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Bank of Marin Bancorp  
Form 10-Q  
August 08, 2013

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-33572

Bank of Marin Bancorp  
(Exact name of Registrant as specified in its charter)

California 20-8859754  
(State or other jurisdiction of incorporation) (IRS Employer Identification No.)

504 Redwood Blvd., Suite 100, Novato, CA 94947  
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (415) 763-4520

Indicate by check mark whether the registrant (1) has filed all reports to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark if the registrant is a shell company, as defined in Rule 12b(2) of the Exchange Act.

Yes  No

As of July 31, 2013, there were 5,454,943 shares of common stock outstanding.

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## PART I FINANCIAL INFORMATION

## ITEM 1. Financial Statements

BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CONDITION

at June 30, 2013 and December 31, 2012

(in thousands, except share data; 2013 unaudited)

	June 30, 2013	December 31, 2012
Assets		
Cash and due from banks	\$32,175	\$28,349
Investment securities		
Held-to-maturity, at amortized cost	131,839	139,452
Available-for-sale, at fair value (amortized cost \$127,989 and \$150,420 at June 30, 2013 and December 31, 2012, respectively)	129,562	153,962
Total investment securities	261,401	293,414
Loans, net of allowance for loan losses of \$14,357 and \$13,661 at June 30, 2013 and December 31, 2012, respectively	1,077,125	1,060,291
Bank premises and equipment, net	9,178	9,344
Interest receivable and other assets	48,639	43,351
Total assets	\$1,428,518	\$1,434,749
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest bearing	\$498,572	\$389,722
Interest bearing		
Transaction accounts	80,221	169,647
Savings accounts	95,317	93,404
Money market accounts	410,676	443,742
CDARS® time accounts	4,296	15,718
Other time accounts	135,355	141,056
Total deposits	1,224,437	1,253,289
Federal Home Loan Bank borrowings	32,200	15,000
Interest payable and other liabilities	13,522	14,668
Total liabilities	1,270,159	1,282,957
Stockholders' Equity		
Preferred stock, no par value	—	—
Authorized - 5,000,000 shares, none issued		
Common stock, no par value		
Authorized - 15,000,000 shares;		
Issued and outstanding - 5,442,628 and 5,389,210 at June 30, 2013 and December 31, 2012, respectively	60,312	58,573
Retained earnings	97,135	91,164
Accumulated other comprehensive income, net	912	2,055
Total stockholders' equity	158,359	151,792
Total liabilities and stockholders' equity	\$1,428,518	\$1,434,749

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

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BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, except per share amounts; unaudited)	Three months ended			Six months ended	
	June 30, 2013	March 31, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Interest income					
Interest and fees on loans	\$13,366	\$13,635	\$15,324	\$27,001	\$30,652
Interest on investment securities					
Securities of U.S. government agencies	585	625	817	1,210	1,784
Obligations of state and political subdivisions	437	638	455	1,075	842
Corporate debt securities and other	339	324	285	663	486
Interest due from banks and other	3	8	56	11	106
Total interest income	14,730	15,230	16,937	29,960	33,870
Interest expense					
Interest on interest bearing transaction accounts	12	11	45	23	89
Interest on savings accounts	8	8	24	16	46
Interest on money market accounts	95	99	180	194	363
Interest on CDARS® time accounts	2	5	21	7	53
Interest on other time accounts	224	232	269	456	573
Interest on borrowed funds	84	79	117	163	264
Total interest expense	425	434	656	859	1,388
Net interest income	14,305	14,796	16,281	29,101	32,482
Provision for (reversal of) loan losses	1,100	(230)	100	870	100
Net interest income after provision for (reversal of) loan losses	13,205	15,026	16,181	28,231	32,382
Non-interest income					
Service charges on deposit accounts	515	521	549	1,036	1,073
Wealth Management and Trust Services	539	547	488	1,086	944
Debit card interchange fees	280	252	259	532	493
Merchant interchange fees	222	205	186	427	379
Earnings on Bank-owned life insurance	186	401	192	587	380
Other income	202	180	126	382	226
Total non-interest income	1,944	2,106	1,800	4,050	3,495
Non-interest expense					
Salaries and related benefits	5,430	5,298	5,314	10,728	10,918
Occupancy and equipment	1,052	1,073	1,056	2,125	2,043
Depreciation and amortization	353	336	341	689	682
Federal Deposit Insurance Corporation insurance	223	214	218	437	451
Data processing	696	549	660	1,245	1,266
Professional services	814	527	516	1,341	1,101
Other expense	1,851	1,698	1,580	3,549	3,059
Total non-interest expense	10,419	9,695	9,685	20,114	19,520
Income before provision for income taxes	4,730	7,437	8,296	12,167	16,357
Provision for income taxes	1,675	2,571	3,345	4,246	6,466
Net income	\$3,055	\$4,866	\$4,951	\$7,921	\$9,891
Net income per common share:					
Basic	\$0.56	\$0.90	\$0.93	\$1.47	\$1.86
Diluted	\$0.55	\$0.89	\$0.91	\$1.44	\$1.82

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Weighted-average shares used to compute net income per common share:

Basic	5,419	5,389	5,337	5,404	5,331
Diluted	5,509	5,487	5,419	5,498	5,422
Dividends declared per common share	\$0.18	\$0.18	\$0.17	\$0.36	\$0.34
Comprehensive income:					
Net income	\$3,055	\$4,866	\$4,951	\$7,921	\$9,891
Other comprehensive (loss) income					
Change in net unrealized gain on available-for-sale securities	(1,666	) (303	) (39	) (1,969	) (11
Reclassification adjustment for (loss) gain on sale of securities included in net income	—	—	(4	) —	34
Net change in unrealized gain on available-for-sale securities, before tax	(1,666	) (303	) (43	) (1,969	) 23
Deferred tax (benefit) expense	(700	) (126	) (18	) (826	) 10
Other comprehensive (loss) income, net of tax	(966	) (177	) (25	) (1,143	) 13
Comprehensive income	\$2,089	\$4,689	\$4,926	\$6,778	\$9,904

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

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BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
for the year ended December 31, 2012 and the six months ended June 30, 2013

(dollars in thousands; 2013 unaudited )	Common Stock		Retained Earnings	Accumulated Other Comprehensive Income, Net of Taxes	Total
	Shares	Amount			
Balance at December 31, 2011	5,336,927	\$56,854	\$77,098	\$1,599	\$135,551
Net income	—	—	17,817	—	17,817
Other comprehensive income	—	—	—	456	456
Stock options exercised	37,563	1,041	—	—	1,041
Excess tax benefit - stock-based compensation	—	42	—	—	42
Stock issued under employee stock purchase plan	700	25	—	—	25
Restricted stock granted	9,030	—	—	—	—
Restricted stock forfeited / cancelled	(380 )	—	—	—	—
Stock-based compensation - stock options	—	206	—	—	206
Stock-based compensation - restricted stock	—	202	—	—	202
Cash dividends paid on common stock	—	—	(3,751 )	—	(3,751 )
Stock purchased by directors under director stock plan	100	4	—	—	4
Stock issued in payment of director fees	5,270	199	—	—	199
Balance at December 31, 2012	5,389,210	\$58,573	\$91,164	\$2,055	\$151,792
Net income	—	—	7,921	—	7,921
Other comprehensive loss	—	—	—	(1,143 )	(1,143 )
Stock options exercised	43,775	1,304	—	—	1,304
Excess tax benefit - stock-based compensation	—	88	—	—	88
Stock issued under employee stock purchase plan	519	20	—	—	20
Restricted stock granted	7,850	—	—	—	—
Restricted stock forfeited / cancelled	(1,735 )	—	—	—	—
Stock-based compensation - stock options	—	96	—	—	96
Stock-based compensation - restricted stock	—	115	—	—	115
Cash dividends paid on common stock	—	—	(1,950 )	—	(1,950 )
Stock purchased by directors under director stock plan	160	6	—	—	6
Stock issued in payment of director fees	2,849	110	—	—	110
Balance at June 30, 2013	5,442,628	\$60,312	\$97,135	\$912	\$158,359

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



BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CASH FLOWS

for the six months ended June 30, 2013 and 2012

(in thousands, unaudited)

	June 30, 2013	June 30, 2012	
Cash Flows from Operating Activities:			
Net income	\$7,921	\$9,891	
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	870	100	
Compensation expense--common stock for director fees	110	100	
Stock-based compensation expense	211	206	
Excess tax benefits from exercised stock options	(66)	(36)	)
Amortization of investment security premiums, net of accretion of discounts	1,676	931	
Accretion of discount on acquired loans	(789)	(1,502)	)
Decrease in deferred loan origination fees, net	(674)	(631)	)
Loss on sale of investment securities	—	34	
Depreciation and amortization	689	682	
Loss on disposal of premise and equipment	—	5	
(Gain) loss on sale of repossessed assets	(5)	3	)
Earnings on bank owned life insurance policies	(587)	(380)	)
Net change in operating assets and liabilities:			
Interest receivable	86	(188)	)
Interest payable	(20)	(123)	)
Deferred rent and other rent-related expenses	44	87	
Other assets	(3,804)	718	
Other liabilities	1,705	(2,346)	)
Total adjustments	(554)	(2,340)	)
Net cash provided by operating activities	7,367	7,551	
Cash Flows from Investing Activities:			
Purchase of securities held-to-maturity	—	(25,661)	)
Purchase of securities available-for-sale	—	(52,710)	)
Proceeds from sale of securities available-for-sale	1,082	2,186	
Proceeds from paydowns/maturity of securities held-to-maturity	6,550	1,843	
Proceeds from paydowns/maturity of securities available-for-sale	20,736	23,305	
Loans originated and principal collected, net	(19,220)	6,364	)
Purchase of bank owned life insurance policies	—	(364)	)
Purchase of premises and equipment	(523)	(263)	)
Proceeds from sale of repossessed assets	40	22	
Net cash provided by (used in) investing activities	8,665	(45,278)	)
Cash Flows from Financing Activities:			
Net (decrease) increase in deposits	(28,852)	27,745	)
Proceeds from stock options exercised	1,304	324	
Advance on Federal Home Loan Bank borrowings	17,200	—	
Repayment of Federal Home Loan Bank borrowings	—	(20,000)	)
Cash dividends paid on common stock	(1,950)	(1,818)	)
Stock issued under employee and director stock purchase plans	26	18	
Excess tax benefits from exercised stock options	66	36	
Net cash (used in) provided by financing activities	(12,206)	6,305	)
Net increase in cash and cash equivalents	3,826	(31,422)	)

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Cash and cash equivalents at beginning of period	28,349	129,743
Cash and cash equivalents at end of period	\$32,175	\$98,321
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$879	\$1,511
Cash paid for income taxes	\$7,889	\$7,936
Supplemental disclosure of non-cash investing and financing activities:		
Change in unrealized gain on available-for-sale securities	\$(1,969	) \$23
Loans transferred to repossessed assets	\$192	\$65
Stock issued in payment of director fees	\$110	\$100

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

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Introductory Explanation

References in this report to “Bancorp” mean the Bank of Marin Bancorp as the parent holding company for Bank of Marin, the wholly-owned subsidiary (the “Bank”). References to “we,” “our,” “us” mean Bancorp and the Bank that are consolidated for financial reporting purposes.

## Note 1: Basis of Presentation

The consolidated financial statements include the accounts of Bancorp and its only wholly-owned bank subsidiary, the Bank. All material intercompany transactions have been eliminated. In the opinion of Management, the unaudited interim consolidated financial statements contain all adjustments necessary to present fairly our financial position, results of operations, changes in stockholders' equity and cash flows. All adjustments are of a normal, recurring nature. Management has evaluated subsequent events through the date of filing, and has determined that there are no subsequent events that require recognition or disclosure except the pending NorCal Community Bancorp ("NorCal") acquisition as discussed in Note 3.

Certain information and footnote disclosures presented in the annual consolidated financial statements are not included in the interim consolidated financial statements. Accordingly, the accompanying unaudited interim consolidated financial statements should be read in conjunction with our 2012 Annual Report on Form 10-K. The results of operations for the three months and six months ended June 30, 2013 are not necessarily indicative of the operating results for the full year.

The following table shows: 1) weighted average basic shares, 2) potential common shares related to stock options, unvested restricted stock and stock warrant, and 3) weighted average diluted shares. Basic earnings per share (“EPS”) are calculated by dividing net income by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock. Diluted EPS are calculated using the weighted average diluted shares. The number of potential common shares included in quarterly diluted EPS is computed using the average market prices during the three months included in the reporting period under the treasury stock method. The number of potential common shares included in year-to-date diluted EPS is a year-to-date weighted average of potential common shares included in each quarterly diluted EPS computation. We have two forms of outstanding common stock: common stock and unvested restricted stock awards. Holders of restricted stock awards receive non-forfeitable dividends at the same rate as common shareholders and they both share equally in undistributed earnings.

(in thousands; except per share data; unaudited)	Three months ended			Six months ended	
	June 30, 2013	March 31, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Weighted average basic shares outstanding	5,419	5,389	5,337	5,404	5,331
Add: Potential common shares related to stock options	39	43	39	41	44
Potential common shares related to unvested restricted stock	2	7	2	4	4
Potential common shares related to warrants	49	48	41	49	43
Weighted average diluted shares outstanding	5,509	5,487	5,419	5,498	5,422
Net income	\$3,055	\$4,866	\$4,951	\$7,921	\$9,891
Basic EPS	\$0.56	\$0.90	\$0.93	\$1.47	\$1.86
Diluted EPS	\$0.55	\$0.89	\$0.91	\$1.44	\$1.82

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Weighted average anti-dilutive shares not included in the calculation of diluted EPS	60	45	69	54	44
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Note 2: Recently Issued Accounting Standards

In December 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-11 Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. The ASU enhances disclosures in order to improve the comparability of offsetting (netting) assets and liabilities reported in accordance with U.S. generally accepted accounting principles ("GAAP") and International Financial Reporting Standards ("IFRS") by requiring entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the statements of condition and instruments and transactions subject to an agreement similar to a master netting arrangement.

In January 2013, the FASB issued ASU No. 2013-01 Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, which clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11. It further clarifies that the scope of ASU No. 2011-11 applies to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria contained in FASB Accounting Standards Codification® or subject to a master netting arrangement or similar agreement. Both ASU 2011-11 and ASU 2013-01 are effective for annual periods beginning on or after January 1, 2013, and interim periods within those annual periods. We adopted these ASUs in the first quarter of 2013.

In February 2013, the FASB issued ASU No. 2013-02, Comprehensive Income (Topic 220) Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The ASU requires entities to present separately by component reclassifications out of accumulated other comprehensive income. An entity is required to disclose in the notes of the financial statements or parenthetically on the face of the financial statements the effect of significant items reclassified out of accumulated other comprehensive income on the respective line items of net income, but only if the item reclassified is required under U.S. GAAP to be reclassified to net income in its entirety. ASU 2013-02 is effective for fiscal years, and interim periods beginning on or after December 15, 2012 for public entities. We adopted this ASU in the first quarter of 2013.

In February 2013, the FASB issued ASU No. 2013-04, Liabilities (Topic 405) Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date. The ASU requires an entity to measure obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. Entities are required to record the amount the entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors at the reporting date. Examples of obligations within the scope of this guidance include debt arrangements, other contractual obligations, settled litigation and judicial rulings. ASU 2013-04 is effective retrospectively to all periods presented for fiscal years and interim periods beginning after December 15, 2013 for public entities. We do not expect this ASU to have a significant impact on our financial condition or results of operations.

