of financial assets and liabilities by measurement category and form (i.e. securities or loans); clarifying that entities must assess valuation allowances on a deferred tax asset related to available for sale debt securities in combination with their other deferred tax assets; and eliminating the requirement to disclose the method and significant assumptions used to estimate fair value for financial instruments measured at amortized cost on the balance sheet. ASU 2016-01 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The Corporation has not yet determined the effect of ASU 2016-01 on its ongoing financial reporting.

Accounting Standards Update No. 2016-02, “Leases” (“ASU 2016-02”), was issued in February 2016 and provides revised guidance related to the accounting and reporting of leases. ASU 2016-02 requires lessees to recognize most leases on the balance sheet. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee will depend on its classification as a finance or operating lease. ASU 2016-02 requires a modified retrospective transition, with a number of practical expedients that entities may elect to apply. ASU 2016-02 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted. The Corporation has not yet determined the effect of ASU 2016-02 on its ongoing financial reporting.

Accounting Standards Update No. 2016-09, “*Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*” (“ASU 2016-09”) was issued in March 2016. ASU 2016-09 was issued as part of the FASB Simplification Initiative which intends to reduce the complexity of GAAP while improving usefulness to users. There are eight main items in this ASU that contribute to the simplification of share-based accounting. ASU 2016-09 will be effective for public business entities for the fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. For all other entities the ASU will be effective for the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Corporation is currently assessing the impact the adoption of ASU 2016-09 will have on its consolidated financial statements.

Accounting Standards Update No. 2016-13, “*Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments*” (“ASU 2016-13”) was issued in June 2016. ASU 2016-13 will significantly change how entities measure and recognize credit impairment for many financial assets. Under this standard, the new current expected credit loss model will require entities to immediately recognize an estimate of credit losses expected to occur over the remaining life of the financial assets that are in the scope of the standard. This new guidance also made targeted amendments to the current impairment model for available-for-sale debt securities. ASU 2016-13 will be effective for public business entities for fiscal years beginning after December 15, 2019, including interim periods within that reporting period. For all other entities the ASU will be

All of the Corporation's mortgage-backed securities have been issued by, or are collateralized by securities issued by, either GNMA, FNMA or FHLMC.

The amortized cost and fair value of debt investments, aggregated by contractual maturity, are shown below. Maturities of mortgage-backed securities do not take into consideration scheduled amortization or prepayments. Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>Within One Year</u>		<u>After One, But Within Five Years</u>		<u>After Five, But Within Ten Years</u>		<u>After Ten Years</u>		<u>Total</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
(In thousands)										
At December 31, 2016:										
Debt securities available for sale:										
U.S. GSE obligations	\$15,016	\$15,029	\$125,010	\$123,680	\$ —	\$ —	\$ —	\$ —	\$140,026	\$138,709
Mortgage-backed securities	17	17	789	822	28,693	28,566	154,475	151,894	183,974	181,299
Corporate debt securities	—	—	4,054	4,016	1,000	1,013	—	—	5,054	5,029
Total debt securities available for sale	<u>15,033</u>	<u>15,046</u>	<u>129,853</u>	<u>128,518</u>	<u>29,693</u>	<u>29,579</u>	<u>154,475</u>	<u>151,894</u>	<u>329,054</u>	<u>325,037</u>
Debt securities held to maturity:										
Mortgage-backed securities	1	1	630	650	3	3	62	65	696	719
Municipal securities	1,605	1,608	15,996	16,344	29,563	30,414	34,642	34,670	81,806	83,036
Total debt securities held to maturity	<u>1,606</u>	<u>1,609</u>	<u>16,626</u>	<u>16,994</u>	<u>29,566</u>	<u>30,417</u>	<u>34,704</u>	<u>34,735</u>	<u>82,502</u>	<u>83,755</u>
Total debt securities	<u>\$16,639</u>	<u>\$16,655</u>	<u>\$146,479</u>	<u>\$145,512</u>	<u>\$59,259</u>	<u>\$59,996</u>	<u>\$189,179</u>	<u>\$186,629</u>	<u>\$411,556</u>	<u>\$408,792</u>

The following table shows the Corporation's securities with gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous loss position:

	<u>Less than One Year</u>		<u>One Year or Longer</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
(In thousands)						
At December 31, 2016:						
U.S. GSE obligations	\$118,686	\$(1,340)	\$ —	\$ —	\$118,686	\$(1,340)
Mortgage-backed securities	149,860	(2,795)	14,425	(359)	164,285	(3,154)
Corporate debt securities	4,016	(38)	—	—	4,016	(38)
Municipal securities	18,626	(664)	—	—	18,626	(664)
Subtotal, debt securities	<u>291,188</u>	<u>(4,837)</u>	<u>14,425</u>	<u>(359)</u>	<u>305,613</u>	<u>(5,196)</u>
Mutual funds	—	—	604	(68)	604	(68)
Total temporarily impaired securities	<u>\$291,188</u>	<u>\$(4,837)</u>	<u>\$15,029</u>	<u>\$ (427)</u>	<u>\$306,217</u>	<u>\$(5,264)</u>
At December 31, 2015:						
U.S. GSE obligations	\$ 84,726	\$ (485)	\$ 4,953	\$ (45)	\$ 89,679	\$ (530)
Mortgage-backed securities	99,190	(1,154)	71,554	(1,782)	170,744	(2,936)
Corporate debt securities	985	(15)	—	—	985	(15)
Municipal securities	3,517	(36)	—	—	3,517	(36)
Subtotal, debt securities	<u>188,418</u>	<u>(1,690)</u>	<u>76,507</u>	<u>(1,827)</u>	<u>264,925</u>	<u>(3,517)</u>
Mutual funds	—	—	612	(60)	612	(60)
Total temporarily impaired securities	<u>\$188,418</u>	<u>\$(1,690)</u>	<u>\$77,119</u>	<u>\$(1,887)</u>	<u>\$265,537</u>	<u>\$(3,577)</u>

Securities are evaluated by management for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost; (2) the financial condition and near-term prospects of the issuer; and (3) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. As of December 31, 2016, one hundred thirty-two debt securities and one equity security had gross unrealized losses, with an aggregate depreciation of 1.69% from the Corporation's amortized cost basis. The largest unrealized loss percentage of any single security was 10.16% (or \$51,000) of its amortized cost. The largest unrealized dollar loss of any single security was \$189,000 (or 3.79%) of its amortized cost. The Corporation believes that the nature and duration of impairment on its debt security positions are primarily a function of interest rate movements and changes in investment spreads, and does not consider full repayment of principal on the reported debt obligations to be at risk. Since nearly all of these securities are rated "investment grade" and a) the Corporation does not intend to sell these securities before recovery, and b) that it is more likely than not that the Corporation will not be required to sell these securities before recovery, the Corporation does not consider these securities to be other-than-temporarily impaired as of December 31, 2016.

The following table sets forth information regarding sales of investment securities and the resulting gains or losses from such sales.

	Year Ended December 31,	
	2016	2015
	(In thousands)	
Amortized cost of securities sold	\$17,632	\$46,935
Gain realized on securities sold	438	690
Proceeds from securities sold	<u>\$18,070</u>	<u>\$47,625</u>

6. LOANS AND ALLOWANCE FOR LOAN LOSSES

The Bank originates loans to businesses and individuals on both a collateralized and an uncollateralized basis. The Bank's customer base is concentrated in Eastern Massachusetts. The Bank has diversified the risk in its commercial loan portfolio by lending to businesses in a wide range of industries. The majority of loans to individuals are collateralized by residential real estate, marketable securities or other assets.

Loans outstanding are detailed by category as follows:

	December 31,	
	2016	2015
	(In thousands)	
Residential real estate:		
Mortgages - fixed rate (20 & 30 year)	\$ 173,222	\$ 179,245
Mortgages - fixed rate (15 year)	98,608	112,925
Mortgages - fixed rate (10 year)	33,574	46,406
Mortgages - adjustable rate	228,028	206,835
Deferred costs net of unearned fees	972	834
Total residential real estate	<u>534,404</u>	<u>546,245</u>
Commercial real estate:		
Mortgages - nonowner occupied	513,578	422,923
Mortgages - owner occupied	43,932	43,265
Construction	58,406	44,624
Deferred costs net of unearned fees	224	259
Total commercial real estate	<u>616,140</u>	<u>511,071</u>
Home equity:		
Home equity - lines of credit	70,883	59,676
Home equity - term loans	3,925	3,630
Deferred costs net of unearned fees	243	216
Total home equity	<u>75,051</u>	<u>63,522</u>
Commercial & Industrial		
Commercial & industrial	59,638	42,209
Deferred costs net of unearned fees	68	175
Total commercial & industrial	<u>59,706</u>	<u>42,384</u>
Consumer:		
Secured	33,386	27,390
Unsecured	1,451	1,585
Deferred costs net of unearned fees	16	17
Total consumer	<u>34,853</u>	<u>28,992</u>
Total loans	<u><u>\$1,320,154</u></u>	<u><u>\$1,192,214</u></u>

Certain directors and officers of the Corporation are customers of the Bank. Loans to these parties are made in the ordinary course of business at the Bank's normal credit terms, including interest rate and collateral requirements, and do not represent more than a normal risk of collection. At December 31, 2016 and 2015, total loans outstanding to these related parties were \$690,000 and \$884,000, respectively. During 2016, \$355,000 of additions and \$406,000 of repayments were made to these loans, compared to \$210,000 of additions and \$167,000 of repayments made during 2015.