In July 2013, the FASB issued ASU No. 2013-10, Derivatives and Hedging (Topic 815) Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedging Accounting Purposes. The ASU provides for the inclusion of the Fed Funds Effective Swap Rate or also referred to as the Overnight Index Swap Rate ("OIS") as a U.S. benchmark interest rate for hedge accounting purposes, in addition to direct Treasury obligations of the U.S. government ("UST") and London Interbank Offered Rate ("LIBOR"). The ASU is a result of the financial crisis in 2008, as the exposure to and the demand for hedging the Fund Funds rate have increased significantly. ASU 2013-10 is effective prospectively for qualifying new or re-designated hedging relationships entered into on or after July 17, 2013. We do not expect this ASU to have a significant impact on our financial condition or results of operations.

In July 2013, the FASB issued ASU No. 2013-11, Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. The ASU requires that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward except as follows. To the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from the disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purposes, then the unrecognized tax benefit should be presented as a liability. ASU 2013-11 is effective prospectively for fiscal years, and interim periods beginning after December 15, 2013 for public entities. We do not expect this ASU to have a significant impact on our financial condition or results of operations.

Note 3: Acquisition

On July 1, 2013, we entered into a definitive agreement to acquire NorCal Community Bancorp, parent company of Bank of Alameda. Bank of Alameda has four branch offices serving Alameda, Emeryville, and Oakland, and had assets of \$263.7 million, total deposits of \$229.6 million, and total loans of \$178.0 million as of June 30, 2013. The transaction is expected to close in the fourth quarter of 2013 and is subject to a number of conditions, including receipt of regulatory approvals and approval of NorCal Community Bancorp's shareholders. For more information concerning such transaction, please see the 8-K Reports filed by Bancorp with the Securities and Exchange Commission on July 1 and July 5, 2013. For other important factors regarding the Norcal acquisition, please see the Forward Looking Statements and Risk Factors sections of this Form 10-Q.

Note 4: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

We group our assets and liabilities that are measured at fair value in three levels within the fair value hierarchy, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1: Valuations are based on quoted prices in active markets for identical assets or liabilities. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not involve a significant degree of judgment.

Level 2: Valuations are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuations for which all significant assumptions are observable or can be corroborated by observable market data.

Level 3: Valuations are based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Values are determined using pricing models and discounted cash flow models and include management judgment and estimation which may be significant.

The following table summarizes our assets and liabilities that were required to be recorded at fair value on a recurring basis.

(in thousands) Description of Financial Instruments	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
At June 30, 2013 (unaudited):				
Securities available-for-sale:				
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies	\$92,577	\$—	\$92,577	\$—
Debentures of government-sponsored agencies	\$19,223	\$—	\$19,223	\$—
Privately-issued collateralized mortgage obligations	\$17,762	\$—	\$17,762	\$—
Derivative financial assets (interest rate contracts)	\$634	\$—	\$634	\$—
Derivative financial liabilities (interest rate contracts)	\$3,270	\$—	\$3,270	\$—
At December 31, 2012:				
Securities available-for-sale:				
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies	\$111,797	\$—	\$111,797	\$—
Debentures of government-sponsored agencies	\$20,589	\$—	\$20,589	\$—
Privately-issued collateralized mortgage obligations	\$21,576	\$—	\$21,576	\$—
Derivative financial assets (interest rate contracts)	\$1	\$—	\$1	\$—
Derivative financial liabilities (interest rate contracts)	\$5,240	\$—	\$5,240	\$—

Securities available-for-sale are recorded at fair value on a recurring basis. When available, quoted market prices (Level 1) are used to determine the fair value of securities available-for-sale. If quoted market prices are not available, we obtain pricing information from a reputable third-party service provider, who may utilize valuation techniques that use current market-based or independently sourced parameters, such as bid/ask prices, dealer-quoted prices, interest rates, benchmark yield curves, prepayment speeds, probability of default, loss severity and credit spreads (Level 2). Level 2 securities include U.S. agencies or government sponsored agencies' debt securities, mortgage-backed securities, government agency-issued and privately-issued collateralized mortgage obligations. As of June 30, 2013 and December 31, 2012, there are no securities that are considered Level 1 or Level 3 securities.

On a recurring basis, derivative financial instruments are recorded at fair value, which is based on the income approach using observable Level 2 market inputs, reflecting market expectations of future interest rates as of the measurement date. Standard valuation techniques are used to calculate the present value of the future expected cash flows assuming an orderly transaction. Valuation adjustments may be made to reflect both our own credit risk and the counterparties' credit quality in determining the fair value of the derivatives. Level 2 inputs for the valuations are limited to observable market prices for LIBOR cash rates (for the very short term), quoted prices for LIBOR futures contracts, observable market prices for LIBOR swap rates, and one-month and three-month LIBOR basis spreads at



commonly quoted intervals. Mid-market pricing of the inputs is used as a practical expedient in the fair value measurements. Key inputs for interest rate valuations are used to project spot rates at resets specified by each swap, as well as to discount those future cash flows to present value at the measurement date. When the value of any collateral placed with counterparties is less than the interest rate derivative liability, the interest rate liability position is further discounted to reflect our potential credit risk to counterparties. We have used the spread between the Standard & Poors BBB rated U.S. Bank

Composite rate and LIBOR with maturity term corresponding to the duration of the swaps to calculate this credit-risk-related discount of future cash flows.

Certain financial assets may be measured at fair value on a non-recurring basis. These assets are subject to fair value adjustments that result from the application of the lower of cost or fair value accounting or write-downs of individual assets, such as other real estate owned. For example, when a loan is identified as impaired, it is reported at the lower of cost or fair value, measured based on the loan's observable market price (Level 1) or the current net realizable value of the underlying collateral securing the loan, if the loan is collateral dependent (Level 3). Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Significant unobservable inputs such as appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as type, leasing status and physical condition. When the appraisals are received, Management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size.

Securities held-to-maturity may be written down to fair value (determined using the same techniques discussed above for securities available-for-sale) as a result of an other-than-temporary impairment, if any.

The following table presents the carrying value of financial instruments that were measured at fair value on a nonrecurring basis and that were still held in the statements of condition at each respective period end, by level within the fair value hierarchy as of June 30, 2013 and December 31, 2012.

(in thousands) Description of Financial Instruments	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) <sup>1</sup>
At June 30, 2013 (unaudited):				
Impaired loans carried at fair value	\$8,681	\$—	\$—	\$8,681
At December 31, 2012:				
Impaired loans carried at fair value	\$5,574	\$—	\$—	\$5,574

<sup>1</sup> Represents collateral-dependent loan principal balances that had been generally written down to the values of the underlying collateral, net of specific valuation allowances of \$1.7 million and \$729 thousand at June 30, 2013 and December 31, 2012, respectively. The carrying value of loans fully charged-off, which includes unsecured lines of credit, overdrafts and all other loans, is zero.

#### Disclosures about Fair Value of Financial Instruments

The table below is a summary of fair value estimates for financial instruments as of June 30, 2013 and December 31, 2012, excluding financial instruments recorded at fair value on a recurring basis (summarized in the first table in this note). The carrying amounts in the following table are recorded in the consolidated statements of condition under the

indicated captions. We have excluded non-financial assets and non-financial liabilities defined by the Codification (ASC 820-10-15-1A), such as Bank premises and equipment, deferred taxes and other liabilities. In addition, we have not disclosed the fair value of financial instruments specifically excluded from disclosure requirements of the Financial Instruments Topic of the Codification (ASC 825-10-50-8), such as Bank-owned life insurance policies.

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(in thousands; 2013 unaudited)	June 30, 2013			December 31, 2012		
	Carrying Amounts	Fair Value	Fair Value Hierarchy	Carrying Amounts	Fair Value	Fair Value Hierarchy
Financial assets						
Cash and cash equivalents	\$32,175	\$32,175	Level 1	\$28,349	\$28,349	Level 1
Investment securities held-to-maturity	131,839	133,282	Level 2	139,452	142,231	Level 2
Loans, net	1,077,125	1,109,940	Level 3	1,060,291	1,111,355	Level 3
Interest receivable	4,987	4,987	Level 2	5,073	5,073	Level 2
Financial liabilities						
Deposits	1,224,437	1,225,735	Level 2	1,253,289	1,254,713	Level 2
Federal Home Loan Bank short-term borrowings	17,200	17,200	Level 1	—	—	Level 1
Federal Home Loan Bank borrowings	15,000	15,714	Level 2	15,000	15,989	Level 2
Interest payable	205	205	Level 2	225	225	Level 2

Following is a description of methods and assumptions used to estimate the fair value of each class of financial instrument not recorded at fair value but required for disclosure purposes:

**Cash and Cash Equivalents** - The carrying amounts of cash and cash equivalents approximate their fair value because of the short-term nature of these instruments.

**Held-to-maturity Securities** - Held-to-maturity securities, which generally consist of obligations of state and political subdivisions and corporate bonds, are recorded at their amortized cost. Their fair value for disclosure purposes is determined using methodologies similar to those described above for available-for-sale securities using Level 2 inputs. If Level 2 inputs are not available, we may utilize pricing models that incorporate unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities (Level 3). As of June 30, 2013 and December 31, 2012, we did not hold any securities whose fair value was measured using significant unobservable inputs.

**Loans** - The fair value of loans with variable interest rates approximates their current carrying value, because their rates are regularly adjusted to current market rates. The fair value of fixed rate loans or variable loans at negotiated interest rate floors or ceilings with remaining maturities in excess of one year is estimated by discounting the future cash flows using current market rates at which similar loans would be made to borrowers with similar credit worthiness and similar remaining maturities. The allowance for loan losses ("ALLL") is considered to be a reasonable estimate of loan discount due to credit risks.

**Interest Receivable and Payable** - The interest receivable and payable balances approximate their fair value due to the short-term nature of their settlement dates.

**Deposits** - The fair value of non-interest bearing deposits, interest bearing transaction accounts, savings accounts and money market accounts is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting the future cash flows using current rates offered for deposits of similar remaining maturities.

**Federal Home Loan Bank Short-term Borrowings** - The balance represents its fair value as these borrowings settle overnight.

**Federal Home Loan Bank Borrowings** - The fair value is estimated by discounting the future cash flows using current rates offered by the Federal Home Loan Bank of San Francisco ("FHLB") for similar credit advances corresponding to the remaining duration of our fixed-rate credit advances.



Commitments - Loan commitments and standby letters of credit generate ongoing fees, which are recognized over the term of the commitment period. In situations where the borrower's credit quality has declined, we record a reserve for these off-balance sheet commitments. Given the uncertainty in the likelihood and timing of a commitment being drawn upon, a reasonable estimate of the fair value of these commitments is the carrying value of the related unamortized loan fees plus the reserve, which is not material.

Note 5: Investment Securities

Our investment securities portfolio consists of obligations of state and political subdivisions, corporate bonds, U.S. government agency securities, including mortgage-backed securities ("MBS") and collateralized mortgage obligations ("CMOs") issued or guaranteed by Federal National Mortgage Association ("FNMA"), Federal Home Loan Mortgage Corporation ("FHLMC"), or Government National Mortgage Association ("GNMA"), debentures issued by government-sponsored agencies such as FNMA and FHLMC, as well as privately issued CMOs, as reflected in the table below:

(in thousands; 2013 unaudited)	June 30, 2013				December 31, 2012			
	Amortized Cost	Fair Value	Gross Gains	Unrealized (Losses)	Amortized Cost	Fair Value	Gross Gains	Unrealized (Losses)
<b>Held-to-maturity</b>								
Obligations of state and political subdivisions	\$89,517	\$90,709	\$1,881	\$(689)	\$96,922	\$99,350	\$2,855	\$(427)
Corporate bonds	42,322	42,573	377	(126)	42,530	42,881	458	(107)
<b>Total held-to-maturity</b>	<b>131,839</b>	<b>133,282</b>	<b>2,258</b>	<b>(815)</b>	<b>139,452</b>	<b>142,231</b>	<b>3,313</b>	<b>(534)</b>
<b>Available-for-sale</b>								
<b>Securities of U. S. government agencies:</b>								
<b>MBS pass-through securities issued by FNMA and FHLMC</b>								
CMOs issued by FNMA	2,326	2,402	76	—	4,447	4,550	105	(2)
CMOs issued by FHLMC	10,223	10,365	156	(14)	13,527	13,778	251	—
CMOs issued by GNMA	30,345	31,078	746	(13)	38,871	39,756	886	(1)
<b>Debentures of government-sponsored agencies</b>								
Privately issued CMOs	17,245	17,762	552	(35)	21,071	21,576	595	(90)
<b>Total available-for-sale</b>	<b>127,989</b>	<b>129,562</b>	<b>2,472</b>	<b>(899)</b>	<b>150,420</b>	<b>153,962</b>	<b>3,776</b>	<b>(234)</b>
<b>Total investment securities</b>	<b>\$259,828</b>	<b>\$262,844</b>	<b>\$4,730</b>	<b>\$(1,714)</b>	<b>\$289,872</b>	<b>\$296,193</b>	<b>\$7,089</b>	<b>\$(768)</b>

The amortized cost and fair value of investment debt securities by contractual maturity at June 30, 2013 are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

(in thousands; unaudited)	June 30, 2013		Available-for-Sale	
	Held-to-Maturity Amortized Cost	Fair Value	Amortized Cost	Fair Value

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Within one year	\$7,357	\$7,367	\$—	\$—
After one year but within five years	93,230	93,866	25,771	26,022
After five years through ten years	28,251	29,083	21,265	20,879
After ten years	3,001	2,966	80,953	82,661
Total	\$131,839	\$133,282	\$127,989	\$129,562

We did not sell any securities during the second quarter of 2013. Two available-for-sale securities were sold in January 2013 with proceeds of \$1.1 million and a slight net gain of \$339. One available-for-sale security was sold in February 2012 with proceeds of \$2.2 million and a loss of \$34 thousand.

Investment securities carried at \$42.4 million and \$47.7 million at June 30, 2013 and December 31, 2012, respectively, were pledged with the State of California: \$41.7 million and \$47.0 million to secure public deposits in compliance with the Local Agency Security Program at June 30, 2013 and December 31, 2012, respectively, and \$726 thousand and \$719 thousand to provide collateral for trust deposits at June 30, 2013 and December 31, 2012, respectively. In addition, investment securities carried at \$1.1 million were pledged to collateralize an internal Wealth Management and Trust Services (“WMTS”) checking account at both June 30, 2013 and December 31, 2012.

#### Other-Than-Temporarily Impaired Debt Securities

We do not have the intent to sell the securities that are temporarily impaired, and it is more likely than not that we will not have to sell those securities before recovery of the cost basis. Additionally, we have evaluated the credit ratings of our investment securities and their issuer and/or insurers, if applicable. Based on our evaluation, Management has determined that no investment security in our investment portfolio is other-than-temporarily impaired.

Sixty-one and fifty-five investment securities were in unrealized loss positions at June 30, 2013 and December 31, 2012, respectively. They are summarized and classified according to the duration of the loss period as follows:

June 30, 2013  (In thousands; unaudited)	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
<b>Held-to-maturity</b>						
Obligations of state & political subdivisions	\$40,908	\$(689)	) —	—	\$40,908	\$(689)
Corporate bonds	12,585	(117)	) 1,990	(9)	14,575	(126)
<b>Total held-to-maturity</b>	<b>53,493</b>	<b>(806)</b>	<b>) 1,990</b>	<b>(9)</b>	<b>55,483</b>	<b>(815)</b>
<b>Available-for-sale</b>						
<b>MBS pass-through securities issued by FNMA and FHLMC</b>						
CMOs issued by FHLMC	2,792	(14)	) —	—	2,792	(14)
CMOs issued by GNMA	4,403	(13)	) —	—	4,403	(13)
Debentures of government-sponsored agencies	14,675	(325)	) —	—	14,675	(325)
Privately issued CMOs	1,868	(34)	) 176	(1)	2,044	(35)
<b>Total available-for-sale</b>	<b>54,883</b>	<b>(898)</b>	<b>) 176</b>	<b>(1)</b>	<b>55,059</b>	<b>(899)</b>
<b>Total temporarily impaired securities</b>	<b>\$108,376</b>	<b>\$(1,704)</b>	<b>) \$2,166</b>	<b>\$(10)</b>	<b>\$110,542</b>	<b>\$(1,714)</b>



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December 31, 2012 (In thousands)	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
<b>Held-to-maturity</b>						
Obligations of state & political subdivisions	\$33,196	\$(427)	\$—	\$—	\$33,196	\$(427)
Corporate bonds	15,649	(107)	—	—	15,649	(107)
<b>Total held-to-maturity</b>	<b>48,845</b>	<b>(534)</b>	<b>—</b>	<b>—</b>	<b>48,845</b>	<b>(534)</b>
<b>Available-for-sale</b>						
<b>MBS pass-through securities issued by FNMA and FHLMC</b>						
CMOs issued by FNMA	3,569	(40)	—	—	3,569	(40)
CMOs issued by GNMA	3,185	(2)	—	—	3,185	(2)
Debentures of government-sponsored agencies	1,550	(1)	—	—	1,550	(1)
Privately issued CMOs	9,899	(101)	—	—	9,899	(101)
Total available-for-sale	4,214	(89)	203	(1)	4,417	(90)
<b>Total temporarily impaired securities</b>	<b>22,417</b>	<b>(233)</b>	<b>203</b>	<b>(1)</b>	<b>22,620</b>	<b>(234)</b>
	\$71,262	\$(767)	\$203	\$(1)	\$71,465	\$(768)

Fifty-nine securities in our portfolio were in a temporary loss position for less than twelve months as of June 30, 2013. We determine that the strengths of GNMA and FNMA through guarantee or support from the U.S. Federal Government are sufficient to protect us from losses. The other temporarily impaired securities are deemed credit worthy after our periodic impairment analysis and are all rated as investment grade by at least one major rating agency. We also monitor the financial information of the issuers of obligations of U.S. states and political subdivisions as part of our ongoing impairment analysis. As a result of this impairment analysis, we concluded that these securities were not other-than-temporarily impaired at June 30, 2013.

As of June 30, 2013, there was one corporate bond and one CMO privately issued by a financial institution (with no guarantee from government sponsored agencies) in a continuous loss position for more than twelve months. The corporate bond was rated an investment grade by both Moody's and S&P. We believe the temporary decline in its fair value is primarily driven by factors other than credit from our review of the issuer's financial information and it is probable that we will be able to collect all amounts due according to the contractual terms and no other-than-temporary impairment exists. The private CMO is collateralized by residential mortgages with low loan-to-value ratios and delinquency ratios and may be prepaid at par prior to maturity. We reviewed the loans collateralizing the security, credit scores of the borrowers, expected default rates and loss severities. Based upon our assessment of expected credit losses of the security given the performance of the underlying collateral and the credit enhancements, we concluded that the security was not other-than-temporarily impaired at June 30, 2013. In addition, the security was rated as investment grade by at least one major rating agency.

#### Securities Carried at Cost

As a member of the FHLB, we are required to maintain a minimum investment in the FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can also increase in the event we need to increase our borrowing capacity with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at its \$100 per share par value. We held \$6.5 million and \$6.0 million of FHLB stock recorded at cost in

other assets on the consolidated statements of condition at June 30, 2013, and December 31, 2012. On July 29, 2013, the FHLB declared a cash dividend for the second quarter of 2013 at an annualized dividend rate of 5.14%. Management does not believe that the FHLB stock is other-than-temporarily-impaired, as we expect to be able to redeem this stock at cost.

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock with a carrying value of zero, which is equal to our cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s covered litigation escrow account. As a result of the restriction, these shares are not considered available-for-sale and are not carried at fair value. The fair value of the Class B common stock we own was \$1.3 million and \$1.1 million at June 30, 2013 and December 31, 2012, respectively, based on the Class A as-converted rate of 0.4206, which is subject to further reduction upon the final settlement of the covered litigation against Visa Inc. and its member banks. See Note 9 herein.

Note 6: Loans and Allowance for Loan Losses

Credit Quality of Loans

Outstanding loans by class and payment aging as of June 30, 2013 and December 31, 2012 are as follows:

Loan Aging Analysis by Class as of June 30, 2013 and December 31, 2012

(dollars in thousands; 2013 and unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential <sup>1</sup>	Installment and other consumer	Total	
June 30, 2013									
30-59 days past due	\$264	\$—	\$—	\$—	\$198	\$—	\$9	\$471	
60-89 days past due	94	—	—	—	—	—	1	95	
Greater than 90 days past due (non-accrual) <sup>2</sup>	2,022	1,403	6,024	7,046	524	1,148	321	18,488	
Total past due	2,380	1,403	6,024	7,046	722	1,148	331	19,054	
Current	168,063	204,788	529,236	20,682	89,574	42,142	17,943	1,072,428	
Total loans <sup>3</sup>	\$170,443	\$206,191	\$535,260	\$27,728	\$90,296	\$43,290	\$18,274	\$1,091,482	
Non-accrual loans to total loans	1.2	% 0.7	% 1.1	% 25.4	% 0.6	% 2.7	% 1.8	% 1.7	%
December 31, 2012									
30-59 days past due	\$29	\$—	\$—	\$—	\$294	\$167	\$98	\$588	
60-89 days past due	—	—	—	—	—	—	—	—	
Greater than 90 days past due (non-accrual) <sup>2</sup>	4,893	1,403	6,843	2,239	545	1,196	533	17,652	
Total past due	4,922	1,403	6,843	2,239	839	1,363	631	18,240	
Current	171,509	195,003	502,163	28,426	92,398	48,069	18,144	1,055,712	
Total loans <sup>3</sup>	\$176,431	\$196,406	\$509,006	\$30,665	\$93,237	\$49,432	\$18,775	\$1,073,952	
Non-accrual loans to total loans	2.8	% 0.7	% 1.3	% 7.3	% 0.6	% 2.4	% 2.8	% 1.6	%

<sup>1</sup> Our residential loan portfolio includes no sub-prime loans, nor is it our normal practice to underwrite loans commonly referred to as "Alt-A mortgages", the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or higher loan-to-value ratios.

<sup>2</sup> Amounts include \$1.4 million and \$1.6 million of Purchased Credit Impaired ("PCI") loans that have stopped accreting interest at June 30, 2013 and December 31, 2012, respectively, and exclude accreting PCI loans of \$2.1 million and \$3.0 million at June 30, 2013 and December 31, 2012, respectively, as their accretable yield interest recognition is independent from the underlying contractual loan delinquency status. There were no accruing loans past due more than ninety days at June 30, 2013 or December 31, 2012.

<sup>3</sup> Amounts were net of deferred loan fees of \$95 thousand and \$769 thousand at June 30, 2013 and December 31, 2012, respectively. Amounts were also net of unaccreted purchase discounts on non-PCI loans of \$1.8 million and \$2.1 million at June 30, 2013 and December 31, 2012, respectively.

Our commercial loans are generally made to established small to mid-sized businesses to provide financing for their working capital needs or acquisition of fixed assets. Management examines historical, current, and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral. The cash flows of borrowers, however, may not occur as expected, and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed, such as accounts receivable or inventory, and include a personal guarantee. Some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. We target stable local businesses with strong guarantors that have proven to be more resilient in periods of economic stress. Typically, the strong guarantors provide an additional source of repayment for most of our credit extensions.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans discussed above. We underwrite these loans to be repaid from cash flow and to be supported by real property collateral.

Repayment of commercial real estate loans is largely dependent on the successful operation of the property securing the loan, or the business conducted on the property securing the loan. Substantially all of these loans underwritten by us meet a minimum debt coverage ratio of 120%, and we also generally require a conservative loan-to-value ratio of 65% or less. Furthermore, substantially all of our loans are guaranteed by the owners of the properties. Commercial real estate loans may be adversely affected by conditions in the real estate markets or in the general economy. In the event of a vacancy, strong guarantors have historically carried the loans until a replacement tenant can be found. The owner's substantial equity investment provides a strong economic incentive to continue to support the commercial real estate projects. As such, we have generally experienced a relatively low level of loss and delinquencies on a percentage basis in this portfolio.

Construction loans are generally made to developers and builders to finance land acquisition as well as the subsequent construction. These loans are underwritten after evaluation of the borrower's financial strength, reputation, prior track record and after obtaining independent appraisals. The construction industry can be severely impacted by several major factors, including: 1) the inherent volatility of real estate markets; 2) vulnerability to delays due to weather, change orders, ability to obtain construction permits, labor or material shortages, and price hikes; and 3) generally thin margins and tight cash flow. Estimates of construction costs and value associated with the complete project may be inaccurate. Repayment of construction loans is largely dependent on the ultimate success of the project.

Consumer loans primarily consist of home equity lines of credit, other residential (tenancy-in-common, or "TIC") loans, and other personal loans. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, mitigates risk. Additionally, trend reports are reviewed by Management on a regular basis. Underwriting standards for home equity lines of credit include, but are not limited to, a maximum loan-to-value ratio of 75% for homes with appraised values up to \$1,250,000 (and even more conservatively for homes with values in excess of this amount), the number of such loans a borrower can have at one time, and documentation requirements. Our underwriting of the other residential loans, mostly secured by TIC units in San Francisco, was cautious compared to traditional residential mortgages due to the unique ownership structure and the interest-only feature of some of these loans. However, these borrowers tend to have more equity in their properties, which mitigates risk. Personal loans are nearly evenly split between mobile home loans and floating home loans along with a small number of installment loans.

We use a risk rating system to evaluate asset quality, and to identify and monitor credit risk in individual loans, and ultimately in the portfolio. Definitions of loans that are risk graded "Special Mention" or worse are consistent with those used by the FDIC. Our internally assigned grades are as follows:

Pass – Loans to borrowers of acceptable or better credit quality. Borrowers in this category demonstrate fundamentally sound financial positions, repayment capacity, credit history and management expertise. Loans in this category must have an identifiable and stable source of repayment and meet the Bank's policy regarding debt service coverage ratios. These borrowers are capable of sustaining normal economic, market or operational setbacks without significant financial impacts. Financial ratios and trends are acceptable. Negative external industry factors are generally not present. The loan may be secured, unsecured or supported by non-real estate collateral for which the value is more difficult to determine and/or marketability is more uncertain. This category also includes "Watch" loans, where the primary source of repayment has been delayed. "Watch" is intended to be a transitional grade, with either an upgrade or downgrade within a reasonable period.

Special Mention - Potential weaknesses that deserve close attention. If left uncorrected, those potential weaknesses may result in deterioration of the payment prospects for the asset. Special Mention assets do not present sufficient risk to warrant adverse classification.

Substandard - Inadequately protected by either the current sound worth and paying capacity of the obligor or the collateral pledged, if any. A Substandard asset has a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that we will sustain some loss if such weaknesses or deficiencies are not corrected. Loss potential, while inherent in the aggregate substandard amount, does not necessarily exist in the individual assets classified Substandard. Well-defined weaknesses include adverse trends or developments of the borrower's financial condition, managerial weaknesses and/or significant collateral deficiencies.

Doubtful - Critical weaknesses that make collection or liquidation in full improbable. There may be specific pending events that work to strengthen the asset, however, the amount or timing of the loss may not be determinable. Pending events generally occur within one year of the asset being classified as Doubtful. Examples include: merger, acquisition, or liquidation; capital injection; guarantee; perfecting liens on additional collateral; and refinancing. Such loans are placed on non-accrual status and usually are collateral-dependent.

We regularly review our credits for accuracy of risk grades whenever new information is received. Borrowers are required to submit financial information at regular intervals:

• Generally, commercial borrowers with lines of credit are required to submit financial information with reporting intervals ranging from monthly to annually depending on credit size, risk and complexity.

• Investor commercial real estate borrowers with loans greater than \$750 thousand are required to submit rent rolls or property income statements at least annually.

• Construction loans are monitored monthly, and assessed on an ongoing basis.

• Home equity and other consumer loans are assessed based on delinquency.

• Loans graded “Watch” or more severe, regardless of loan type, are assessed no less than quarterly.

The following table represents our analysis of loans by internally assigned grades, including the PCI loans, at June 30, 2013 and December 31, 2012:

(in thousands; 2013 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Purchased credit-impaired	Total
<b>Credit Risk Profile by Internally Assigned Grade:</b>									
<b>June 30, 2013</b>									
Pass	\$ 149,248	\$ 183,679	\$ 517,220	\$ 19,954	\$ 85,529	\$ 39,757	\$ 17,502	\$ 1,317	\$ 1,014,206
Special Mention	16,155	19,681	9,228	728	2,132	1,056	—	693	49,673
Substandard	4,764	296	8,119	7,046	2,635	2,477	772	1,494	27,603
<b>Total loans</b>	<b>\$ 170,167</b>	<b>\$ 203,656</b>	<b>\$ 534,567</b>	<b>\$ 27,728</b>	<b>\$ 90,296</b>	<b>\$ 43,290</b>	<b>\$ 18,274</b>	<b>\$ 3,504</b>	<b>\$ 1,091,482</b>
<b>December 31, 2012</b>									
Pass	\$ 148,771	\$ 170,553	\$ 489,978	\$ 26,287	\$ 86,957	\$ 45,634	\$ 17,809	\$ 1,862	\$ 987,851
Special Mention	13,267	20,346	8,671	1,970	2,931	1,067	—	933	49,185
Substandard	13,753	2,992	8,963	2,408	3,349	2,731	966	1,754	36,916
<b>Total loans</b>	<b>\$ 175,791</b>	<b>\$ 193,891</b>	<b>\$ 507,612</b>	<b>\$ 30,665</b>	<b>\$ 93,237</b>	<b>\$ 49,432</b>	<b>\$ 18,775</b>	<b>\$ 4,549</b>	<b>\$ 1,073,952</b>

#### Troubled Debt Restructuring

Our loan portfolio includes certain loans that have been modified in a Troubled Debt Restructuring (“TDR”), where economic concessions have been granted to borrowers experiencing financial difficulties. These concessions typically result from our loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. TDRs on nonaccrual status at the time of restructure may be returned to accruing status after considering the borrower’s sustained repayment performance for a reasonable period, generally six months, and there is reasonable assurance of repayment and of performance.

When a loan is modified, Management evaluates any possible impairment based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan agreement, except when the sole remaining source of repayment for the loan is the operation or liquidation of the collateral. In these cases Management uses the current fair value of the collateral, less selling costs, instead of discounted cash flows. If Management determines that the value of the modified loan is less than the recorded investment in the loan (net of previous charge-offs and unamortized premium or discount), impairment is recognized through a specific allowance or a charge-off of the loan.