The following table sets forth the recorded investment for non-performing loans.

	December 31,	
	2016	2015
	(In thousands)	
Non-accrual loans	\$1,023	\$1,481
Loans past due >90 days, but still accruing	232	—
Troubled debt restructurings	421	—
Total non-performing loans	<u>\$1,676</u>	<u>\$1,481</u>

A breakdown of non-accrual loans receivable is as follows:

	December 31,	
	2016	2015
	(In thousands)	
Non-accrual loans:		
Residential mortgage loans	\$ 998	\$ 754
Commercial mortgage loans	—	306
Home equity loans	—	—
Commercial & Industrial	24	420
Consumer loans	1	1
Total	<u>\$1,023</u>	<u>\$1,481</u>

Troubled Debt Restructurings

Loans are considered restructured in a troubled debt restructuring when the Corporation has granted concessions to a borrower due to the borrower's financial condition that it otherwise would not have considered. These concessions may include modifications of the terms of the debt such as deferral of payments, extension of maturity, reduction of principal balance, reduction of the stated interest rate other than normal market rate adjustments, or a combination of these concessions. Debt may be bifurcated with separate terms for each tranche of the restructured debt. Restructuring a loan in lieu of aggressively enforcing the collection of the loan may benefit the Corporation by increasing the ultimate probability of collection.

Restructured loans are classified as accruing or non-accruing based on management's assessment of the collectability of the loan. Loans which are already on nonaccrual status at the time of the restructuring generally remain on nonaccrual status for approximately 6 months or longer before management considers such loans for return to accruing status. Accruing restructured loans are placed into nonaccrual status if and when the borrower fails to comply with the restructured terms and management deems it unlikely that the borrower will return to a status of compliance in the near term.

Troubled debt restructurings are classified as impaired loans. The Corporation identifies loss allocations for impaired loans on an individual loan basis. During 2016, two loans were determined to be TDRs. The recorded investment (which consists of the unpaid principal balance, net of charge-offs and unamortized deferred loan origination fees and costs, at the time of the restructuring) in troubled debt restructurings was approximately \$444,000 and \$0 respectively, at December 31, 2016 and 2015. The allowance for loan losses included specific reserves for these troubled debt restructurings of approximately \$117,000 and \$0, respectively, at December 31, 2016 and 2015.

As of December 31, 2016, there were no significant commitments to lend additional funds to borrowers whose loans were restructured.

Impaired Loans

Impaired loans are loans for which it is probable that the Corporation will not be able to collect all amounts due according to the contractual terms of the loan agreements and loans restructured in a troubled debt restructuring. In 2016, the Company had twelve loans considered impaired with a recorded investment of \$1.4 million as compared to 2015 where the Company had eight loans considered impaired with a recorded investment of \$1.1 million. The interest income recognized associated with these loans was not significant to the results of operations. The recorded investment in impaired loans consists of unpaid principal balance, net of charge-offs, interest payments received applied to principal and unamortized deferred loan origination fees and costs.

The following table contains period-end balances of loans receivable disaggregated by credit quality indicator:

		December 31, 2016		
		(In thousands)		
		<u>Residential Mortgages</u>	<u>Home Equity</u>	<u>Consumer</u>
Credit risk profile based on payment activity:				
Performing		\$ 533,273	\$ 75,051	\$34,852
Non-performing		1,131	—	1
Total		<u>\$ 534,404</u>	<u>\$ 75,051</u>	<u>\$34,853</u>
		<u>Commercial Mortgages</u>	<u>Commercial & Industrial</u>	
Credit risk profile by internally assigned grade:				
Pass			\$612,636	\$56,310
Special mention			2,861	1,431
Substandard			643	1,965
Doubtful			—	—
Loss			—	—
Total			<u>\$616,140</u>	<u>\$59,706</u>
		December 31, 2015		
		(In thousands)		
		<u>Residential Mortgages</u>	<u>Home Equity</u>	<u>Consumer</u>
Credit risk profile based on payment activity:				
Performing		\$ 545,491	\$ 63,522	\$28,991
Non-performing		754	—	1
Total		<u>\$ 546,245</u>	<u>\$ 63,522</u>	<u>\$28,992</u>
		<u>Commercial Mortgages</u>	<u>Commercial & Industrial</u>	
Credit risk profile by internally assigned grade:				
Pass			\$506,520	\$39,490
Special mention			4,007	2,570
Substandard			544	324
Doubtful			—	—
Loss			—	—
Total			<u>\$511,071</u>	<u>\$42,384</u>

With respect to residential real estate, home equity and consumer loans, the Bank utilizes the following categories as indicators of credit quality:

- Performing – These loans are accruing and are considered having low to moderate risk.
- Non-performing – These loans either have been placed on non-accrual, or are past due more than 90 days but are still accruing, and may contain greater than average risk.

With respect to commercial real estate and commercial loans, the Bank utilizes a ten grade internal loan rating system as an indicator of credit quality. The grades are as follows:

- Loans rated 1-6 (Pass) – These loans are considered “pass” rated with low to average risk.
- Loans rated 7 (Special Mention) – These loans have potential weaknesses warranting close attention which if left uncorrected may result in deterioration of the credit at some future date.
- Loans rated 8 (Substandard) – These loans have well-defined weaknesses that jeopardize the orderly liquidation of the debt under the original loan terms. Loss potential exists but is not identifiable in any one customer.
- Loans rated 9 (Doubtful) – These loans have pronounced weaknesses that make full collection highly questionable and improbable.
- Loans rated 10 (Loss) – These loans are considered uncollectible and continuance as a bankable asset is not warranted.

The following table contains period-end balances of loans receivable disaggregated by past due status:

	December 31, 2016					Total Loans
	Current	30 - 59 Days	60 - 89 Days	90 Days or Greater	Total Past Due	
	(In thousands)					
Loans receivable:						
Residential mortgage loans	\$ 532,925	\$698	\$179	\$602	\$1,479	\$ 534,404
Commercial mortgage loans	615,658	—	250	232	482	616,140
Home equity loans	75,047	4	—	—	4	75,051
Commercial & Industrial	59,532	173	—	1	174	59,706
Consumer loans	34,842	6	5	—	11	34,853
Total	<u>\$1,318,004</u>	<u>\$881</u>	<u>\$434</u>	<u>\$835</u>	<u>\$2,150</u>	<u>\$1,320,154</u>
	December 31, 2015					
	Current	30 - 59 Days	60 - 89 Days	90 Days or Greater	Total Past Due	Total Loans
	(In thousands)					
Loans receivable:						
Residential mortgage loans	\$ 545,743	\$ 502	\$ —	\$ —	\$ 502	\$ 546,245
Commercial mortgage loans	509,950	—	815	306	1,121	511,071
Home equity loans	63,454	68	—	—	68	63,522
Commercial & Industrial	41,221	409	364	390	1,163	42,384
Consumer loans	28,106	886	—	—	886	28,992
Total	<u>\$1,188,474</u>	<u>\$1,865</u>	<u>\$1,179</u>	<u>\$ 696</u>	<u>\$3,740</u>	<u>\$1,192,214</u>

The following table contains period-end balances of the allowance for loan losses and related loans receivable disaggregated by impairment method:

		December 31, 2016						
		Residential Mortgages	Commercial Mortgages	Home Equity	Commercial & Industrial	Consumer	Unallocated	Total
		(In thousands)						
Allowance for loan losses:								
	Individually evaluated for impairment	\$ 69	\$ —	\$ 7	\$ 114	\$ —	\$ —	\$ 190
	Collectively evaluated for impairment	4,898	8,452	650	807	264	—	15,071
	Total	<u>\$ 4,967</u>	<u>\$ 8,452</u>	<u>\$ 657</u>	<u>\$ 921</u>	<u>\$ 264</u>	<u>\$ —</u>	<u>\$ 15,261</u>
Loans receivable:								
	Individually evaluated for impairment	\$ 1,027	\$ —	\$ 102	\$ 289	\$ —		\$ 1,418
	Collectively evaluated for impairment	533,377	616,140	74,949	59,417	34,853		1,318,736
	Total	<u>\$534,404</u>	<u>\$616,140</u>	<u>\$75,051</u>	<u>\$59,706</u>	<u>\$34,853</u>		<u>\$1,320,154</u>
		December 31, 2015						
		Residential Mortgages	Commercial Mortgages	Home Equity	Commercial & Industrial	Consumer	Unallocated	Total
		(In thousands)						
Allowance for loan losses:								
	Individually evaluated for impairment	\$ —	\$ —	\$ —	\$ 174	\$ —	\$ —	\$ 174
	Collectively evaluated for impairment	5,244	8,094	699	615	354	11	15,017
	Total	<u>\$ 5,244</u>	<u>\$ 8,094</u>	<u>\$ 699</u>	<u>\$ 789</u>	<u>\$ 354</u>	<u>\$ 11</u>	<u>\$ 15,191</u>
Loans receivable:								
	Individually evaluated for impairment	\$ —	\$ 544	\$ —	\$ 515	\$ —		\$ 1,059
	Collectively evaluated for impairment	546,245	510,527	63,522	41,869	28,992		1,191,155
	Total	<u>\$546,245</u>	<u>\$511,071</u>	<u>\$63,522</u>	<u>\$42,384</u>	<u>\$28,992</u>		<u>\$1,192,214</u>

As discussed in Note 2, Summary of Significant Accounting Policies, the provision for loan losses is evaluated on a regular basis by management in order to determine the adequacy of the allowance for loan losses.