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The table below summarizes outstanding TDR loans by loan class as of June 30, 2013 and December 31, 2012. The summary includes those TDRs that are on non-accrual status and those that continue to accrue interest.

(in thousands; 2013 unaudited)	As of June 30, 2013	December 31, 2012
Recorded investment in Troubled Debt Restructurings <sup>1</sup>		
Commercial and industrial	\$6,690	\$9,470
Commercial real estate, owner-occupied	1,403	1,403
Construction	6,523	1,929
Home equity	889	908
Other residential	2,110	2,831
Installment and other consumer	1,714	1,743
Total	\$19,329	\$18,284

<sup>1</sup> Includes \$10.0 million and \$10.8 million of TDR loans that were accruing interest as of June 30, 2013 and December 31, 2012, respectively.

The table below presents the following information for TDRs modified during the periods presented: number of contracts modified, the recorded investment in the loans prior to modification, and the recorded investment in the loans after the loans were restructured. The table below excludes fully paid-off or fully charged-off TDR loans.

(dollars in thousands; unaudited)	Number of Contracts Modified	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment at period end
Troubled Debt Restructurings during the three months ended June 30, 2013:				
Construction	1	\$ 4,745	\$ 4,766	\$4,806
Troubled Debt Restructurings during the three months ended March 31, 2013:				
Commercial and industrial <sup>1</sup>	2	\$ 499	\$ 497	\$464
Troubled Debt Restructurings during the three months ended June 30, 2012:				
Commercial and industrial	2	\$ 915	\$ 939	\$974
Home equity	1	372	374	374
Total	3	\$ 1,287	\$ 1,313	\$1,348
Troubled Debt Restructurings during the six months ended June 30, 2013:				
Commercial and industrial <sup>1</sup>	2	\$ 499	497	\$464
Construction	1	4,745	4,766	4,806
Total	3	\$ 5,244	5,263	\$5,270
Troubled Debt Restructurings during the six months ended June 30, 2012:				
Commercial	9	\$ 9,321	\$ 9,241	\$7,768

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Construction	6	11,324	11,324	11,297
Home Equity	2	472	474	473
Total	17	\$ 21,117	\$ 21,039	\$ 19,538

<sup>1</sup> Excludes two contracts modified during the three months ended March 31, 2013, which were subsequently paid off during the three months ended June 30, 2013. The pre-modification and post-modification outstanding recorded investment balances were both \$218 thousand.

Modifications during the six months ended June 30, 2013 primarily involved maturity or payment extensions, while modifications in the six months ended June 30, 2012 primarily involved payment extensions and forbearances. There were no payment defaults during the first half of 2013, where the default occurred within the first twelve months after modification into a TDR. There were three commercial loans, two commercial real estate loans, and one construction

loan modified as troubled debt restructurings within the previous twelve months with recorded investments of \$887 thousand that subsequently defaulted and were charged-off in the six months ended June 30, 2012. We are reporting these defaulted TDRs based on a payment default definition of more than ninety days past due.

Impaired Loan Balances and Their Related Allowance by Major Classes of Loans

The table below summarizes information on impaired loans and their related allowance. Total impaired loans include non-accrual loans, accruing TDR loans and accreting PCI loans that have experienced post-acquisition declines in cash flows expected to be collected.

(dollars in thousands; 2013 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
June 30, 2013								
Recorded investment in impaired loans:								
With no specific allowance recorded	\$ 2,449	\$ 1,403	\$ 3,082	\$ 2,115	\$ 890	\$ 2,341	\$ 65	\$ 12,345
With a specific allowance recorded	4,241	1,132	2,941	6,647	277	230	1,774	17,242
Total recorded investment in impaired loans	\$ 6,690	\$ 2,535	\$ 6,023	\$ 8,762	\$ 1,167	\$ 2,571	\$ 1,839	\$ 29,587
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	\$ 2,449	\$ 3,060	\$ 5,074	\$ 2,302	\$ 1,417	\$ 2,341	\$ 106	\$ 16,749
With a specific allowance recorded	4,504	2,178	2,941	9,343	403	230	1,774	21,373
Total unpaid principal balance of impaired loans	\$ 6,953	\$ 5,238	8,015	\$ 11,645	\$ 1,820	\$ 2,571	\$ 1,880	\$ 38,122
Specific allowance	\$ 928	\$ 58	\$ 141	\$ 1,353	\$ 74	\$ 25	\$ 491	\$ 3,070
Average recorded investment in impaired loans during the quarter ended June 30, 2013								
Interest income recognized on impaired loans during the quarter ended June 30, 2013	107	53	—	185	12	22	18	397
Average recorded investment in impaired loans during the quarter ended March 31, 2013								
Interest income recognized on	134	54	—	27	8	23	16	262

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impaired loans during the quarter ended March 31, 2013								
Average recorded investment in impaired loans during the six months ended June 30, 2013	8,409	2,528	6,073	6,468	1,145	2,828	1,900	29,351
Interest income recognized on impaired loans during the six months ended June 30, 2013	241	107	—	212	20	45	34	659
December 31, 2012								
Recorded investment in impaired loans:								
With no specific allowance recorded	\$ 6,825	\$ 1,403	\$ 3,725	\$ 2,328	\$ 931	\$ 2,598	\$ 978	\$ 18,788
With a specific allowance recorded	2,645	471	4,513	1,840	261	715	1,070	11,515
Total recorded investment in impaired loans	\$ 9,470	\$ 1,874	8,238	\$ 4,168	\$ 1,192	\$ 3,313	\$ 2,048	\$ 30,303
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	\$ 7,633	\$ 3,060	\$ 5,717	\$ 2,514	\$ 1,417	\$ 2,598	\$ 1,020	\$ 23,959
With a specific allowance recorded	2,930	966	4,887	4,519	324	715	1,070	15,411
Total recorded investment in impaired loans	\$ 10,563	\$ 4,026	10,604	\$ 7,033	\$ 1,741	\$ 3,313	\$ 2,090	\$ 39,370
Specific allowance	\$ 1,131	\$ 26	\$ 374	\$ 118	\$ 154	\$ 120	\$ 431	\$ 2,354
Average recorded investment in impaired loans during the quarter ended June 30, 2012	12,352	1,859	6,803	14,303	1,199	1,472	2,126	40,114
Interest income recognized on impaired loans during the quarter ended June 30, 2012	177	69	—	159	7	50	19	481
Average recorded investment in impaired loans during the six months ended June 30, 2012	13,285	1,856	5,313	14,424	1,133	2,273	2,114	40,398
Interest income recognized on impaired loans during	321	69	65	321	12	75	36	899

the six months ended  
June 30, 2012

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The gross interest income that would have been recorded had non-accrual loans been current totaled \$272 thousand, \$264 thousand and \$227 thousand in the quarters ended June 30, 2013, March 31, 2013 and June 30, 2012, respectively, and totaled \$536 thousand and \$483 thousand for the six months ended June 30, 2013 and June 30, 2012, respectively. PCI loans are excluded from the foregone interest data above as their accretable yield interest recognition is independent from the underlying contractual loan delinquency status. See "Purchased Credit-Impaired Loans" below for further discussion.

Management monitors delinquent loans continuously and identifies problem loans, generally loans graded substandard or worse, to be evaluated individually for impairment testing. Generally, we charge off our estimated losses related to specifically-identified impaired loans when it is deemed uncollectible. The charged-off portion of impaired loans outstanding at June 30, 2013 totaled approximately \$5.8 million. At June 30, 2013, there were \$212 thousand outstanding commitments to extend credit on impaired loans, including loans to borrowers whose terms have been modified in troubled debt restructurings.

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The following table discloses loans by major portfolio category and activity in the ALLL, as well as the related ALLL disaggregated by impairment evaluation method:

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, industrial	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
For the three months ended June 30, 2013									
Allowance for loan losses:									
Beginning balance	\$4,032	\$1,348	\$4,020	\$650	\$1,216	\$431	\$1,366	\$371	\$13,433
Provision (reversal)	(189 )	(26 )	345	1,084	63	(30 )	28	(175 )	1,100
Charge-offs	(386 )	—	—	(13 )	(126 )	—	(85 )	—	(610 )
Recoveries	342	84	3	—	—	—	4	—	433
Ending balance	\$3,799	\$1,406	\$4,368	\$1,721	\$1,153	\$401	\$1,313	\$196	\$14,320
For the three months ended March 31, 2013									
Allowance for loan losses:									
Beginning balance	\$4,100	\$1,313	\$4,372	\$611	\$1,264	\$551	\$1,231	\$219	\$13,651
Provision (reversal)	(50 )	35	(375 )	42	(49 )	(120 )	135	152	(230 )
Charge-offs	(71 )	—	—	(4 )	(7 )	—	(1 )	—	(83 )
Recoveries	53	—	23	1	8	—	1	—	86
Ending balance	\$4,032	\$1,348	\$4,020	\$650	\$1,216	\$431	\$1,366	\$371	\$13,433
For the six months ended June 30, 2013									
Allowance for loan losses:									
Beginning balance	\$4,100	\$1,313	\$4,372	\$611	\$1,264	\$551	\$1,231	\$219	\$13,651
Provision (reversal)	(239 )	9	(30 )	1,126	14	(150 )	163	(23 )	870
Charge-offs	(457 )	—	—	(17 )	(133 )	—	(86 )	—	(693 )
Recoveries	395	84	26	1	8	—	5	—	519
Ending balance	\$3,799	\$1,406	\$4,368	\$1,721	\$1,153	\$401	\$1,313	\$196	\$14,320
As of June 30, 2013:									
Ending ALLL related to loans collectively evaluated for impairment	\$2,871	\$1,348	\$4,227	\$368	\$1,079	\$376	\$822	\$196	\$11,287
Ending ALLL related to loans individually evaluated for impairment	\$745	\$—	\$141	\$1,353	\$74	\$25	\$491	\$—	\$2,829
Ending ALLL related to purchased credit-impaired loans	\$183	\$58	\$—	\$—	\$—	\$—	\$—	\$—	\$241
Loans outstanding:									
Collectively evaluated for impairment	\$163,753	\$203,656	\$528,544	\$18,966	\$89,129	\$40,719	\$16,435	\$—	\$1,000,602
Individually evaluated for impairment <sup>1</sup>	6,414	—	6,023	8,762	1,167	2,571	1,839	—	26,776

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Purchased credit-impaired	276	2,535	693	—	—	—	—	—	3,504
Total	\$170,443	\$206,191	\$535,260	\$27,728	\$90,296	\$43,290	\$18,274	\$—	\$1,09
Ratio of allowance for loan losses to total loans	2.23	% 0.68	% 0.82	% 6.21	% 1.28	% 0.93	% 7.19	% NM	1.32
Allowance for loan losses to non-accrual loans	188	% 100	% 73	% 24	% 220	% 35	% 409	% NM	78

<sup>1</sup> Total excludes \$2.8 million of PCI loans that have experienced post-acquisition declines in cash flows expected to be collected. These loans are included in the "purchased credit-impaired" amount in the next line below.

NM - Not Meaningful

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Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
As of December 31, 2012:									
Ending ALLL related to loans collectively evaluated for impairment	\$2,969	\$1,287	\$3,998	\$493	\$1,110	\$431	\$800	\$219	\$11,300
Ending ALLL related to loans individually evaluated for impairment	\$1,090	\$—	\$178	\$118	\$154	\$120	\$431	\$—	\$2,091
Ending ALLL related to purchased credit-impaired loans	\$41	\$26	\$196	\$—	\$—	\$—	\$—	\$—	\$263
Loans outstanding:									
Collectively evaluated for impairment	\$166,860	\$193,891	\$500,768	\$26,497	\$92,045	\$46,119	\$16,727	\$—	\$1,042,807
Individually evaluated for impairment <sup>1</sup>	8,931	—	6,844	4,168	1,192	3,313	2,048	—	26,496
Purchased credit-impaired	640	2,515	1,394	—	—	—	—	—	4,549
Total	\$176,431	\$196,406	\$509,006	\$30,665	\$93,237	\$49,432	\$18,775	\$—	\$1,073,815
Ratio of allowance for loan losses to total loans	2.32	% 0.67	% 0.86	% 1.99	% 1.36	% 1.11	% 6.56	% NM	1.27
Allowance for loan losses to non-accrual loans	84	% 94	% 64	% 27	% 232	% 46	% 231	% NM	77

<sup>1</sup> Total excludes \$3.8 million PCI loans that have experienced credit deterioration post-acquisition, which are included in the "purchased credit-impaired" amount in the next line below.

NM - Not Meaningful

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
For the three months ended June 30, 2012									
Allowance for loan losses:									
Beginning balance	\$ 3,770	\$ 1,152	\$ 3,700	\$ 1,133	\$ 1,394	\$ 504	\$ 1,547	\$ 322	\$ 13,522
Provision (reversal)	305	(9)	(29)	(148)	180	58	(222)	(35)	100
Charge-offs	(253)	—	(5)	—	—	—	(5)	—	(263)
Recoveries	64	5	—	—	6	—	1	—	76
Ending balance	\$ 3,886	\$ 1,148	\$ 3,666	\$ 985	\$ 1,580	\$ 562	\$ 1,321	\$ 287	\$ 13,435

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For the six months ended June 30, 2012

Allowance for loan losses:

Beginning balance	\$ 4,334	\$ 1,305	\$ 3,710	\$ 1,505	\$ 1,444	\$ 940	\$ 1,182	\$ 219	\$ 14,639
Provision (reversal)	32	19	134	(348 )	234	(182 )	143	68	100
Charge-offs	(850 )	(181 )	(178 )	(172 )	(110 )	(196 )	(5 )	—	(1,692 )
Recoveries	370	5	—	—	12	—	1	—	388
Ending balance	\$ 3,886	\$ 1,148	\$ 3,666	\$ 985	\$ 1,580	\$ 562	\$ 1,321	\$ 287	\$ 13,435

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## Purchased Credit-Impaired Loans

We evaluated loans purchased in accordance with accounting guidance in ASC 310-30 related to loans acquired with deteriorated credit quality. Acquired loans are considered credit-impaired if there is evidence of deterioration of credit quality since origination and it is probable, at the acquisition date, that we will be unable to collect all contractually required payments receivable. Management has determined certain loans purchased to be PCI loans based on credit indicators such as nonaccrual status, past due status, loan risk grade, loan-to-value ratio, etc. Revolving credit agreements (e.g. home equity lines of credit and revolving commercial loans) are not considered PCI loans as cash flows cannot be reasonably estimated.

For acquired loans not considered credit-impaired, the difference between the contractual amounts due (principal amount) and the fair value is accounted for subsequently through accretion. We elected to recognize discount accretion based on the acquired loan's contractual cash flows using an effective interest rate method. The accretion is recognized through the net interest margin.

The following table reflects the outstanding balance and related carrying value of PCI loans as of June 30, 2013 and December 31, 2012:

	June 30, 2013		December 31, 2012	
	Unpaid principal balance	Carrying value	Unpaid principal balance	Carrying value
PCI Loans (dollars in thousands; 2013 unaudited)				
Commercial and industrial	\$539	\$276	\$2,163	\$640
Commercial real estate	5,434	3,228	6,370	3,909
Total purchased credit-impaired loans	\$5,973	\$3,504	\$8,533	\$4,549

The activities in the accretable yield, or income expected to be earned, for PCI loans were as follows:

Accretable Yield (dollars in thousands, unaudited)	Three months ended			Six months ended	
	June 30, 2013	March 31, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Balance at beginning of period	\$3,583	\$3,960	\$5,625	\$3,960	\$5,405
Additions	—	—	—	—	—
Removals <sup>1</sup>	(195)	(596)	—	(791)	(225)
Accretion	(156)	(236)	(478)	(392)	(988)
Reclassifications from nonaccretable difference <sup>2</sup>	45	455	239	500	1,194
Balance at end of period	\$3,277	\$3,583	\$5,386	\$3,277	\$5,386

<sup>1</sup> Represents the accretable difference that is relieved when a loan exits the PCI population due to payoff, full charge-off, or transfer to repossessed assets, etc.

<sup>2</sup> Primarily relates to improvements in expected credit performance and changes in expected timing of cash flows.

## Pledged Loans

Our FHLB line of credit is secured under terms of a blanket collateral agreement by a pledge of certain qualifying loans with an unpaid principal balance of \$672.4 million and \$567.8 million at June 30, 2013 and December 31, 2012, respectively. Our FHLB line of credit totaled \$391.0 million and \$321.3 million at June 30, 2013 and December 31, 2012, respectively. In addition, we pledge a certain residential loan portfolio, which totaled \$26.5 million and \$30.1

million at June 30, 2013 and December 31, 2012, respectively, to secure our borrowing capacity with the Federal Reserve Bank ("FRB"). Also see Note 7 below.

Note 7: Borrowings

Federal Funds Purchased – We had unsecured lines of credit totaling \$87.0 million with correspondent banks for overnight borrowings at both June 30, 2013 and December 31, 2012. In general, interest rates on these lines approximate the Federal funds target rate. At June 30, 2013 and December 31, 2012, we had no overnight borrowings outstanding under these credit facilities.

Federal Home Loan Bank Borrowings – As of June 30, 2013 and December 31, 2012, we had lines of credit with the FHLB totaling \$391.0 million and \$321.3 million, respectively, based on eligible collateral of certain loans. FHLB overnight borrowings totaled \$17.2 million at a rate of 0.10% at June 30, 2013 and zero at December 31, 2012.

On February 5, 2008, we entered into a ten-year borrowing agreement under the same FHLB line of credit for \$15.0 million at a fixed rate of 2.07%, which remained outstanding at June 30, 2013. Interest-only payments are required every three months until the entire principal is due on February 5, 2018. The FHLB has the unconditional right to accelerate the due date on August 5, 2013 and every three months thereafter (the “put dates”). If the FHLB exercises its right to accelerate the due date, the FHLB will offer replacement funding at the current market rate, subject to certain conditions. We must comply with the put date, but are not required to accept replacement funding.

At June 30, 2013, \$358.8 million was remaining as available for borrowing from the FHLB. The FHLB overnight borrowing and the FHLB line of credit are secured by a certain loan portfolio under a blanket lien.

Federal Reserve Line of Credit – We have a line of credit with the FRB secured by a certain residential loan portfolio. At June 30, 2013 and December 31, 2012, we had borrowing capacity under this line totaling \$26.5 million and \$30.1 million, respectively, and had no outstanding borrowings with the FRB.

Note 8: Stockholders' Equity

Preferred Stock

Under the United States Department of the Treasury Capital Purchase Program (the “TCPP”), which was intended to stabilize and inject liquidity into the financial industry, on December 5, 2008, Bancorp issued to the U.S. Treasury 28,000 shares of senior preferred stock with a zero par value and a \$1,000 per share liquidation preference, along with a warrant to purchase 154,242 shares of common stock at a per share exercise price of \$27.23, in exchange for aggregate consideration of \$28.0 million. The proceeds of \$28.0 million were allocated between the preferred stock and the warrant with \$27.0 million allocated to preferred stock and \$961 thousand allocated to the warrant, based on their relative fair value at the time of issuance. The warrant was immediately exercisable and expires 10 years after the issuance date.

Under the American Recovery and Reinvestment Act of 2009, which allowed participants in the TCPP to withdraw from the program, we repurchased all 28,000 shares of outstanding preferred stock from the U.S. Treasury at \$28 million plus accrued but unpaid dividends of \$179 thousand on March 31, 2009. At the time of repurchase, we also accelerated the remaining accretion of the preferred stock totaling \$945 thousand through retained earnings, reducing our net income available to common stockholders. The warrant was subsequently auctioned to two institutional investors in November 2011 and remains outstanding. It is adjusted for cash dividend increases to represent a right to purchase 155,804 shares of common stock at \$26.96 per share as of June 30, 2013 in accordance with Section 13(c) of the Form of Warrant to Purchase Common Stock.

## Dividends

Presented below is a summary of cash dividends paid to common shareholders, recorded as a reduction of retained earnings.

(in thousands except per share data, unaudited)	Three months ended		June 30, 2012	Six months ended	
	June 30, 2013	March 31, 2013		June 30, 2013	June 30, 2012
Cash dividends to common stockholders	\$979	\$971	\$910	\$1,950	\$1,818
Cash dividends per common share	\$0.18	\$0.18	\$0.17	\$0.36	\$0.34

## Share-Based Payments

The fair value of stock options on the grant date is recorded as a stock-based compensation expense in the consolidated statements of comprehensive income over the requisite service period with a corresponding increase in common stock. Stock-based compensation also includes compensation expense related to the issuance of unvested restricted common shares pursuant to the 2007 Equity Plan. The grant-date fair value of the restricted common shares, which equals its intrinsic value on that date, is being recorded as compensation expense over the requisite service period with a corresponding increase in common stock as the shares vest. In addition, we record excess tax benefits on the exercise

of non-qualified stock options, the disqualifying disposition of incentive stock options and vesting of restricted stock as an addition to common stock with a corresponding decrease in current taxes payable.

The holders of the unvested restricted common shares are entitled to dividends on the same per-share ratio as the holders of common stock. Dividends paid on the portion of share-based awards not expected to vest are also included in stock-based compensation expense. Tax benefits on dividends paid on the portion of share-based awards expected to vest are recorded as an increase to common stock with a corresponding decrease in current taxes payable.

## Note 9: Commitments and Contingencies

## Financial Instruments with Off-Balance Sheet Risk

We make commitments to extend credit in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit in the form of loans or through standby letters of credit. 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 many of the commitments are expected to expire without being fully drawn upon, the total commitment amount does not necessarily represent future cash requirements.

We are exposed to credit loss equal to the contract amount of the commitment in the event of nonperformance by the borrower. We use the same credit policies in making commitments as we do for on-balance-sheet instruments and we evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us, is based on Management's credit evaluation of the borrower. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and real property.

The contractual amount of loan commitments and standby letters of credit not reflected on the consolidated statements of condition was \$271.2 million at June 30, 2013 at rates ranging from 1.70% to 18.00%. This amount included \$159.4 million under commercial lines of credit (these commitments are contingent upon customers maintaining specific credit standards), \$82.7 million under revolving home equity lines, \$5.5 million under undisbursed construction loans, \$13.4 million under standby letters of credit, and a remaining \$10.1 million under personal and other lines of credit. We have set aside an allowance for losses in the amount of \$542 thousand for these commitments as of June 30, 2013, which is recorded in interest payable and other liabilities on the consolidated statements of condition.

## Operating Leases

We rent certain premises and equipment under long-term, non-cancelable operating leases expiring at various dates through the year 2024. Most of the leases contain certain renewal options and escalation clauses. At June 30, 2013, the approximate minimum future commitments payable under non-cancelable contracts for leased premises are as follows:

(in thousands)	2013	2014	2015	2016	2017	Thereafter	Total
Operating leases	\$1,461	\$2,806	\$2,881	\$2,964	\$2,986	\$12,109	\$25,207

## Litigation and Regulatory Matters

We may be party to legal actions which arise from time to time as part of the normal course of our business. We believe, after consultation with legal counsel, that we have meritorious defenses in these actions, and that litigation contingency liability, if any, will not have a material adverse effect on our financial position, results of operations, or cash flows.

We are responsible for our proportionate share of certain litigation indemnifications provided to Visa U.S.A. by its member banks in connection with lawsuits related to anti-trust charges and interchange fees. On July 13, 2012, Visa U.S.A. signed a memorandum of understanding to enter into a settlement agreement to resolve the Class Plaintiffs' claims and an agreement in principle to resolve the Individual Plaintiffs' claims in the same multi-district interchange litigation. The settlement includes a cash payment through further reduction in conversion rate of Visa Class B shares

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by member banks and a ten basis point reduction in credit card interchange rates for eight months. A number of procedural steps remain before this settlement can become final and the full impact to member banks like us is still uncertain. However, we are not aware of significant future cash settlement payments required by us on the litigation and the ten basis point reduction in credit card interchange fees for us is not expected to be material. Also refer to Note 13 to the Consolidated Financial Statements of the Bancorp's 2012 Annual Report on Form 10-K.

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Note 10: Derivative Financial Instruments and Hedging Activities

We have entered into interest rate swap agreements, primarily as an asset/liability management strategy, in order to mitigate the changes in the fair value of specified long-term fixed-rate loans (or firm commitments to enter into long-term fixed-rate loans) caused by changes in interest rates. These hedges allow us to offer long-term fixed rate loans to customers without assuming the interest rate risk of a long-term asset. Converting our fixed-rate interest stream to a floating-rate interest stream, generally benchmarked to the one-month U.S. dollar LIBOR index, protects us against changes in the fair value of our loans otherwise associated with fluctuating interest rates.

The fixed-rate payment features of the interest rate swap agreements are generally structured at inception to mirror substantially all of the provisions of the hedged loan agreements. These interest rate swaps, designated and qualified as fair value hedges, are carried on the consolidated statements of condition at their fair value in other assets (when the fair value is positive) or in other liabilities (when the fair value is negative). One of our interest rate swap agreements qualifies for shortcut hedge accounting treatment. The change in fair value of the swap using the shortcut accounting treatment is recorded in other non-interest income, while the change in fair value of swaps using non-shortcut accounting is recorded in interest income. The unrealized gain or loss in fair value of the hedged fixed-rate loan due to LIBOR interest rate movements is recorded as an adjustment to the hedged loan and offset in other non-interest income (for shortcut accounting treatment) or interest income (for non-shortcut accounting treatment).

From time to time, we make firm commitments to enter into long-term fixed-rate loans with borrowers backed by yield maintenance agreements and simultaneously enter into forward interest rate swap agreements with correspondent banks to mitigate the change in fair value of the yield maintenance agreement. Prior to loan funding, yield maintenance agreements with net settlement features that meet the definition of a derivative are considered as non-designated hedges and are carried on the consolidated statements of condition at their fair value in other assets (when the fair value is positive) or in other liabilities (when the fair value is negative). The offsetting changes in the fair value of the forward swap and the yield maintenance agreement are recorded in interest income. In June 2007, August 2010 and June 2011, three previously undesignated forward swaps were designated to offset the change in fair value of a fixed-rate loan originated in each of those periods. Subsequent to the point of the swap designations, the related yield maintenance agreements are no longer considered derivatives. Their fair value at the designation date was recorded in other assets and is amortized using the effective yield method over the life of the respective designated loans.

The net effect of the change in fair value of interest rate swaps, the amortization of the yield maintenance agreement and the change in the fair value of the hedged loans result in an insignificant amount of hedge ineffectiveness recognized in interest income.

Our credit exposure, if any, on interest rate swaps is limited to the favorable value (net of any collateral pledged to us) and interest payments of all swaps by each counterparty. Conversely, when an interest rate swap is in a liability position exceeding a certain threshold, we may be required to post collateral to the counterparty in an amount determined by the agreements (generally when our derivative liability position is greater than \$100 thousand or \$1.3 million, depending upon the counterparty). Collateral levels are monitored and adjusted on a regular basis for changes in interest rate swap values. As of June 30, 2013, seven of our ten derivative instruments are currently in a liability position totaling \$3.3 million and have collateral requirements, for which we have posted cash collateral of \$5.6 million.

As of June 30, 2013, we have ten interest rate swap agreements, which are scheduled to mature in September 2018, April 2019, June 2020, August 2020, June 2022, June 2031, October 2031, July 2032, August 2037 and October 2037. All of our derivatives are accounted for as fair value hedges. Our interest rate swaps are settled monthly with counterparties. Accrued interest on the swaps totaled \$69 thousand and \$75 thousand as of June 30, 2013 and

December 31, 2012, respectively. Information on our derivatives follows:

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(in thousands; 2013 unaudited)	Asset derivatives		Liability derivatives	
	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012
Fair value hedges:				
Interest rate contracts notional amount	\$10,731	\$4,932	\$31,200	\$38,156
Interest rate contracts fair value <sup>1</sup>	\$634	\$1	\$3,270	\$5,240

(in thousands; unaudited)	Three months ended		
	June 30, 2013	March 31, 2013	June 30, 2012
Increase (decrease) in value of designated interest rate swaps recognized in interest income	\$1,956	\$647	\$(931)
Payment on interest rate swaps recorded in interest income	(359)	(358)	(316)
(Decrease) increase in value of hedged loans recognized in interest income	(2,095)	(692)	989
(Decrease) increase in value of yield maintenance agreement recognized against interest income	(18)	(18)	271
Net (loss) gain on derivatives recognized against interest income <sup>2</sup>	\$(516)	\$(421)	\$13

(in thousands; unaudited)	Six months ended	
	June 30, 2013	June 30, 2012
Increase (decrease) in value of designated interest rate swaps recognized in interest income	\$2,603	\$(357)
Payment on interest rate swaps recorded in interest income	(717)	(634)
(Decrease) increase in value of hedged loans recognized in interest income	(2,787)	360
(Decrease) increase in value of yield maintenance agreement recognized against interest income	(36)	204
Net loss on derivatives recognized against interest income <sup>2</sup>	\$(937)	\$(427)

<sup>1</sup> See Note 4 for valuation methodology.

<sup>2</sup> Includes hedge ineffectiveness of \$(157) thousand, \$(63) thousand and \$329 thousand for the quarters ended June 30, 2013, March 31, 2013 and June 30, 2012, respectively. Ineffectiveness of \$(220) thousand and \$207 thousand was recorded in interest income during the six months ended June 30, 2013 and June 30, 2012, respectively. Changes in value of swaps were included in the assessment of hedge effectiveness.

Our derivative transactions with counterparties are under International Swaps and Derivative Association (“ISDA”) master agreements that include “right of set-off” provisions. “Right of set-off” provisions are legally enforceable rights to offset recognized amounts and there may be an intention to settle such amounts on a net basis. We do not offset such financial instruments for financial reporting purposes.

Information on financial instruments that are eligible for offset in the consolidated statements of condition follows:

Offsetting of Financial Assets and Derivative Assets

(in thousands; 2013 unaudited)		Gross Amounts Not Offset in the Statements of Condition				
		Gross Amounts of Recognized Assets <sup>1</sup>	Gross Amounts Offset in the Statements of Condition	Net Amounts of Assets Presented in the Statements of Condition <sup>1</sup>	Financial Instruments	Cash Collateral Received
As of June 30, 2013						
Derivatives by Counterparty						
Counterparty A	\$634	\$—	\$634	\$(634	)\$—	\$—
Counterparty B	—	—	—	—	—	—
Total	\$634	\$—	\$634	\$(634	)\$—	\$—
As of December 31, 2012						
Derivatives by Counterparty						
Counterparty A	\$1	\$—	\$1	\$(1	)\$—	\$—
Counterparty B	—	—	—	—	—	—
Total	\$1	\$—	\$1	\$(1	)\$—	\$—

<sup>1</sup> Amounts exclude accrued interest totaling \$7 thousand and \$1 thousand at June 30, 2013 and December 31, 2012, respectively.