In 2016, the Corporation updated its methodology for determining its allowance for loan losses to better reflect changes in the risk profile of its loan portfolio including greater disaggregation of environmental factors, an update to assigned risk allocations for qualitative factors, and an update to the historical loss experience look-back period. The updates did not significantly impact the individual loan portfolios or the total allowance.

Changes in the allowance for loan losses were as follows:

	Year Ended December 31, 2016							Total
	Residential Mortgages	Commercial Mortgages (1)	Home Equity	Commercial & Industrial	Consumer	Unallocated	Impaired	
	(In thousands)							
Balance at beginning of year	\$5,244	\$8,094	\$699	\$615	\$354	\$ 11	\$174	\$15,191
Provision for loan losses	(695)	727	(46)	113	28	(11)	16	132
Change in methodology	336	(377)	(3)	136	(92)	—	—	—
Loans charged off	—	—	—	(71)	(33)	—	—	(104)
Recoveries	13	7	1	14	7	—	—	42
Balance at end of year	<u>\$4,898</u>	<u>\$8,451</u>	<u>\$651</u>	<u>\$807</u>	<u>\$264</u>	<u>\$ —</u>	<u>\$190</u>	<u>\$15,261</u>

(1) Commercial Mortgages includes Multifamily Commercial Real Estate and Commercial Construction.

The following table shows the changes in allowance as of December 31, 2015:

	Year Ended December 31, 2015							Total
	Residential Mortgages	Commercial Mortgages (1)	Home Equity	Commercial & Industrial	Consumer	Unallocated	Impaired	
	(In thousands)							
Balance at beginning of year	\$5,174	\$7,285	\$679	\$ 750	\$328	\$ 53	\$ —	\$14,269
Provision for loan losses	107	801	21	(15)	29	(42)	174	1,075
Loans charged off	(37)	—	(1)	(124)	(16)	—	—	(178)
Recoveries	—	8	—	4	13	—	—	25
Balance at end of year	<u>\$5,244</u>	<u>\$8,094</u>	<u>\$699</u>	<u>\$ 615</u>	<u>\$354</u>	<u>\$ 11</u>	<u>\$ 174</u>	<u>\$15,191</u>

(1) Commercial Mortgages includes Multifamily Commercial Real Estate and Commercial Construction.

7. FEDERAL HOME LOAN BANK OF BOSTON STOCK

As a voluntary member of the FHLB of Boston (“FHLB Boston”), the Bank is required to invest in stock of the FHLB Boston (which is considered a restricted equity security) in an amount based upon its outstanding advances from the FHLB Boston. At December 31, 2016, the Bank’s investment in FHLB Boston stock exceeded its required investment by \$4,098,000. No market exists for shares of this stock. The Bank’s cost for FHLB Boston stock is equal to its par value. Upon redemption of the stock, which is at the discretion of the FHLB Boston, the Bank would receive an amount equal to the par value of the stock. At its discretion, the FHLB Boston may also declare dividends on its stock.

The Bank’s investment in FHLB Boston stock is reviewed for impairment at each reporting date based on the ultimate recoverability of the cost basis of the stock. As of December 31, 2016, no impairment has been recognized.

8. BANKING PREMISES AND EQUIPMENT

A summary of the cost and accumulated depreciation and amortization of property, leasehold improvements and equipment is presented below:

	<u>December 31,</u>		<u>Estimated Useful Lives</u>
	<u>2016</u>	<u>2015</u>	
	(In thousands)		
Land	\$ 1,116	\$ 1,116	
Building and leasehold improvements	12,801	12,437	3-30 years
Equipment, including vaults	10,506	7,920	3-20 years
Construction in process	25	3,107	
Subtotal	24,448	24,580	
Accumulated depreciation and amortization	(13,997)	(13,209)	
Total	<u>\$ 10,451</u>	<u>\$ 11,371</u>	

Total depreciation expense for the years ended December 31, 2016 and 2015 amounted to approximately \$2,107,000 and \$1,935,000, respectively, and is included in occupancy and equipment expenses in the accompanying consolidated statements of income.

9. GOODWILL AND OTHER INTANGIBLE ASSETS

At December 31, 2016 and 2015, the carrying value of goodwill, which is included in other assets, totaled \$412,000. Goodwill is tested for impairment, based on its fair value, at least annually. As of December 31, 2016, no goodwill impairment has been recognized.

An analysis of mortgage servicing rights, which are included in other assets, follows:

	<u>Mortgage Servicing Rights</u>	<u>Valuation Allowance</u>	<u>Total</u>
	(In thousands)		
Balance at December 31, 2014	\$ 332	\$ —	\$ 332
Mortgage servicing rights capitalized	305	—	305
Amortization charged against servicing income	(138)	—	(138)
Change in impairment reserve	—	(8)	(8)
Balance at December 31, 2015	499	(8)	491
Mortgage servicing rights capitalized	545	—	545
Amortization charged against servicing income	(202)	—	(202)
Change in impairment reserve	—	(22)	(22)
Balance at December 31, 2016	<u>\$ 842</u>	<u>\$ (30)</u>	<u>\$ 812</u>

The fair value of our mortgage servicing rights portfolio was \$1,032,000 and \$647,000 as of December 31, 2016 and 2015, respectively. The fair value of mortgage servicing rights is estimated based on the present value of expected cash flows, incorporating assumptions for discount rate, prepayment speed and servicing cost.

10. DEPOSITS

Deposits are summarized as follows:

	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
Demand deposits (non-interest bearing)	\$ 472,923	\$ 436,998
Interest bearing checking	430,706	370,400
Money market	72,057	73,911
Savings	539,190	497,525
Retail certificates of deposit under \$100,000	42,471	46,277
Retail certificates of deposit \$100,000 or greater	72,355	75,858
Wholesale certificates of deposit	56,336	56,255
Total deposits	<u>\$1,686,038</u>	<u>\$1,557,224</u>

Certificates of deposit had the following schedule of maturities:

	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
Less than 3 months remaining	\$ 32,268	\$ 39,001
3 to 5 months remaining	17,558	17,329
6 to 11 months remaining	36,240	21,973
12 to 23 months remaining	44,467	33,054
24 to 47 months remaining	29,826	56,601
48 months or more remaining	10,803	10,432
Total certificates of deposit	<u>\$171,162</u>	<u>\$178,390</u>

Interest expense on retail certificates of deposit \$100,000 or greater was \$475,000 and \$482,000 for the years ended December 31, 2016 and 2015, respectively.

11. BORROWINGS

Information relating to short-term borrowings is presented below:

	<u>Year Ended December 31,</u>	
	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
FHLB Boston short-term borrowings:		
Ending balance	\$ —	\$ —
Average daily balance	\$ 3,668	\$ 81,167
Ending interest rate	NA	NA
Average interest rate	0.54%	0.26%
Highest month-end balance	\$21,000	\$142,000

Information relating to long-term borrowings is presented below:

	<u>December 31, 2016</u>		<u>December 31, 2015</u>	
	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>
	(Dollars in thousands)			
FHLB Boston long-term advances:				
Due 09/01/2020; amortizing	<u>\$3,746</u>	<u>1.94%</u>	<u>\$3,910</u>	<u>1.94%</u>

All short- and long-term borrowings with the FHLB Boston are secured by the Bank's stock in the FHLB Boston and a blanket lien on "qualified collateral" defined principally as 90% of the market value of certain U.S. Government and GSE obligations and 75% of the carrying value of certain residential mortgage loans. Based upon collateral pledged, the Bank's unused borrowing capacity with the FHLB Boston at December 31, 2016 was approximately \$306,752,000. The maturity date of the Bank's long term borrowing at December 31, 2016 was September 1, 2020.

The Bank also has a line of credit with the FRB Boston. At December 31, 2016, the Bank had pledged commercial real estate and commercial & industrial loans with aggregate principal balances of approximately \$306,761,000 as collateral for this line of credit. Based upon the collateral pledged, the Bank's unused borrowing capacity with the FRB Boston at December 31, 2016 was approximately \$159,607,000.

12. INCOME TAXES

The components of income tax expense were as follows:

	Year Ended December 31,	
	2016	2015
	(In thousands)	
Current:		
Federal	\$7,551	\$6,855
State	1,833	1,458
Total current expense	<u>9,384</u>	<u>8,313</u>
Deferred:		
Federal	(645)	(594)
State	(183)	(168)
Total deferred benefit	<u>(828)</u>	<u>(762)</u>
Total income tax expense	<u>\$8,556</u>	<u>\$7,551</u>

The following is a reconciliation of the total income tax provision, calculated at statutory federal income tax rates, to the income tax provision in the consolidated statements of income:

	Year Ended December 31,	
	2016	2015
	(In thousands)	
Provision at statutory rates	\$ 8,908	\$ 8,136
Increase/(decrease) resulting from:		
State tax, net of federal tax benefit	1,073	839
Tax-exempt income	(1,099)	(1,041)
ESOP dividends	(214)	(207)
Bank owned life insurance	(214)	(233)
Other	102	57
Total income tax expense	<u>\$ 8,556</u>	<u>\$ 7,551</u>

The Corporation's net deferred tax asset consisted of the following components:

	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
Gross deferred tax assets:		
Allowance for loan losses	\$ 6,234	\$ 6,206
Accrued retirement benefits	5,595	4,646
Unrealized losses on AFS securities	1,496	851
Incentive compensation	1,413	886
Equity based compensation	333	268
Rent	299	186
ESOP dividends	249	241
Other	295	177
Total gross deferred tax assets	<u>15,914</u>	<u>13,461</u>
Gross deferred tax liabilities:		
Deferred loan origination costs	(625)	(617)
Depreciation of premises and equipment	(1,100)	(601)
Mortgage servicing rights	(332)	(201)
Goodwill	(165)	(122)
Total gross deferred tax liabilities	<u>(2,222)</u>	<u>(1,541)</u>
Net deferred tax asset	<u>\$13,692</u>	<u>\$11,920</u>

It is management's belief, that it is more likely than not, that the reversal of deferred tax liabilities and results of future operations will generate sufficient taxable income to realize the deferred tax assets. In addition, the Corporation's net deferred tax asset is supported by recoverable income taxes. Therefore, no valuation allowance was required at either December 31, 2016 or 2015 for the deferred tax assets. It should be noted, however, that factors beyond management's control, such as the general state of the economy and real estate values, can affect future levels of taxable income and that no assurance can be given that sufficient taxable income will be generated in future periods to fully absorb deductible temporary differences.

At December 31, 2016 and 2015, the Corporation had no unrecognized tax benefits or any uncertain tax positions. The Corporation does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

The Corporation's federal income tax returns are open and subject to examination from the 2013 tax return year and forward. The Corporation's state income tax returns are generally open from the 2013 and later tax return years based on individual state statute of limitations.

13. PENSION AND RETIREMENT PLANS

The Corporation has a noncontributory, defined benefit pension plan ("Pension Plan") covering substantially all employees hired before May 2, 2011. Employees in positions requiring at least 1,000 hours of service per year were eligible to participate upon the attainment of age 21 and the completion of one year of service. Benefits are based primarily on years of service and the employee's average monthly pay during the five highest consecutive plan years of the employee's final ten years. The Corporation also provides supplemental retirement benefits to certain executive officers of the Corporation under the terms of Supplemental Executive Retirement Agreements ("Supplemental Retirement Plan"). The Supplemental Retirement Plan became effective on October 1, 1989. Benefits to be paid under the plan are contractually agreed upon and detailed in individual agreements with the executives. The Corporation uses a December 31 measurement date each year to determine the benefit obligations for these plans.

Projected benefit obligations and funded status were as follows:

	Pension Plan		Supplemental Retirement Plan	
	2016	2015	2016	2015
	(In thousands)			
Change in projected benefit obligation:				
Obligation at beginning of year	\$40,653	\$40,964	\$ 8,419	\$ 8,211
Service cost	1,561	1,711	282	732
Interest cost	1,771	1,632	366	328
Actuarial loss/(gain)	1,044	(2,671)	316	(483)
Benefits paid	(1,114)	(983)	(492)	(369)
Obligation at end of year	<u>43,915</u>	<u>40,653</u>	<u>8,891</u>	<u>8,419</u>
Change in plan assets:				
Fair value at beginning of year	38,482	40,400	—	—
Actual return on plan assets	2,453	(935)	—	—
Employer contribution	—	—	492	369
Benefits paid	(1,114)	(983)	(492)	(369)
Fair value at end of year	<u>39,821</u>	<u>38,482</u>	<u>—</u>	<u>—</u>
Underfunded status at end of year	<u>\$ (4,094)</u>	<u>\$ (2,171)</u>	<u>\$ (8,891)</u>	<u>\$ (8,419)</u>

Amounts recognized in the consolidated balance sheets consisted of:

	Pension Plan		Supplemental Retirement Plan	
	2016	2015	2016	2015
	(In thousands)			
Other (liabilities)/assets	<u>\$ (4,094)</u>	<u>\$ (2,171)</u>	<u>\$ (8,891)</u>	<u>\$ (8,419)</u>

Amounts recognized in accumulated other comprehensive income (loss) consisted of:

	Pension Plan		Supplemental Retirement Plan	
	2016	2015	2016	2015
	(In thousands)			
Net actuarial loss/(gain)	\$11,798	\$11,261	\$679	\$428
Prior service (benefit)	(20)	(25)	—	—
	<u>\$11,778</u>	<u>\$11,236</u>	<u>\$679</u>	<u>\$428</u>

Information for pension plans with an accumulated benefit obligation in excess of plan assets:

	Pension Plan		Supplemental Retirement Plan	
	2016	2015	2016	2015
	(In thousands)			
Projected benefit obligation	\$43,915	\$40,653	\$8,891	\$8,419
Accumulated benefit obligation	37,473	34,705	8,891	8,419
Fair value of plan assets	39,821	38,482	—	—

The components of net periodic benefit cost and amounts recognized in other comprehensive income were as follows:

	<u>Pension Plan</u>		<u>Supplemental Retirement Plan</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
	(In thousands)			
Net periodic benefit cost:				
Service cost	\$ 1,561	\$ 1,711	\$282	\$ 732
Interest cost	1,771	1,632	366	329
Expected return on assets	(2,837)	(2,986)	—	—
Amortization of prior service credit	(4)	(4)	64	—
Amortization of net actuarial loss	891	778	—	24
Net periodic benefit cost	<u>1,382</u>	<u>1,131</u>	<u>712</u>	<u>1,085</u>
Amounts recognized in other comprehensive income:				
Net actuarial loss/(gain)	1,429	1,249	251	(483)
Amortization of prior service credit	4	4	—	—
Amortization of net actuarial loss	(891)	(778)	—	—
Total recognized in other comprehensive income	<u>542</u>	<u>475</u>	<u>251</u>	<u>(483)</u>
Total recognized in net periodic benefit cost and other comprehensive income	<u>\$ 1,924</u>	<u>\$ 1,606</u>	<u>\$963</u>	<u>\$ 602</u>

Weighted-average assumptions used to determine projected benefit obligations are as follows:

	<u>Pension Plan</u>		<u>Supplemental Retirement Plan</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
Discount rate	4.25%	4.35%	4.25%	4.35%
Rate of compensation increase	4.00%	4.00%	NA	NA

Weighted-average assumptions used to determine net periodic benefit cost are as follows:

	<u>Pension Plan</u>		<u>Supplemental Retirement Plan</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
Discount rate	4.35%	4.00%	4.35%	4.00%
Expected long-term return on plan assets	7.50%	7.50%	NA	NA
Rate of compensation increase	4.00%	4.00%	NA	NA

The expected long-term rate of return has been established based on the ongoing investment of pension plan assets in a diversified portfolio of equities and fixed income securities. The components of the expected long-term rate of return include annual expectations for a risk-free rate of return of approximately 3.00% per year, plus long-term annual inflation at approximately 3.00% per year, plus a risk premium rate of return of approximately 1.50% per year.

The Corporation maintains an Investment Policy for its defined benefit pension plan. The objective of this policy is to seek a balance between capital appreciation, current income, and preservation of capital, with a longer term tilt towards equities because of the extended time horizon of the pension plan.

The Investment Policy guidelines suggest that the target asset allocation percentages are from 30% to 60% in domestic large cap equities, from 5% to 20% in domestic small/mid cap equities, from 0% to 20% in international equities and from 20% to 50% in cash and fixed income. The Corporation does not expect to make a contribution to its defined benefit pension plan in 2017.

The Corporation's defined pension plan weighted-average asset allocations by asset category were as follows:

	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
Equity securities	67%	70%
Debt securities	28	23
Cash and equivalents	<u>5</u>	<u>7</u>
Total	<u>100%</u>	<u>100%</u>

The three broad levels of fair values used to measure the pension plan assets are as follows:

- Level 1 – Quoted prices for identical assets in active markets.
- Level 2 – Quoted prices for similar assets in active markets; quoted prices for identical or similar assets in inactive markets; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.
- Level 3 – Valuations derived from techniques in which one or more significant inputs or significant value drivers are unobservable in the markets and which reflect the Corporation's market assumptions.

The following table summarizes the various categories of the pension plan's assets:

	<u>Fair Value as of December 31, 2016</u>			
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
	(In thousands)			
Asset category:				
Cash and cash equivalents	\$ 2,112	\$ —	\$ —	\$ 2,112
Fixed Income	11,186	—	\$ —	\$11,186
Equity securities:				
Common stocks:				
Large cap core	10,905	—	—	10,905
Mid cap core	4,380	—	—	4,380
Small cap core	2,338	—	—	2,338
Mutual funds:				
Domestic Equity	4,472	—	—	4,472
International	4,327	—	—	4,327
Preferred Stock	<u>101</u>	<u>—</u>	<u>—</u>	<u>101</u>
Total	<u>\$39,821</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$39,821</u>

There were no transfers between fair value levels during the years ended December 31, 2016 and 2015.