Offsetting of Financial Liabilities and Derivative Liabilities

(in thousands; 2013 unaudited)		Gross Amounts Not Offset in the Statements of Condition				
		Gross Amounts of Recognized Liabilities <sup>2</sup>	Gross Amounts Offset in the Statements of Condition	Net Amounts of Liabilities Presented in the Statements of Condition <sup>2</sup>	Financial Instruments	Cash Collateral Pledged
As of June 30, 2013						
Derivatives by Counterparty						
Counterparty A	\$1,296	\$—	\$1,296	\$(634	)\$(662	)\$—
Counterparty B	1,974	—	1,974	—	(1,974	)—

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Total	\$3,270	\$—	\$3,270	\$(634	)\$(2,636	)\$—
As of December 31, 2012						
Derivatives by Counterparty						
Counterparty A	\$2,616	\$—	\$2,616	\$(1	)\$(1,860	)\$755
Counterparty B	2,624	—	2,624	—	(2,624	)—
Total	\$5,240	\$—	\$5,240	\$(1	)\$(4,484	)\$755

<sup>2</sup> Amounts exclude accrued interest totaling \$62 thousand and \$74 thousand at June 30, 2013 and December 31, 2012, respectively.

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

In the following pages, Management discusses its analysis of the financial condition and results of operations for the second quarter of 2013 compared to the second quarter of 2012 and to the first quarter of 2013, as well as the six months ended June 30, 2013 compared to the same period in 2012. This discussion should be read in conjunction with the related consolidated financial statements in this Form 10-Q and with the audited consolidated financial statements and accompanying notes included in our 2012 Annual Report on Form 10-K. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

### Forward-Looking Statements

This discussion of financial results includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the "1933 Act") and Section 21E of the Securities Exchange Act of 1934, as amended, (the "1934 Act"). Those sections of the 1933 Act and 1934 Act provide a "safe harbor" for forward-looking statements to encourage companies to provide prospective information about their financial performance so long as they provide meaningful, cautionary statements identifying important factors that could cause actual results to differ significantly from projected results.

Our forward-looking statements include descriptions of plans or objectives of Management for future operations, products or services, and forecasts of its revenues, earnings or other measures of economic performance. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include the words "believe," "expect," "intend," "estimate" or words of similar meaning, or future or conditional verbs such as "will," "would," "should," "could" or "may."

Forward-looking statements are based on Management's current expectations regarding economic, legislative, and regulatory issues that may impact our earnings in future periods. A number of factors—many of which are beyond Management's control—could cause future results to vary materially from current Management expectations. Such factors include, but are not limited to, general economic conditions, the economic uncertainty in the United States and abroad, changes in interest rates, deposit flows, real estate values, expected future cash flows on acquired loans, and competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation; and other economic, competitive, governmental, regulatory and technological factors affecting our operations, pricing, products and services.

The events or factors that could cause results or performance to materially differ from those expressed in the forward-looking statements concerning the NorCal acquisition include:

- lower than expected consolidated revenues for us;
- higher than expected acquisition related costs;
- losses of deposit and loan customers resulting from the acquisition;
- greater than expected operating costs and/or loan losses;
- significant increases in competition;
- unexpected difficulties or delays in obtaining regulatory approvals for the acquisition;
- the inability to achieve expected cost savings from the acquisition, or the inability to achieve those savings as soon as expected; and
- unexpected costs and difficulties in adapting to technological changes and integrating systems.

These and other important factors are detailed in the Risk Factors section of this Form 10-Q and in the Risk Factors section of our 2012 Form 10-K as filed with the SEC, copies of which are available from us at no charge.

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Forward-looking statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.

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## RESULTS OF OPERATIONS

Highlights of the financial results are presented in the following table:

(dollars in thousands, except per share data; unaudited)	For the three months ended			For the six months ended		
	June 30, 2013	March 31, 2013	June 30, 2012	June 30, 2013	June 30, 2012	
For the period:						
Net income	\$3,055	\$4,866	\$4,951	\$7,921	\$9,891	
Net income per share						
Basic	\$0.56	\$0.90	\$0.93	\$1.47	\$1.86	
Diluted	\$0.55	\$0.89	\$0.91	\$1.44	\$1.82	
Return on average equity	7.72	% 12.76	% 14.01	% 10.19	% 14.20	%
Return on average assets	0.86	% 1.38	% 1.39	% 1.12	% 1.40	%
Common stock dividend payout ratio	32.06	% 19.96	% 18.28	% 24.63	% 18.28	%
Average shareholders' equity to average total assets	11.20	% 10.83	% 9.96	% 11.02	% 9.87	%
Efficiency ratio	64.12	% 57.36	% 53.56	% 60.67	% 54.26	%
Tax equivalent net interest margin	4.30	% 4.48	% 4.94	% 4.39	% 4.96	%
At period end:						
Book value per common share	\$29.10	\$28.88	\$26.92			
Total assets	\$1,428,518	\$1,427,022	\$1,407,000			
Total loans	\$1,091,482	\$1,071,835	\$1,025,194			
Total deposits	\$1,224,437	\$1,231,551	\$1,230,717			
Loan-to-deposit ratio	89.1	% 87.0	% 83.3	%		
Total risk based capital ratio - Bancorp	14.0	% 14.0	% 13.9	%		

## Executive Summary

On July 1, 2013, we entered into a definitive agreement to acquire NorCal Community Bancorp, parent company of Bank of Alameda. Bank of Alameda has four branch offices serving Alameda, Emeryville, and Oakland, and had assets of \$263.7 million, total deposits of \$229.6 million, and total loans of \$178.0 million as of June 30, 2013. The transaction is expected to be completed in the fourth quarter of 2013 and is subject to a number of conditions, including regulatory approvals and approval of NorCal Community Bancorp's shareholders. For more information concerning such transaction, please see the Form 8-K Reports filed by Bancorp with the Securities and Exchange Commission on July 1 and July 5, 2013. For other important factors regarding the Norcal acquisition, please see the Forward Looking Statements and Risk Factors sections of this Form 10-Q.

Earnings totaled \$3.1 million for the second quarter of 2013, compared to \$4.9 million in the first quarter of 2013 and \$5.0 million in the second quarter of 2012. Diluted earnings per share totaled \$0.55 in the second quarter of 2013, compared to \$0.89 in the prior quarter and \$0.91 in the same quarter last year. For the six-month period ended June 30, 2013, earnings totaled \$7.9 million compared to \$9.9 million in the same period a year ago. Diluted earnings



per share for the six-month period ended June 30, 2013 totaled \$1.44 compared to \$1.82 in the same period a year ago.

The provision for loan losses totaled \$1.1 million in the second quarter of 2013, compared to a reversal of the provision for loan losses of \$230 thousand in the prior quarter and a provision for loan losses of \$100 thousand in the same quarter a year ago. The provision for loan losses in the second quarter of 2013 primarily relates to a new specific reserve of \$1.2 million established on a non-performing land development loan. The loan went into non-accrual status in the second quarter of 2013, which prompted an updated appraisal and the specific reserve. Management does not believe this individual land development loan is indicative of a decline in credit quality of our loan portfolio.

Gross loans totaled \$1.1 billion at June 30, 2013, up \$17.5 million or 1.6% when compared to December 31, 2012. The current competitive banking environment continues to be a challenge for community banks. Loan fundings in the first half of 2013 totaled \$116.8 million, offset by payoffs/pay-downs of \$98.6 million. Non-accrual loans totaled \$18.5 million, or 1.69% of the total loan portfolio at June 30, 2013, compared to \$17.7 million or 1.64% at December 31,

2012. The change in non-accrual loans primarily reflects the delinquent land development loan of \$4.8 million mentioned above that was transferred to non-accrual status during the second quarter of 2013. The allowance for loan losses increased to 1.32% of loans at June 30, 2013, compared to 1.27% at December 31, 2012.

Deposits totaled \$1.2 billion at June 30, 2013 compared to \$1.3 billion at December 31, 2012. Non-interest bearing deposits totaled 40.7% of total deposits at June 30, 2013, compared to 31.1% at December 31, 2012. The increase in non-interest bearing deposits is primarily due to a strategic product change which discontinued interest on one type of consumer account in early 2013. This resulted in a reclassification of the accounts from interest-bearing to non-interest bearing with the account balances totaling \$82.6 million at June 30, 2013.

The total risk-based capital ratio for Bancorp totaled 14.0% at June 30, 2013, up from 13.7% at December 31, 2012, due to accumulation of undistributed earnings and continues to be well above regulatory requirements for a well-capitalized institution. The total risk-based capital ratio is expected to decline when the pending NorCal acquisition is completed. However, we expect to remain well-capitalized under the current minimum requirements for capital adequacy, as well as under the new Basel III rules.

Net interest income totaled \$14.3 million in the second quarter of 2013 compared to \$14.8 million in the prior quarter and \$16.3 million in the same quarter a year ago. The tax-equivalent net interest margin was 4.30% in the second quarter of 2013 compared to 4.48% in the prior quarter and 4.94% in the same quarter a year ago. The net interest income decrease in the second quarter of 2013 compared to the prior quarter primarily relates to \$177 thousand in accelerated amortization on an early redemption of a municipal security in the second quarter of 2013 and a lower level of gains on pay-offs of purchased credit-impaired ("PCI") loans. The decrease in net interest income in the second quarter of 2013 compared to the same quarter a year ago primarily relates to rate concessions and downward repricing on existing loans, new loans yielding lower rates and a lower level of accretion on loans acquired from the Federal Deposit Insurance Corporation in 2011 in connection with the closure of Charter Oak Bank.

Non-interest income in the second quarter of 2013 totaled \$1.9 million, compared to \$2.1 million in the prior quarter and \$1.8 million in the same quarter a year ago. The decrease in the second quarter of 2013 compared to the prior quarter primarily relates to a \$223 thousand BOLI death benefit realized in the first quarter of 2013. The increase in the second quarter of 2013 compared to the same quarter a year ago primarily relates to higher Wealth Management and Trust Services fees and higher dividend income from the Federal Home Loan Bank of San Francisco.

Non-interest expense totaled \$10.4 million in the second quarter of 2013, compared to \$9.7 million in both the prior quarter and the same quarter a year ago. The increase compared to the prior quarter and the same quarter a year ago primarily relates to higher acquisition-related professional expenses and higher staffing costs as the Bank continues to grow. The increase in non-interest expense from the prior quarter also reflects higher data processing charges due to technological upgrades. We expect to continue to incur acquisition-related professional expenses in the next half of 2013. If the NorCal acquisition closes as expected in the fourth quarter of 2013, we anticipate to incur significant system integration and personnel costs in the beginning of 2014.

#### Critical Accounting Policies

Critical accounting policies are those that are both most important to the portrayal of our financial condition and results of operations and require Management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Management has determined the following five accounting policies to be critical: Allowance for Loan Losses, Acquired Loans, Other-than-temporary Impairment of Investment Securities, Accounting for Income Taxes and Fair Value Measurements.

#### Allowance for Loan Losses

Allowance for loan losses is based upon estimates of loan losses and is maintained at a level considered adequate to provide for probable losses inherent in the outstanding loan portfolio. The allowance is increased by provisions charged to expense and reduced by charge-offs, net of recoveries. In periodic evaluations of the adequacy of the allowance balance, Management considers our past loan loss experience by type of credit, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, current economic conditions and other factors. We formally assess the adequacy of the allowance for loan losses on a quarterly basis. These assessments include the periodic re-grading of loans based on changes in their

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

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

For our methodology on estimating the allowance for loan losses on acquired loans, refer to the section Acquired Loans below.

#### Acquired Loans

From time to time, we acquire loans through business acquisitions. Acquired loans are recorded at their estimated fair values at acquisition date in accordance with ASC 805 Business Combinations, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses is not carried over or recorded for acquired loans as of the acquisition date.

The process of estimating fair values of the acquired loans, including the estimate of losses that are expected to be incurred over the estimated remaining lives of the loans at acquisition date and the ongoing updates to Management's expectation of future cash flows, requires significant subjective judgments and assumptions, particularly considering the current economic environment. The economic environment and the lack of market liquidity and transparency are factors that have influenced, and may continue to affect, these assumptions and estimates.

We estimated the fair value of acquired loans at the acquisition date based on a discounted cash flow methodology that considered factors including the type of loan and related collateral, risk classification, fixed or variable interest rate, term of loan and whether or not the loan was amortizing, and current discount rates. Loans were grouped together according to similar characteristics and were treated in the aggregate when applying various valuation techniques. The estimate of expected cash flows incorporates our best estimate of current key assumptions, such as property values, default rates, loss severity and prepayment speeds. The discount rates used for loans were based on current market rates for new originations of comparable loans, where available, and include adjustments for liquidity concerns.

To the extent comparable market rates are not readily available, a discount rate was derived based on the assumptions of market participants' cost of funds, servicing costs and return requirements for comparable risk assets. In either case, the discount rate does not include a factor for credit losses, as that has been considered in estimating the cash flows. The initial estimate of cash flows to be collected was derived from assumptions such as default rates, loss severities and prepayment speeds.

We purchased certain loans with evidence of credit quality deterioration subsequent to their origination and for which it was probable, at acquisition, that we would be unable to collect all contractually required payments. Management

has applied significant subjective judgment in determining which loans are PCI loans. Evidence of credit quality deterioration as of the purchase date may include data such as past due and nonaccrual status, risk grades and recent loan-to-value percentages. Revolving credit agreements (e.g. home equity lines of credit and revolving commercial loans), where the borrower had revolving privileges at acquisition date, are not considered PCI loans because the timing and amount of cash flows cannot be reasonably estimated.

The accounting guidance for PCI loans provides that the excess of the cash flows initially expected to be collected over the fair value of the loans at the acquisition date (i.e., the accretable yield) should be accreted into interest income at a level rate of return over the remaining term of the loan, provided that the timing and amount of future cash flows is reasonably estimable. The difference between the contractually required payments and the cash flows expected to

be collected at acquisition, considering the impact of prepayments, is referred to as the nonaccretable difference and is not recorded.

The initial estimate of cash flows expected to be collected is updated each quarter and requires the continued usage of key assumptions and estimates similar to the initial estimate of fair value. Given the current economic environment, we apply judgment to develop our estimate of cash flows for PCI loans given the impact of real estate value changes, changing probability of default, loss severities and prepayment speeds.

For purposes of accounting for the PCI loans associated with the closure of Charter Oak Bank, we elected not to apply the pooling method but to account for these loans individually. Disposals of loans, which may include sales of loans to third parties, receipt of payments in full by the borrower, or foreclosure of the collateral, result in removal of the loan from the PCI loan portfolio at its carrying amount.

If we have probable and significant increases in cash flows expected to be collected on PCI loans, we first reverse any previously established allowance for loan loss and then increase interest income as a prospective yield adjustment over the remaining life of the loans. The impact of changes in variable interest rates is recognized prospectively as adjustments to interest income. All PCI loans that were classified as non-accrual loans prior to the acquisition were no longer classified as non-accrual because we believed that we would fully collect the new carrying value of these loans at acquisition. Subsequent to the acquisition, specific allowances are allocated to PCI loans that have experienced credit deterioration through an increase to the allowance for loan losses. The amount of cash flows expected to be collected and, accordingly, the adequacy of the allowance for loan losses are particularly sensitive to changes in loan credit quality. When there is doubt as to the timing and amount of future cash flows to be collected, PCI loans are classified as non-accrual loans. It is important to note that judgment is required to classify PCI loans as performing or non-accrual, and is dependent on having a reasonable expectation about the timing and amount of cash flows expected to be collected.

For acquired loans not considered PCI loans, we recognize the entire fair value discount accretion based on the acquired loan's contractual cash flows using an effective interest rate method for term loans, and on a straight line basis to interest income for revolving lines, as the timing and amount of cash flows under revolving lines are not predictable. Subsequent to Acquisition, if the probable and estimable losses for non-PCI loans exceed the amount of the remaining unaccreted discount, the excess is established as an allowance for loan losses.

For further information regarding our acquired loans, see Note 6 to our Consolidated Financial Statements in this Form 10-Q.

#### Other-than-temporary Impairment of Investment Securities

At each financial statement date, we assess whether declines in the fair value of held-to-maturity and available-for-sale securities below their costs are deemed to be other than temporary. We consider, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) our intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair value. Evidence evaluated includes, but is not limited to, the remaining payment terms of the instrument and economic factors that are relevant to the collectability of the instrument, such as: current prepayment speeds, the current financial condition of the issuer(s), industry analyst reports, credit ratings, credit default rates, interest rate trends and the value of any underlying collateral. Credit-related other-than-temporary impairment results in a charge to earnings and the corresponding establishment of a new cost basis for the security. Non-credit-related other-than-temporary impairment results in a charge to other comprehensive income, net of applicable taxes, and the corresponding establishment of a new cost basis for the security. The other-than-temporary impairment recognized in other comprehensive income for debt securities classified as

held-to-maturity is accreted from other comprehensive income to the amortized cost of the debt security over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows.

#### Accounting for Income Taxes

Income taxes reported in the financial statements are computed based on an asset and liability approach. We recognize the amount of taxes payable or refundable for the current year, and deferred tax assets and liabilities for the expected future tax consequences that have been recognized in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. We record net

deferred tax assets to the extent it is more likely than not that they will be realized. In evaluating our ability to recover the deferred tax assets, Management considers all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies and recent financial operations. In projecting future taxable income, Management develops assumptions including the amount of future state and federal pretax operating income, the reversal of temporary differences, and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates being used to manage the underlying business. Bancorp files consolidated federal and combined state income tax returns.

We recognize the financial statement effect of a tax position when it is more likely than not, based on the technical merits and all available evidence, that the position will be sustained upon examination, including the resolution through protests, appeals or litigation processes. For tax positions that meet the more-likely-than-not threshold, we measure the largest amount of tax benefit that is greater than fifty percent likely of being realized upon ultimate settlement with the taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described previously is recognized as a liability for unrecognized tax benefits, along with any related interest and penalties. Interest and penalties related to unrecognized tax benefits are recognized as a component of tax expenses.

In deciding whether or not our tax positions taken meet the more-likely-than-not recognition threshold, we must make judgments and interpretations about the application of inherently complex state and federal tax laws. To the extent tax authorities disagree with tax positions taken by us, our effective tax rates could be materially affected in the period of settlement with the taxing authorities. Revision of our estimate of accrued income taxes also may result from our own income tax planning, which may affect our effective tax rates and our results of operations for any given quarter.

#### Fair Value Measurements

We use fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. We base our fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Securities available-for-sale and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record certain assets at fair value on a non-recurring basis, such as purchased loans recorded at acquisition date, certain impaired loans held for investment and securities held-to-maturity that are other-than-temporarily impaired. These non-recurring fair value adjustments typically involve write-downs of individual assets due to application of lower-of-cost or market accounting.

We have established and documented a process for determining fair value. We maximize the use of observable inputs when developing fair value measurements. Whenever there is no readily available market data, Management uses its best estimate and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these financial statements. For detailed information on our use of fair value measurements and our related valuation methodologies, see Note 4 to the Consolidated Financial Statements in this Form 10-Q.



## Net Interest Income

Net interest income is the difference between the interest earned on loans, investments and other interest-earning assets and the interest expense incurred on deposits and other interest-bearing liabilities. Net interest income is impacted by changes in general market interest rates and by changes in the amounts and composition of interest-earning assets and interest-bearing liabilities. Interest rate changes can create fluctuations in the net interest margin due to an imbalance in the timing of repricing or maturity of assets or liabilities. We manage interest rate risk exposure with the goal of minimizing the impact of interest rate volatility on net interest margin.

Net interest margin is expressed as net interest income divided by average interest-earning assets. Net interest rate spread is the difference between the average rate earned on total interest-earning assets and the average rate incurred on total interest-bearing liabilities. Both of these measures are reported on a taxable-equivalent basis. Net interest margin is the higher of the two because it reflects interest income earned on assets funded with non-interest-bearing sources of funds, which include demand deposits and stockholders' equity.

The following table, Average Statements of Condition and Analysis of Net Interest Income, compares interest income and average interest-earning assets with interest expense and average interest-bearing liabilities for the periods presented. The table also indicates net interest income, net interest margin and net interest rate spread for each period presented.

## Average Statements of Condition and Analysis of Net Interest Income

(Dollars in thousands; unaudited)	Three months ended June 30, 2013			Three months ended March 31, 2013			Three months ended June 30, 2012		
	Average	Interest Income/	Yield/	Average	Interest Income/	Yield/	Average	Interest Income/	Yield/
	Balance	Expense	Rate	Balance	Expense	Rate	Balance	Expense	Rate
<b>Assets</b>									
Interest-bearing due from banks <sup>1</sup>	\$4,485	\$3	0.26 %	\$5,710	\$8	0.56 %	\$70,003	\$56	0.32 %
Investment securities <sup>2, 3</sup>	266,774	1,452	2.18 %	284,429	1,780	2.50 %	230,609	1,750	3.04 %
Loans <sup>1, 3, 4</sup>	1,070,333	13,537	5.00 %	1,062,957	13,808	5.20 %	1,028,761	15,466	5.95 %
Total interest-earning assets <sup>1</sup>	1,341,592	14,992	4.42 %	1,353,096	15,596	4.61 %	1,329,373	17,272	5.14 %
Cash and non-interest-bearing due from banks	27,331			28,250			53,269		
Bank premises and equipment, net	9,313			9,425			9,136		
Interest receivable and other assets, net	38,981			37,892			35,813		
Total assets	\$1,417,217			\$1,428,663			\$1,427,591		
<b>Liabilities and Stockholders' Equity</b>									
Interest-bearing transaction accounts	\$83,285	\$12	0.06 %	\$129,379	\$11	0.03 %	\$147,463	\$45	0.12 %
Savings accounts	95,083	8	0.03 %	96,561	8	0.03 %	85,118	24	0.11 %
Money market accounts	410,823	95	0.09 %	432,154	99	0.09 %	431,625	180	0.17 %
CDARS® time accounts	5,194	2	0.15 %	12,866	5	0.16 %	28,045	21	0.30 %

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Other time accounts	136,759	224	0.66 %	140,254	232	0.67 %	142,189	269	0.76 %
Overnight borrowing <sup>1</sup>	12,785	5	0.15 %	3,513	2	0.23 %	—	—	— %
FHLB fixed-rate advances	15,000	79	2.07 %	15,000	77	2.07 %	15,000	78	2.07 %
Subordinated debenture <sup>1</sup>	—	—	— %	—	—	— %	5,000	39	3.09 %
Total interest-bearing liabilities	758,929	425	0.22 %	829,727	434	0.21 %	854,440	656	0.31 %
Demand accounts	486,410			429,335			417,354		
Interest payable and other liabilities	13,092			14,892			13,646		
Stockholders' equity	158,786			154,709			142,151		
Total liabilities & stockholders' equity	\$1,417,217			\$1,428,663			\$1,427,591		
Tax-equivalent net interest income/margin <sup>1</sup>		\$14,567	4.30 %		\$15,162	4.48 %		\$16,616	4.94 %
Reported net interest income/margin <sup>1</sup>		\$14,305	4.21 %		\$14,796	4.37 %		\$16,281	4.85 %
Tax-equivalent net interest rate spread			4.20 %			4.40 %			4.83 %

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	Six months ended June 30, 2013			Six months ended June 30, 2012		
	Average Balance	Interest Income/Yield/ ExpenseRate		Average Balance	Interest Income/Yield/ ExpenseRate	
(Dollars in thousands; unaudited)						
<b>Assets</b>						
Interest-bearing due from banks <sup>1</sup>	\$5,094	\$11	0.43 %	\$78,552	\$106	0.27 %
Investment securities <sup>2,3</sup>	275,553	3,236	2.35 %	214,426	3,472	3.24 %
Loans <sup>1,3,4</sup>	1,066,665	27,346	5.10 %	1,028,667	30,939	5.95 %
Total interest-earning assets <sup>1</sup>	1,347,312	30,593	4.52 %	1,321,645	34,517	5.17 %
Cash and non-interest-bearing due from banks	27,788			52,640		
Bank premises and equipment, net	9,369			9,260		
Interest receivable and other assets, net	38,440			35,310		
Total assets	\$1,422,909			1,418,855		
<b>Liabilities and Stockholders' Equity</b>						
Interest-bearing transaction accounts	\$106,205	\$23	0.04 %	\$145,311	\$89	0.12 %
Savings accounts	95,818	16	0.03 %	81,974	46	0.11 %
Money market accounts	421,430	194	0.09 %	433,979	363	0.17 %
CDARS® time accounts	9,009	7	0.16 %	34,068	53	0.31 %
Other time accounts	138,496	456	0.66 %	145,709	573	0.79 %
Overnight borrowing <sup>1</sup>	8,175	7	0.17 %	—	—	— %
FHLB fixed-rate advances	15,000	156	2.07 %	17,418	185	2.10 % <sup>5</sup>
Subordinated debenture <sup>1</sup>	—	—	— % <sup>6</sup>	5,000	79	3.13 %
Total interest-bearing liabilities	794,133	859	0.22 %	863,459	1,388	0.32 %
Demand accounts	458,030			401,063		
Interest payable and other liabilities	13,987			14,230		
Stockholders' equity	156,759			140,103		
Total liabilities & stockholders' equity	\$1,422,909			\$1,418,855		
Tax-equivalent net interest income/margin <sup>1</sup>		29,734	4.39 %		33,129	4.96 %
Reported net interest income/margin <sup>1</sup>		29,101	4.30 %		32,482	4.86 %
Tax-equivalent net interest rate spread			4.30 %			4.85 %

<sup>1</sup> Interest income/expense is divided by actual number of days in the period times 360 days to correspond to stated interest rate terms, where applicable.

<sup>2</sup> Yields on available-for-sale securities are calculated based on amortized cost balances rather than fair value, as changes in fair value are reflected as a component of stockholders' equity. Investment security interest is earned on 30/360 day basis monthly.

<sup>3</sup> Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the Federal statutory rate of 35 percent.

<sup>4</sup> Average balances on loans outstanding include non-performing loans. The amortized portion of net loan origination fees is included in interest income on loans, representing an adjustment to the yield.

#### Second Quarter of 2013 Compared to First Quarter of 2013

The tax-equivalent net interest margin was 4.30% in the second quarter of 2013, compared to 4.48% in the prior quarter. The decrease of eighteen basis points was primarily due to accelerated amortization on an early redemption of a municipal security in the second quarter of 2013 and a lower level of accretion and gains on pay-offs of purchased loans. In addition, rate concessions and downward repricing on existing loans, as well as new loans yielding lower rates continue to negatively impact the loan yield. The decreases were partially offset by a shift in the mix of interest-earning assets from lower-yielding investment securities towards higher-yielding loans. The net interest spread decreased twenty basis points over the same period for the same reasons.

The average yield on interest-earning assets decreased nineteen basis points in the second quarter of 2013 compared to the first quarter of 2013 due to the reasons listed above. The loan portfolio as a percentage of average interest-earning assets was 80% and 79% for the second quarter of 2013 and the first quarter of 2013, respectively. Total average interest-earning assets decreased \$11.5 million, or 0.9%, in the second quarter of 2013, compared to the first quarter of 2013.

Market interest rates are, in part, based on the target Federal funds interest rate (the interest rate banks charge each other for short-term borrowings) implemented by the Federal Reserve Open Market Committee ("FOMC"). In December of 2008, the target interest rate reached a historic low with a range of 0% to 0.25% where it remains as of June 30, 2013. Other monetary policy measures taken by the Federal Reserve, including quantitative easing, also impact the interest rate environment. In September of 2012, the Federal Reserve announced a third round of quantitative easing. At the FOMC meeting in June of 2013, members continued their pledge to keep the target range for the federal funds rate at 0% to 0.25% and currently anticipate that this exceptionally low range for the Federal funds rate will be appropriate at least as long as the unemployment rate remains above 6.5%. The combination of this low interest rate environment and the fierce market competition on loan pricing continue to apply downward rate pressure on our loan portfolio.

#### Second Quarter of 2013 Compared to Second Quarter of 2012

The tax-equivalent net interest margin was 4.30% in the second quarter of 2013, compared to 4.94% in the same quarter last year. The decrease of sixty-four basis points was primarily due to rate concessions and downward repricing on existing loans, new loans yielding lower rates, and a lower level of accretion and gains on pay-offs of purchased loans. These decreases were partially offset by a shift in the mix of interest-earning assets from lower-yielding interest-bearing due from banks towards higher-yielding loans and securities, as well as the downward repricing of deposits. The net interest spread decreased sixty-three basis points over the same period for the same reasons.

The average yield on interest-earning assets decreased seventy-two basis points in the second quarter of 2013 compared to the second quarter of 2012 due to the reasons listed above. The loan portfolio as a percentage of average interest-earning assets was 80% and 77% for the second quarter of 2013 and the second quarter of 2012, respectively. Total average interest-earning assets increased \$12.2 million, or 0.9%, in the second quarter of 2013, compared to the second quarter of 2012.

The average rate on interest-bearing liabilities decreased nine basis points in the second quarter of 2013 compared to the same period a year ago, primarily due to lower offered deposit rates.

#### Six Months 2013 Compared to Six Months 2012

The tax-equivalent net interest margin was 4.39% in the first six months of 2013, compared to 4.96% in the same period last year. The decrease of fifty-seven basis points was primarily due to rate concessions and downward repricing on existing loans, new loans yielding lower rates, and a lower level of accretion and gains on pay-offs of purchased loans. These decreases were partially offset by a shift in the mix of interest-earning assets from lower-yielding interest-bearing due from banks towards higher-yielding loans and securities, as well as the downward repricing of deposits. The net interest spread decreased fifty-five basis points over the same period for the same reasons.

The average yield on interest-earning assets decreased sixty-five basis points in the first six months of 2013 compared to the first six months of 2012 due to the reasons listed above. The loan portfolio as a percentage of average interest-earning assets was 79% and 78% for for the six months ended June 30, 2013 and 2012, respectively. Total average interest-earning assets increased \$25.7 million, or 1.9%, in the first six months of 2013 compared to the first six months of 2012.

The average rate on interest-bearing liabilities decreased ten basis points in the first six months of 2013 compared to the same period a year ago, primarily due to lower offered deposit rates.