The Corporation offers postretirement health care benefits for current and future retirees of the Bank. Employees receive a fixed monthly benefit at age 65 toward the purchase of postretirement medical coverage. The benefit received is based on the employee's years of active service. The Corporation uses a December 31 measurement date each year to determine the benefit obligation for this plan.

Projected benefit obligations and funded status were as follows:

	Postretirement Healthcare Plan	
	2016	2015
	(In thousands)	
Change in projected benefit obligation:		
Obligation at beginning of year	\$ 621	\$ 646
Service cost	17	18
Interest cost	24	25
Actuarial loss/(gain)	(68)	(44)
Benefits paid	(26)	(24)
Obligation at end of year	<u>568</u>	<u>621</u>
Change in plan assets:		
Fair value at beginning of year	—	—
Actual return on plan assets	—	—
Employer contribution	26	24
Benefits paid	(26)	(24)
Fair value at end of year	<u>—</u>	<u>—</u>
Underfunded status at end of year	<u><u>\$ (568)</u></u>	<u><u>\$ (621)</u></u>

Amounts recognized in the consolidated balance sheets consisted of:

	Postretirement Healthcare Plan	
	2016	2015
	(In thousands)	
Other liabilities	<u><u>\$ (568)</u></u>	<u><u>\$ (621)</u></u>

Amounts recognized in accumulated other comprehensive loss consisted of:

	Postretirement Healthcare Plan	
	2016	2015
	(In thousands)	
Net actuarial (gain) loss	\$(128)	\$(69)
Prior service cost	—	(4)
	<u><u>\$(128)</u></u>	<u><u>\$(73)</u></u>

Information for pension plans with an accumulated benefit obligation in excess of plan assets:

	Postretirement Healthcare Plan	
	2016	2015
	(In thousands)	
Projected benefit obligation	\$568	\$621
Accumulated benefit obligation	568	621
Fair value of plan assets	—	—

The components of net periodic benefit cost and amounts recognized in other comprehensive income were as follows:

	Postretirement Healthcare Plan	
	2016	2015
	(In thousands)	
Net periodic benefit cost:		
Service cost	\$ 17	\$ 18
Interest cost	23	25
Expected return on assets	—	—
Amortization of prior service credit	(4)	(8)
Amortization of net actuarial gain	(9)	—
Net periodic benefit cost	<u>27</u>	<u>35</u>
Amounts recognized in other comprehensive income:		
Net actuarial (gain)/loss	(68)	(44)
Amortization of prior service credit	4	8
Amortization of net actuarial gain	9	—
Total recognized in other comprehensive income	<u>(55)</u>	<u>(36)</u>
Total recognized in net periodic benefit cost and other comprehensive income	<u>\$ (28)</u>	<u>\$ (1)</u>

Weighted-average assumptions used to determine projected benefit obligations are as follows:

	Postretirement Healthcare Plan	
	2016	2015
Discount rate	4.25%	4.35%
Rate of compensation increase	NA	NA

Weighted-average assumptions used to determine net periodic benefit cost are as follows:

	Postretirement Healthcare Plan	
	2016	2015
Discount rate	4.35%	4.00%
Expected long-term return on plan assets	NA	NA
Rate of compensation increase	NA	NA

Assumed health care cost trend rates are as follows:

	December 31,	
	2016	2015
Health care cost trend rate assumed for next year	4.00%	4.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	4.00%	4.00%
Year that the rate reaches the ultimate trend rate	2017	2016

Assumed health care trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	One Percentage Point	
	Increase	Decrease
	(In thousands)	
Effect on total service and interest cost	\$ —	\$ —
Effect on postretirement benefit obligation	5	(5)

Benefits expected to be paid in the next ten years are as follows:

<u>Year ended December 31,</u>	<u>Pension Plan</u>	<u>Supplemental Retirement Plan</u>	<u>Postretirement Healthcare Plan</u>	<u>Total</u>
	(In thousands)			
2017	\$ 1,319	\$ 500	\$ 29	\$ 1,848
2018	1,445	592	29	2,066
2019	1,475	589	28	2,092
2020	1,640	586	33	2,259
2021	1,699	590	33	2,322
2022-2026 inclusive	<u>10,315</u>	<u>2,960</u>	<u>199</u>	<u>13,474</u>
Ten year total	<u>\$17,893</u>	<u>\$5,817</u>	<u>\$351</u>	<u>\$24,061</u>

The estimated amounts that will be amortized from accumulated other comprehensive income into net periodic benefit cost during 2017 are as follows:

	<u>Pension Plan</u>	<u>Supplemental Retirement Plan</u>	<u>Postretirement Healthcare Plan</u>	<u>Total</u>
	(In thousands)			
Prior service cost	\$ 4	\$ —	\$ —	\$ 4
Net (gain) loss	900	—	(7)	893
Total	<u>\$904</u>	<u>\$ —</u>	<u>\$ (7)</u>	<u>\$897</u>

The Corporation maintains a Profit Sharing Plan (“PSP”) that provides for deferral of federal and state income taxes on employee contributions allowed under Section 401(k) of federal law. The Corporation matches employee contributions up to 100% of the first 3% of each participant’s salary. Each year, the Corporation may also make a discretionary contribution to the PSP. Employees are eligible to participate in the 401(k) feature of the PSP on the first business day of the quarter following their initial date of service and attainment of age 21. Employees are eligible to participate in discretionary contribution feature of the PSP on January 1 and July 1 of each year provided they have attained the age of 21 and the completion of 12 months of service consisting of at least 1,000 hours.

The Corporation has an Employee Stock Ownership Plan (“ESOP”) for its eligible employees. Employees are eligible to participate upon the attainment of age 21 and the completion of 12 months of service consisting of at least 1,000 hours. It is anticipated that the ESOP will purchase from the Corporation shares presently authorized but unissued at a price determined by an independent appraiser and certified by a committee of the trustees of the ESOP. Purchases of the Corporation’s stock by the ESOP will be funded solely by employer contributions. At December 31, 2016 and 2015, the ESOP owned 326,377 shares and 327,569 shares, respectively, of the Corporation’s common stock.

Total expenses related to the Profit Sharing and ESOP Plans for the years ended December 31, 2016 and 2015, amounted to approximately \$949,000 and \$900,000, respectively.

14. STOCK OPTION AND DIRECTOR STOCK PLANS

In 1993, the Corporation adopted a Stock Option Plan for key employees as an incentive for them to assist the Corporation in achieving long-range performance goals. During 2005, the Corporation’s shareholders amended the plan to permit the issuance of restricted stock, restricted stock units (“RSUs”) and stock appreciation rights (“SARs”).

Stock options time-vest over a five-year period. All options expire 10 years from the date granted and have been issued at fair value at the date of grant which, in some instances, may be less than publicly traded values. A

summary of stock options outstanding as of December 31, 2016 and 2015, and changes during the years ended on those dates is presented below:

	2016		2015	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Stock options:				
Outstanding at beginning of year	108,952	\$29.72	176,997	\$29.61
Granted	—	—	—	—
Forfeited	—	—	—	—
Expired	(21,900)	28.11	(31,828)	29.88
Exercised	(41,440)	30.01	(36,217)	29.06
Outstanding at end of year	<u>45,612</u>	<u>30.23</u>	<u>108,952</u>	<u>29.72</u>
Exercisable at end of year	<u>45,612</u>	<u>\$30.23</u>	<u>108,952</u>	<u>\$29.72</u>

The following table summarizes information about stock options outstanding at December 31, 2016:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/16	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at 12/31/16	Weighted Average Exercise Price
\$25.00 - \$29.99	32,004	0.79 years	\$29.11	32,004	\$29.11
\$30.00 - \$34.99	13,608	0.14 years	32.87	13,608	32.87
	<u>45,612</u>	<u>0.59 years</u>	<u>\$30.23</u>	<u>45,612</u>	<u>\$30.23</u>

Restricted stock awards time-vest either over a three-year or five-year period and have been fair valued as of the date of grant. The holders of restricted stock awards participate fully in the rewards of stock ownership of the Corporation, including voting and dividend rights. A summary of non-vested restricted shares outstanding as of December 31, 2016 and 2015, and changes during the years ended on those dates is presented below:

	2016		2015	
	Number of Shares	Weighted Average Grant Value	Number of Shares	Weighted Average Grant Value
Restricted stock:				
Non-vested at beginning of year	47,808	\$42.08	39,086	\$37.84
Granted	16,346	46.35	26,376	44.82
Vested	(18,050)	40.86	(13,212)	35.85
Forfeited	(4,147)	43.00	(4,442)	39.60
Non-vested at end of year	<u>41,957</u>	<u>\$44.17</u>	<u>47,808</u>	<u>\$42.08</u>

Restricted stock unit awards vest based upon the Corporation's performance over a three-year period and have been fair valued as of the date of grant. The holders of performance-based RSU awards do not participate in the rewards of stock ownership of the Corporation until vested. A summary of non-vested restricted stock units outstanding as of December 31, 2016 and 2015, and changes during the years ended on those dates is presented below:

	2016		2015	
	Number of Shares	Weighted Average Grant Value	Number of Shares	Weighted Average Grant Value
Restricted stock units:				
Non-vested at beginning of year	20,149	\$43.05	26,588	\$39.85
Granted	14,305	46.00	6,976	44.46
Vested (Performance achieved)	—	—	—	—
Forfeited	(1,713)	44.94	(5,045)	42.51
Expired (Performance not achieved)	(6,800)	40.70	(8,370)	34.39
Non-vested at end of year	<u>25,941</u>	<u>\$45.17</u>	<u>20,149</u>	<u>\$43.05</u>

In 1993, the Corporation initiated a Director Stock Plan ("DSP"). The DSP provides that Directors of the Corporation receive their annual retainer fee in the form of stock in the Corporation. Total shares issued under the DSP in the years ending December 31, 2016 and 2015 were 5,577 and 5,837, respectively.

The following table presents the amounts recognized in the consolidated financial statements for stock options, nonvested share awards and nonvested performance shares:

	December 31,	
	2016	2015
	(In thousands)	
Share-based compensation expense	\$997	\$520
Related income tax benefit	\$407	\$212

15. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

To meet the financing needs of its customers, the Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business. These financial instruments are primarily comprised of commitments to extend credit, commitments to sell residential real estate mortgage loans, risk participation agreements and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for loan commitments and standby letters of credit is represented by the contractual amount of those instruments assuming that the amounts are fully advanced and that collateral or other security is of no value. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Off-balance-sheet financial instruments with contractual amounts that present credit risk included the following:

	<u>December 31,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
Financial instruments whose contractual amount represents credit risk:		
Commitments to extend credit:		
Unused portion of existing lines of credit	\$256,767	\$245,446
Origination of new loans	26,024	47,598
Standby letters of credit	7,763	10,033
Liabilities associated with letters of credit	—	36
Financial instruments whose notional amount exceeds the amount of credit risk:		
Commitments to sell residential mortgage loans	9,622	—
Customer related derivative contracts:		
Interest rate swaps with customers	68,372	11,625
Mirror swaps with counterparties	68,372	11,625
Risk participation agreements with counterparties	16,378	—

Standby letters of credit are conditional commitments issued by the Bank to guarantee performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. Most guarantees extend for one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The collateral supporting those commitments varies and may include real property, accounts receivable or inventory. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained upon extension of the credit is based on management's credit evaluation of the customer. Collateral held varies, but may include primary residences, accounts receivable, inventory, property, plant and equipment, and income-producing commercial real estate.

16. COMMITMENTS AND CONTINGENCIES

The Corporation is obligated under various lease agreements covering its main office, branch offices and other locations. These agreements are accounted for as operating leases and their terms expire between 2017 and 2030 and, in some instances, contain options to renew for periods up to twenty-five years. The total minimum rentals due in future periods under these agreements in effect at December 31, 2016 were as follows:

<u>Year Ended December 31,</u>	<u>Future Minimum Lease Payments</u>
	(In thousands)
2017	\$ 4,159
2018	4,003
2019	3,554
2020	3,064
2021	2,733
Thereafter	<u>15,635</u>
Total minimum lease payments	<u>\$33,148</u>

Several lease agreements contain clauses calling for escalation of minimum lease payments contingent on increases in real estate taxes, gross income adjustments, percentage increases in the consumer price index and certain ancillary maintenance costs. Total rental expense amounted to approximately \$4,626,000 and \$4,229,000 for the years ended December 31, 2016 and 2015, respectively.

Under the terms of a sublease agreement, the Corporation will receive minimum annual rental payments of approximately \$29,000 through July 31, 2019. Total rental income amounted to approximately \$76,000 and \$33,000 for the years ended December 31, 2016 and 2015, respectively.

The Bank is involved in various legal actions arising in the normal course of business. Although the ultimate outcome of these actions cannot be ascertained at this time, it is the opinion of management, after consultation with counsel, that the resolution of such actions will not have a material adverse effect on the consolidated financial condition of the Corporation.

The Corporation has entered into agreements with its President and with certain other senior officers, whereby, following the occurrence of a change in control of the Corporation, if employment is terminated (except because of death, retirement, disability or for “cause” as defined in the agreements) or is voluntarily terminated for “good reason,” as defined in the agreements, said officers will be entitled to receive additional compensation, as defined in the agreements.

17. STOCKHOLDERS' EQUITY

Capital guidelines issued by the Federal Reserve Board (“FRB”) and by the FDIC require that the Corporation and the Bank maintain minimum capital levels for capital adequacy purposes. These regulations also require banks and their holding companies to maintain higher capital levels to be considered “well-capitalized”. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Corporation’s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, there are specific capital guidelines that involve quantitative measures of assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The risk-based capital rules are designed to make regulatory capital more sensitive to differences in risk profiles among bank and bank holding companies, to account for off-balance-sheet exposure and to minimize disincentives for holding liquid assets. Management believes that as of December 31, 2016 and 2015, the Corporation and the Bank met all applicable minimum capital requirements and were considered “well-capitalized” by both the FRB and the FDIC. There have been no events or conditions since the end of the year that management believes would have changed the Corporation’s or the Bank’s category.

The Corporation's and the Bank's actual and required capital measures were as follows:

	Actual		Minimum Capital Required For Capital Adequacy		Minimum Capital Required For Capital Adequacy Plus Capital Conservation Buffer Basel III Phase-In Schedule		Minimum Capital Required For Capital Adequacy Plus Capital Conservation Buffer Basel III Fully Phased In		Minimum To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
At December 31, 2016:										
Cambridge Bancorp:										
Total capital (to risk-weighted assets)	\$159,141	13.1%	\$96,873	8.0%	\$104,441	8.625%	\$127,145	10.5%	N/A	N/A
Tier I capital (to risk-weighted assets)	144,003	11.9%	72,654	6.0%	80,223	6.625%	102,927	8.5%	N/A	N/A
Common equity tier I capital (to risk-weighted assets)	144,003	11.9%	54,491	4.5%	62,059	5.125%	84,763	7.0%	N/A	N/A
Tier I capital (to average assets)	144,003	7.9%	72,488	4.0%	72,488	4.000%	72,488	4.0%	N/A	N/A
Cambridge Trust Company:										
Total capital (to risk-weighted assets)	\$156,928	13.0%	\$96,873	8.0%	\$104,441	8.625%	\$127,145	10.5%	\$121,091	10.0%
Tier I capital (to risk-weighted assets)	141,790	11.7%	72,654	6.0%	80,223	6.625%	102,927	8.5%	96,873	8.0%
Common equity tier I capital (to risk-weighted assets)	141,790	11.7%	54,491	4.5%	62,059	5.125%	84,763	7.0%	78,709	6.5%
Tier I capital (to average assets)	141,790	7.8%	72,488	4.0%	72,488	4.000%	72,488	4.0%	90,610	5.0%
At December 31, 2015:										
Cambridge Bancorp:										
Total capital (to risk-weighted assets)	\$143,044	12.7%	\$90,159	8.0%	\$ 90,159	8.0%	\$118,334	10.5%	N/A	N/A
Tier I capital (to risk-weighted assets)	128,943	11.4%	67,620	6.0%	67,620	6.0%	95,794	8.5%	N/A	N/A
Common equity tier I capital (to risk-weighted assets)	128,943	11.4%	50,715	4.5%	50,715	4.5%	78,890	7.0%	N/A	N/A
Tier I capital (to average assets)	128,943	7.5%	68,619	4.0%	68,619	4.0%	68,619	4.0%	N/A	N/A
Cambridge Trust Company:										
Total capital (to risk-weighted assets)	\$141,341	12.5%	\$90,159	8.0%	\$ 90,159	8.0%	\$118,334	10.5%	\$112,699	10.0%
Tier I capital (to risk-weighted assets)	127,240	11.3%	67,620	6.0%	67,620	6.0%	95,794	8.5%	90,159	8.0%
Common equity tier I capital (to risk-weighted assets)	127,240	11.3%	50,715	4.5%	50,715	4.5%	78,890	7.0%	73,255	6.5%
Tier I capital (to average assets)	127,240	7.5%	67,783	4.0%	67,783	4.0%	67,783	4.0%	84,729	5.0%

18. OTHER INCOME

The components of other income were as follows:

	Year Ended December 31,	
	2016	2015
	(In thousands)	
Safe deposit box income	\$366	\$342
Loan fee income	229	248
Miscellaneous income	326	291
Total other income	<u>\$921</u>	<u>\$881</u>

19. OTHER OPERATING EXPENSES

The components of other operating expenses were as follows:

	<u>Year Ended December 31,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
Director fees	\$ 513	\$ 561
Contributions / Public relations	434	517
Printing and supplies	291	341
Travel and entertainment	331	302
Dues and memberships	276	286
Security	233	282
Postage	241	264
Other losses	227	205
Miscellaneous expense	386	271
Total other operating expenses	<u>\$2,932</u>	<u>\$3,029</u>

20. OTHER COMPREHENSIVE INCOME

Comprehensive income is defined as all changes to equity except investments by and distributions to stockholders. Net income is a component of comprehensive income, with all other components referred to in the aggregate as “other comprehensive income”. The Corporation’s other comprehensive income consists of unrealized gains or losses on securities held at year-end classified as available-for-sale and the component of the unfunded retirement liability computed in accordance with the requirements of ASC 715, “*Compensation – Retirement Benefits*”. The before-tax and after-tax amount of each of these categories, as well as the tax (expense)/benefit of each, is summarized as follows:

	<u>Year Ended December 31, 2016</u>		
	<u>Before Tax Amount</u>	<u>Tax (Expense) or Benefit</u>	<u>Net-of-tax Amount</u>
	(In thousands)		
Defined benefit retirement plans:			
Change in unfunded retirement liability	\$ (738)	\$301	\$ (437)
Unrealized gains/(losses) on AFS securities:			
Unrealized holding gains/(losses) arising during the period	(1,224)	489	(735)
Reclassification adjustment for gains recognized in net income	(438)	157	(281)
	<u>\$ (2,400)</u>	<u>\$947</u>	<u>\$ (1,453)</u>
	<u>Year Ended December 31, 2015</u>		
	<u>Before Tax Amount</u>	<u>Tax (Expense) or Benefit</u>	<u>Net-of-tax Amount</u>
	(In thousands)		
Defined benefit retirement plans:			
Change in unfunded retirement liability	\$ 67	\$ (27)	\$ 40
Unrealized (losses)/gains on AFS securities:			
Unrealized holding (losses)/gains arising during the period	(1,504)	524	(980)
Reclassification adjustment for gains recognized in net income	(690)	247	(443)
	<u>\$ (2,127)</u>	<u>\$744</u>	<u>\$ (1,383)</u>

Reclassifications out of Accumulated Other Comprehensive Income (“AOCI”) are presented below:

Year Ended December 31, 2016		
<u>Details about AOCI Components</u>	<u>Amount Reclassified from AOCI</u>	<u>Affected Line Item on the Statement of Income</u>
(In thousands)		
Unrealized gains/(losses) on AFS securities:		
	\$ 438	Gain on disposition of investment securities
	<u>(157)</u>	Income tax expense
	<u>\$ 281</u>	Net income

Year Ended December 31, 2015		
<u>Details about AOCI Components</u>	<u>Amount Reclassified from AOCI</u>	<u>Affected Line Item on the Statement of Income</u>
(In thousands)		
Unrealized gains/(losses) on AFS securities:		
	\$ 690	Gain on disposition of investment securities
	<u>(247)</u>	Income tax expense
	<u>\$ 443</u>	Net income

21. EARNINGS PER SHARE

The following represents a reconciliation between basic and diluted earnings per share:

	<u>Year ended December 31,</u>	
	<u>2016</u>	<u>2015</u>
Earnings per common share - basic:		
Net income	\$16,896	\$15,694
Less dividends and undistributed earnings allocated to participating securities	<u>(182)</u>	<u>(182)</u>
Net income applicable to common shareholders	\$16,714	\$15,512
Weighted average common shares	3,990	3,938
Earnings per common share - basic	<u>\$ 4.19</u>	<u>\$ 3.94</u>
Earnings per common share - diluted:		
Net income	\$16,896	\$15,694
Less dividends and undistributed earnings allocated to participating securities	<u>(181)</u>	<u>—</u>
Net income applicable to common shareholders	\$16,715	\$15,694
Weighted average common shares	3,990	3,938
Dilutive effect of common stock equivalents	<u>39</u>	<u>55</u>
Weighted average diluted common shares	4,029	3,993
Earnings per common share - diluted	<u>\$ 4.15</u>	<u>\$ 3.93</u>

22. DERIVATIVE FINANCIAL INSTRUMENTS

The Corporation enters into interest rate derivatives to accommodate the business requirements of its customers. Derivatives are recognized as either assets or liabilities on the balance sheet and are measured at fair value. The

accounting for changes in the fair value of derivatives depends on the intended use of the derivative and resulting designation.

Interest Rate Swaps

The Bank has entered into interest rate swap contracts to help commercial loan borrowers manage their interest rate risk. The interest rate swap contracts with commercial loan borrowers allow them to convert floating-rate loan payments to fixed-rate loan payments. When the Bank enters into an interest rate swap contract with a commercial loan borrower, it simultaneously enters into a “mirror” swap contract with a third party. The third party exchanges the client’s fixed-rate loan payments for floating-rate loan payments. As of December 31, 2016 and 2015, The Bank had interest rate swap contracts with commercial loan borrowers with notional amounts of \$68.4 million and \$11.6 million, respectively, and equal amounts of “mirror” swap contracts with third-party financial institutions. These derivatives are not designated as hedges and therefore, changes in fair value are recognized in earnings. Because these derivatives have mirror-image contractual terms, the changes in fair value substantially offset each other through earnings. Fees earned in connection with the execution of derivatives related to this program are recognized in earnings through other loan related derivative income.

The credit risk associated with swap transactions is the risk of default by the counterparty. To minimize this risk, the Corporation enters into interest rate agreements only with highly rated counterparties that management believes to be creditworthy. The notional amounts of these agreements do not represent amounts exchanged by the parties and, thus, are not a measure of the potential loss exposure.

Risk Participation Agreements

During 2016, the Corporation entered into risk participation agreements (“RPAs”) with other banks participating in commercial loan arrangements. Participating banks guarantee the performance on borrower-related interest rate swap contracts. RPAs are derivative financial instruments and are recorded at fair value. These derivatives are not designated as hedges and therefore, changes in fair value are recognized in earnings with a corresponding offset within other liabilities.

Under a risk participation-out agreement, a derivative asset, the Corporation participates out a portion of the credit risk associated with the interest rate swap position executed with the commercial borrower, for a fee paid to the participating bank. Under a risk participation-in agreement, a derivative liability, the Corporation assumes, or participates in, a portion of the credit risk associated with the interest rate swap position with the commercial borrower, for a fee received from the other bank.

As of December 31, 2016, the notional amounts of the risk participation-out agreements and risk participation-in agreements were \$16.4 million and \$0 million, respectively.

The following table presents the fair values of derivative instruments in the Corporation’s Consolidated Balance Sheets:

	Asset Derivatives Fair Value		Liability Derivatives Fair Value	
	2016	2015	2016	2015
Derivatives not Designated as Hedging Instruments:				
Loan related derivative contracts:				
Interest rate swaps with customers	\$ 165	\$315	\$1,467	\$ —
Mirror swaps with counterparties	1,467	—	165	315
Risk participation agreements	—	—	12	—
Total	<u>\$1,632</u>	<u>\$315</u>	<u>\$1,644</u>	<u>\$ 315</u>

23. FAIR VALUE MEASUREMENTS

The following is a summary of the carrying values and estimated fair values of the Corporation's significant financial instruments as of the dates indicated.

	December 31, 2016		December 31, 2015	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
	(In thousands)			
Financial assets:				
Cash and cash equivalents	\$ 54,050	\$ 54,050	\$ 24,645	\$ 24,645
Securities - available for sale	325,641	325,641	347,173	347,173
Securities - held to maturity	82,502	83,755	83,063	86,541
Loans excluding HFS, net	1,304,893	1,286,497	1,177,023	1,176,648
FHLB Boston stock	4,098	4,098	6,465	6,465
Accrued interest receivable	4,627	4,627	4,222	4,222
Loan level interest rate swaps	1,632	1,632	315	315
Financial liabilities:				
Deposits	1,686,038	1,684,065	1,557,224	1,555,542
Short-term borrowings	—	—	—	—
Long-term borrowings	3,746	3,745	3,910	3,905
Loan level interest rate swaps	1,632	1,632	315	315
Risk Participation Agreements	12	12	—	—

The Corporation follows ASC 820, "Fair Value Measurements and Disclosures" for financial assets and liabilities. ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosure requirements about fair value measurements. ASC 820, among other things, emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on the assumptions the market participants would use in pricing the asset or liability. In addition, ASC 820 specifies a hierarchy of valuations techniques based on whether the types of valuation information ("inputs") are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Corporation's market assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 – Quoted prices for identical assets or liabilities in active markets.
- Level 2 – Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.
- Level 3 – Valuations derived from techniques in which one or more significant inputs or significant value drivers are unobservable in the markets and which reflect the Corporation's market assumptions.

Under ASC 820, fair values are based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When available, the Corporation uses quoted market prices to determine fair value. If quoted prices are not available, fair value is based upon valuation techniques such as matrix pricing or other models that use, where possible, current market-based or independently sourced market parameters, such as interest rates. If observable market-based inputs are not available, the Corporation uses unobservable inputs to determine appropriate valuation adjustments using methodologies applied consistently over time.

Valuation techniques based on unobservable inputs are highly subjective and require judgments regarding significant matters such as the amount and timing of future cash flows and the selection of discount rates that may appropriately reflect market and credit risks. Changes in these judgments often have a material impact on the fair value estimates. In addition, since these estimates are as of a specific point in time, they are susceptible to

material near-term changes. The fair values disclosed do not reflect any premium or discount that could result from offering significant holdings of financial instruments at bulk sale, nor do they reflect the possible tax ramifications or estimated transaction costs. Changes in economic conditions may also dramatically affect the estimated fair values.

The Corporation uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Securities available for sale, and derivative instruments and hedges are recorded at fair value on a recurring basis. Additionally, from time to time, the Corporation may be required to record at fair value other assets on a nonrecurring basis, such as collateral dependent impaired loans.

The following table summarizes certain assets reported at fair value on a recurring basis:

Fair Value as of December 31, 2016				
<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>	
(In thousands)				
Measured on a recurring basis:				
Securities available for sale:				
U.S. GSE obligations	\$ —	\$138,709	\$ —	\$138,709
Mortgage-backed securities	—	181,299	—	181,299
Corporate debt securities	—	5,029	—	5,029
Mutual funds	604	—	—	604
Other assets:				
Interest rate swaps with customers	—	1,632	—	1,632
Other liabilities:				
Mirror swaps with counterparties	—	1,632	—	1,632
Risk Participation Agreements	—	12	—	12

Fair Value as of December 31, 2015				
<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>	
(In thousands)				
Measured on a recurring basis:				
Securities available for sale:				
U.S. GSE obligations	\$ —	\$139,770	\$ —	\$139,770
Mortgage-backed securities	—	205,806	—	205,806
Corporate debt securities	—	985	—	985
Mutual funds	612	—	—	612
Other assets:				
Interest rate swaps with customers	—	315	—	315
Other liabilities:				
Mirror swaps with counterparties	—	315	—	315

The following table presents the carrying value of assets held at December 31, 2016, which were measured at fair value on a non-recurring basis during the year ended December 31, 2016:

	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2 (In thousands)	Significant Unobservable Inputs Level 3	Total
Items Recorded at Fair Value on a Nonrecurring Basis				
Assets:				
Collateral dependent impaired loans	\$ —	\$ —	\$ 654	\$ 654
Loans Held For Sale	—	—	6,506	6,506
Total assets at fair value on a nonrecurring basis	<u>\$ —</u>	<u>\$ —</u>	<u>\$7,160</u>	<u>\$7,160</u>

The following is a description of the principal valuation methodologies used by the Corporation to estimate the fair values of its financial instruments.

Investment Securities

For investment securities, fair values are primarily based upon valuations obtained from a national pricing service which uses matrix pricing with inputs that are observable in the market or can be derived from, or corroborated by, observable market data. When available, quoted prices in active markets for identical securities are utilized.

Loans Held for Sale

For loans held for sale, fair values are estimated using projected future cash flows, discounted at rates based upon either trades of similar loans or mortgage-backed securities, or at current rates at which similar loans would be made to borrowers with similar credit ratings and for similar remaining maturities.

Loans

For most categories of loans, fair values are estimated using projected future cash flows, discounted at rates based upon either trades of similar loans or mortgage-backed securities, or at current rates at which similar loans would be made to borrowers with similar credit ratings and for similar remaining maturities. Loans that are deemed to be impaired in accordance with ASC 310, "Receivables", are valued based upon the lower of cost or fair value of the underlying collateral.

FHLB Boston Stock

The fair value of FHLB Boston stock equals its carrying value since such stock is only redeemable at its par value.

Deposits

The fair value of non-maturity deposit accounts is the amount payable on demand at the reporting date. This amount does not take into account the value of the Bank's long-term relationships with core depositors. The fair value of fixed-maturity certificates of deposit is estimated using a replacement cost of funds approach and is based upon rates currently offered for deposits of similar remaining maturities.

Long-Term Borrowings

For long-term borrowings, fair values are estimated using future cash flows, discounted at rates based upon current costs for debt securities with similar terms and remaining maturities.

Other Financial Assets and Liabilities

Cash and cash equivalents, accrued interest receivable and short-term borrowings have fair values which approximate their respective carrying values because these instruments are payable on demand or have short-term maturities and present relatively low credit risk and interest rate risk.

Derivative Instruments and Hedges

The valuation of these instruments is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including

interest rate curves and implied volatilities. The Bank incorporates credit valuation adjustments to appropriately reflect nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Bank has considered the impact of netting and any applicable credit enhancements, such as collateral postings.

Off-Balance-Sheet Financial Instruments

In the course of originating loans and extending credit, the Bank will charge fees in exchange for its commitment. While these commitment fees have value, the Bank has not estimated their value due to the short-term nature of the underlying commitments and their immateriality.

Values Not Determined

In accordance with ASC 820, the Corporation has not estimated fair values for non-financial assets such as banking premises and equipment, goodwill, the intangible value of the Bank's portfolio of loans serviced for itself and the intangible value inherent in the Bank's deposit relationships (i.e., core deposits), among others. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Corporation.

[THIS PAGE INTENTIONALLY LEFT BLANK]

[THIS PAGE INTENTIONALLY LEFT BLANK]

CAMBRIDGE TRUST COMPANY

DIRECTORS

DONALD T. BRIGGS
President
Federal Realty Boston
Executive Vice President – Development
Federal Realty Investment Trust

JEANETTE G. CLOUGH
President and Chief Executive Officer
Mount Auburn Hospital

SARAH G. GREEN
Retired Chief Operating Officer
Federal Reserve Bank of Richmond

EDWARD F. JANKOWSKI
Retired Senior Vice President-Residential
Lending and Corporate Compliance
Rockland Trust Company

HAMBLETON LORD
Managing Director
Launchpad Venture Group

LEON A. PALANDJIAN
Managing Member
Intercontinental Capital Management, LLC

ROBERT S. PETERKIN
Professor of Practice Emeritus
Harvard Graduate School of Education
Principal
Peterkin Consulting Group

CATHLEEN A. SCHMIDT
Executive Director & CEO
McLane Middleton Professional
Association

DENIS K. SHEAHAN
Chairman, President and Chief Executive
Officer
Cambridge Bancorp and Cambridge Trust
Company

R. GREGG STONE
Manager
Kestrel Management, LLC

ANNE M. THOMAS
Retired Special Counsel
City of Somerville

DAVID C. WARNER
Lead Director
Cambridge Bancorp and Cambridge Trust
Company
Partner
J. M. Forbes & Co. LLP

LINDA WHITLOCK

Retired President and Chief Executive Officer
Boys & Girls Clubs of Boston
Founder and Principal
The Whitlock Group

SUSAN R. WINDHAM-BANNISTER, Ph.D.

President & CEO
Biomedical Growth Strategies

OFFICERS

LYNNE M. BURROW

Executive Vice President – Chief Information
Officer & Director of Strategy & Planning

MICHAEL F. CAROTENUTO

Senior Vice President – Chief Financial Officer

THOMAS A. JOHNSON

Executive Vice President – Consumer Banking
Director & Corporate Secretary

MARTIN B. MILLANE, JR.

Executive Vice President – Chief Lending
Officer

JENNIFER A. PLINE

Executive Vice President – Head of Wealth
Management

PILAR PUEYO

Senior Vice President – Director of Human
Resources

ROBERT N. SIEGRIST

Senior Vice President – Marketing Director

Cambridge Bancorp Board of Directors



Front row from left to right: **Edward F. Jankowski, Linda Whitlock, Denis K. Sheahan, Cathleen A. Schmidt, Sarah G. Green,** Back row from left to right: **Anne M. Thomas, David C. Warner, Hambleton Lord, Jeanette G. Clough, Leon A. Palandjian, R. Gregg Stone, Robert S. Peterkin, Donald T. Briggs, Susan R. Windham-Bannister, Ph.D.**



Corporate Headquarters

Harvard Square

1336 Massachusetts Avenue
Cambridge, MA 02138
617-876-5500

Branch Locations

Harvard Square

1336 Massachusetts Avenue
Cambridge, MA 02138
617-876-2790

Huron Village

353 Huron Avenue
Cambridge, MA 02138
617-661-1317

Kendall Square

326 Main Street
Cambridge, MA 02142
617-441-0951

Porter Square

1720 Massachusetts Avenue
Cambridge, MA 02138
617-661-0398

University Park at MIT

350 Massachusetts Avenue
Cambridge, MA 02139
617-225-0792

Beacon Hill

65 Beacon Street
Boston, MA 02108
617-523-3551

South End

565 Tremont Street
Boston, MA 02118
617-236-2247

Belmont

361 Trapelo Road
Belmont, MA 02478
617-484-0892

Concord

75 Main Street
Concord, MA 01742
978-369-9909

Lexington

1690 Massachusetts Avenue
Lexington, MA 02420
781-863-0976

Weston

494 Boston Post Road
Weston, MA 02493
781-893-5500

Wealth Management Offices

Wealth Management

Main Office

75 State Street, 18th Floor
Boston, MA 02109
617-876-5500

Concord, NH

49 South Main Street, Suite 203
Concord, NH 03301
603-226-1212

Manchester, NH

1000 Elm Street, Suite 201
Manchester, NH 03101
603-657-9015

Portsmouth, NH

One Harbour Place, Suite 240
Portsmouth, NH 03801
603-373-6010

Cambridge Bancorp

Parent of Cambridge Trust Company
CambridgeTrust.com