#### Provision for Loan Losses

Management assesses the adequacy of the allowance for loan losses on a quarterly basis based on several factors including growth of the loan portfolio, analysis of probable losses in the portfolio, recent loss experience and the current economic climate. Actual losses on loans are charged against the allowance, and the allowance is increased by loss recoveries and through the provision for loan losses charged to expense. For further discussion, see the section captioned "Critical Accounting Policies."

The provision for loan losses totaled \$1.1 million in the second quarter of 2013, compared to a reversal of the provision for loan losses of \$230 thousand in the prior quarter and a provision for loan losses of \$100 thousand in the same quarter a year ago. The \$1.1 million provision for loan losses in the second quarter of 2013 primarily relates to a land development loan of \$4.8 million that went onto non-accrual status during the second quarter when the property fell out of escrow and the interest reserve was depleted. Since the loan matured and could not be paid off by the failed sale, an appraisal was ordered in April. The appraisal indicated a decline in the collateral value resulting in a \$1.2 million specific reserve on this loan. This property has gone back into escrow in July 2013, which does not guarantee a final sale. Reflecting the specific reserve established on this land development loan, the allowance for loan losses increased to 1.32% of loans at June 30, 2013, from 1.25% at March 31, 2013 and 1.27% at December 31, 2012.

The non-performing loans totaled \$18.5 million, or 1.69% of Bancorp's loan portfolio at June 30, 2013, compared to \$15.3 million, or 1.43% at March 31, 2013 and \$17.7 million, or 1.64% at December 31, 2012. The increase in non-performing loans from the prior quarter primarily relates to the land development loan of \$4.8 million mentioned above that went onto non-accrual status during the quarter.

Impaired loan balances totaled \$29.6 million at June 30, 2013, compared to \$27.2 million at March 31, 2013 and \$30.3 million at December 31, 2012, with specific valuation allowances of \$3.1 million, \$1.9 million and \$2.4 million, respectively. Classified loans, which have regulatory risk grades of "substandard" or "doubtful", decreased to \$27.6 million at June 30, 2013, from \$31.1 million at March 31, 2013 and \$36.9 million at December 31, 2012.

Net charge-offs in the second quarter of 2013 totaled \$177 thousand, compared to net recoveries of \$3 thousand in the prior quarter and net charge-offs of \$187 thousand in the second quarter of 2012. The percentage of net charge-offs to average loans was 0.02% in the second quarter of 2013, compared to zero in the first quarter of 2013 and 0.02% in the second quarter of 2012.

## Non-interest Income

The table below details the components of non-interest income.

	Three months ended			June 30, 2013 compared to March 31, 2013		June 30, 2013 compared to June 30, 2012	
	(dollars in thousands; unaudited) June 30, 2013	March 31, 2013	June 30, 2012	Amount Increase (Decrease)	Percent Increase (Decrease)	Amount Increase (Decrease)	Percent Increase (Decrease)
Service charges on deposit accounts	\$515	\$521	\$549	\$(6 )	(1.2 )%	\$(34 )	(6.2 )%
Wealth Management and Trust Services	539	547	488	(8 )	(1.5 )%	51	10.5 %
Debit card interchange fees	280	252	259	28	11.1 %	21	8.1 %
Merchant interchange fees	222	205	186	17	8.3 %	36	19.4 %
Earnings on Bank-owned life insurance	186	401	192	(215 )	(53.6 )%	(6 )	(3.1 )%
Other income	202	180	126	22	12.2 %	76	60.3 %
Total non-interest income	\$1,944	\$2,106	\$1,800	\$(162 )	(7.7 )%	\$144	8.0 %
	Six months ended			Amount	Percent		
(dollars in thousands; unaudited)	June 30, 2013	June 30, 2012		Increase (Decrease)	Increase (Decrease)		
Service charges on deposit accounts	\$1,036	\$1,073		\$(37 )	(3.4 )%		
Wealth Management and Trust Services	1,086	944		142	15.0 %		
Debit card interchange fees	532	493		39	7.9 %		
Merchant interchange fees	427	379		48	12.7 %		
Earnings on Bank-owned life insurance	587	380		207	54.5 %		
Other income	382	226		156	69.0 %		
Total non-interest income	\$4,050	\$3,495		\$555	15.9 %		

The increase in Wealth Management and Trust Services (WMTS) income in both the three-month and six-month periods ended June 30, 2013 compared to the same periods last year is due to the acquisition of new assets and market value appreciation of existing assets under management. WMTS income decreased slightly compared to the prior quarter due to the absence of non-recurring extraordinary fees earned for estate and probate administration services



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performed in the first quarter. Assets under management totaled approximately \$298.1 million at June 30, 2013, \$304.4 million at March 31, 2013 and \$279.1 million at June 30, 2012.

Debit card interchange fees in the second quarter of 2013 increased when compared to the prior quarter and the same quarter in 2012 primarily due to an increase in the volume of debit card usage. Debit card interchange fees also increased in the six months ended June 30, 2013 when compared to the same period last year for the same reason.

Merchant interchange fees increased in the second quarter of 2013 when compared to the prior quarter due to higher merchant sales volume. The increase when compared to the same quarter a year ago is due to higher merchant sales

volume, as well as the addition of a new vendor. Merchant interchange fees also increased in the first six months of 2013 when compared to the first six months of 2012 for the same reasons.

Bank-owned life insurance (“BOLI”) income decreased when compared to the prior quarter due to a \$223 thousand death benefit realized on the death of an insured employee in the first quarter of 2013. The increase in BOLI income for the first six months of 2013 when compared to the same period in 2012 is due to the same reason.

Other income increased for the three months ended June 30, 2013 when compared to the previous quarter and the same quarter a year ago, primarily due to higher dividend income from the FHLB and higher credit card referral fees and interchange. The increase in other income when comparing the first six months of 2013 to the first six months of 2012 is primarily due to higher dividend income from the FHLB, a loss on sale of investments in the first quarter of 2012 of \$38 thousand that did not recur and higher credit card referral fees and interchange.



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Advertising	232	244	(12	)	(4.9	)%
Other expense	3,317	2,815	502		17.8	%
Total other non-interest expense	3,549	3,059	490		16.0	%
Total non-interest expense	20,114	19,520	594		3.0	%

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Salary and benefit expenses increased when comparing the second quarter of 2013 to the prior quarter mainly due to higher salaries including annual merit increases and additional full-time equivalent ("FTE") staff. The increase in the second quarter of 2013 when compared to the same quarter in 2012 is primarily due to higher salaries and associated payroll taxes, offset by higher capitalized and deferred loan origination costs, as a result of revised standard loan origination costs effective January 1, 2013. The decrease in salaries and benefits in the first six months of 2013 compared to the same period in 2012 is primarily attributable to higher salaries and associated payroll taxes, which were more than offset by higher capitalized and deferred loan origination costs, resulting from the revision of standard loan origination costs mentioned above.

The increase in data processing expenses when compared to the previous quarter primarily reflects charges for technological upgrades. The increase when compared to the same quarter a year ago reflects technological upgrades, partially offset by savings from the re-negotiation and execution of a new contract with our current data processing vendor that resulted in a reduction of our ongoing data processing expenses effective July 1, 2012. Data processing expenses for the first six months of 2013 decreased when compared to the first six months of 2012 due to the contract re-negotiation discussed above.

Professional service expenses increased when compared to all presented periods. The increases are primarily due to legal fees related to the NorCal acquisition, other professional fees for compliance and regulatory consulting and higher accounting fees relating to internal audit services in the current period.

Other expenses in the second quarter of 2013 increased when compared to the prior quarter and the second quarter of 2012. The increase when compared to the prior quarter is primarily due to employee recruitment fees. The increase in other expenses compared to the same quarter last year primarily reflected the recruitment fees mentioned above, as well as higher provision for losses on off-balance sheet commitments, director expenses and loan servicing, and appraisal expenses. Other expenses in the first six months of 2013 increased when compared to the same period a year ago due to higher provision for losses on off-balance sheet commitments, recruitment fees, promotion and development expenses, and director expenses.

#### Provision for Income Taxes

The provision for income taxes for the second quarter of 2013 is \$1.7 million at an effective tax rate of 35.4%, compared to \$2.6 million at an effective tax rate of 34.6% in the previous quarter and \$3.3 million at an effective tax rate of 40.3% in the same quarter last year. The provision for income taxes for the first half of 2013 is \$4.2 million at an effective tax rate of 34.9%, compared to \$6.5 million at an effective tax rate of 39.5% for the first half of 2012. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities, BOLI and certain tax-exempt loans). Therefore, there are normal fluctuations in the effective rate from period to period based on the relationship of net permanent differences to income before tax.

Bancorp and the Bank have entered into a tax allocation agreement which provides that income taxes shall be allocated between the parties on a separate entity basis. The intent of this agreement is that each member of the consolidated group will incur no greater tax liability than it would have incurred on a stand-alone basis.

We file a consolidated return in the U.S. Federal tax jurisdiction and a combined return in the State of California tax jurisdiction. We are no longer subject to tax examinations by taxing authorities for years beginning before 2010 for U.S. Federal or before 2009 for California. There were no federal income tax examinations at the issuance of this report.

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The State of California is currently examining 2011 and 2012 corporate income tax returns. At the time of issuance of this quarterly report, no adjustments have been proposed by the California Franchise Tax Board in connection with the examination thus far. Although timing of the resolution or closure of the examination is highly uncertain, we do not believe that our unrecognized tax benefits would materially change in the next 12 months.

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## FINANCIAL CONDITION

## Summary

During the first half of 2013, total assets decreased \$6.2 million to \$1.4 billion. The decrease in assets primarily reflects a decrease in investment securities, partially offset by an increase in net loans. Our investment securities portfolio decreased \$32.0 million in the first six months of 2013, primarily due to \$19.7 million of pay-downs and \$7.6 million of called securities. Two available-for-sale privately issued CMO securities totaling \$1.1 million were sold in the first six months of 2013. Investment securities in our portfolio that may be backed by mortgages having sub-prime or Alt-A features (certain privately issued CMOs) represent 5.8% of our total investment portfolio at June 30, 2013, compared to 6.4% at December 31, 2012.

We had a relatively strong level of loan originations this year that was partially offset by early pay-offs and refinancing activity, in line with current market pressure and strong competition for quality loans, as well as maturities and our successful resolution of problem loans. The following table presents the composition of our loans outstanding by class:

Loans Outstanding (Dollars in thousands; June 30, 2013 unaudited)	June 30, 2013	December 31, 2012
Commercial and industrial	\$ 170,443	\$ 176,431
Real estate		
Commercial owner-occupied	206,191	196,406
Commercial investor-owned	535,260	509,006
Construction	27,728	30,665
Home equity	90,296	93,237
Other residential <sup>1</sup>	43,290	49,432
Installment and other consumer loans	18,274	18,775
Total loans	1,091,482	1,073,952
Allowance for loan losses	(14,357	) (13,661
Total net loans	\$ 1,077,125	\$ 1,060,291

<sup>1</sup> Our residential loan portfolio includes no sub-prime loans, nor is it our normal practice to underwrite loans commonly referred to as "Alt-A mortgages", the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or collateral compositions reflecting high loan-to-value ratios. However, substantially all of our residential loans are indexed to Treasury Constant Maturity Rates and have provisions to reset five years after their origination dates.

During the first six months of 2013, total liabilities decreased \$12.8 million to \$1.3 billion. The decrease in total liabilities is primarily due to a decrease in deposits, partially offset by an increase in FHLB overnight borrowings. The lower level of deposits primarily reflects a decline in most deposit categories, except for non-interest bearing deposits and saving accounts. Non-interest bearing deposits increased \$108.9 million to \$498.6 million at June 30, 2013. The increase in non-interest bearing deposits in the first half of 2013 is primarily due to a strategic product change which discontinued interest on one type of consumer account in the first quarter of 2013. This resulted in a reclassification of the accounts from interest-bearing transaction to non-interest bearing accounts, with the affected balances totaling \$82.6 million at June 30, 2013. Non-interest bearing deposits comprised 40.7% of total deposits at June 30, 2013, compared to 31.1% at December 31, 2012.





## Capital Adequacy

We are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on our consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and the Bank's prompt corrective action classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Prompt corrective action provisions are not directly applicable to bank holding companies such as Bancorp.

Quantitative measures established by regulation to ensure capital adequacy require Bancorp and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to quarterly average assets.

Capital ratios are reviewed by Management on a regular basis to ensure that capital exceeds the prescribed regulatory minimums and is adequate to meet our anticipated future needs. For all periods presented, the Bank's ratios exceed the regulatory definition of "well capitalized" under the regulatory framework for prompt corrective action and Bancorp's ratios exceed the required minimum ratios for capital adequacy purposes. In addition, we expect the ratios will continue to meet the minimum requirements for capital adequacy purposes factoring in the pending NorCal acquisition, as discussed in Note 3 to the consolidated financial statements in this form 10-Q.

In December 2010, the Basel Committee on Bank Supervision finalized a set of international guidelines for determining regulatory capital known as "Basel III." These guidelines were developed to address many of the perceived weaknesses in the banking industry that contributed to the past financial crisis, including excessive leverage, inadequate and low quality capital and insufficient liquidity buffers. In July 2013, the Board of Governors of the Federal Reserve, the FDIC and the Office of the Comptroller, finalized a rule to implement Basel III. The rule is subject to a phase in period beginning January 2015, and all changes should be implemented by January 2019. The guidelines, among other things, increase minimum capital requirements of bank holding companies, including increasing the Tier 1 capital to risk-weighted assets ratio to 6%, introducing a new requirement to maintain a minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5%, and in 2019, when fully phased in, a capital conservation buffer of an additional 2.5% of risk weighted assets. In addition, there have been several updates to the way risk weighted assets are assessed. The three changes that will affect the Bank most significantly are: the movement of past due exposures from 100% to 150% risk weight; the movement of off-balance sheet items with an original maturity of one year or less from 0% to 20% risk weight; and the risk weighting of mortgage-backed securities using the gross-up approach instead of the ratings based approach. We have modeled our ratios under the finalized rules and we do not expect that we will be required to raise additional capital.

The Bank's and Bancorp's capital adequacy ratios as of June 30, 2013 and December 31, 2012 are presented in the following tables. We continue to build capital in 2013 due to the accumulation of net income.

Capital Ratios for Bancorp (in thousands; June 30, 2013 unaudited)	Actual Ratio		Ratio to Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio
As of June 30, 2013				
Total Capital (to risk-weighted assets)	\$172,345	14.05	% ≥\$98,164	≥ 8.0%
Tier 1 Capital (to risk-weighted assets)	\$157,446	12.83	% ≥\$49,082	≥ 4.0%
Tier 1 Capital (to average assets)	\$157,446	11.14	% ≥\$56,559	≥ 4.0%

As of December 31, 2012

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Total Capital (to risk-weighted assets)	\$ 163,900	13.71	% ≥\$95,655	≥ 8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 149,737	12.52	% ≥\$47,827	≥ 4.0%
Tier 1 Capital (to average assets)	\$ 149,737	10.30	% ≥\$58,169	≥ 4.0%

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Capital Ratios for the Bank (in thousands; June 30, 2013 unaudited)	Actual Ratio		Ratio for Capital Adequacy Purposes		Ratio to be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of June 30, 2013						
Total Capital (to risk-weighted assets)	\$ 168,248	13.71	% ≥\$98,159	≥ 8.0%	≥\$122,699	≥ 10.0%
Tier 1 Capital (to risk-weighted assets)	\$ 153,349	12.50	% ≥\$49,080	≥ 4.0%	≥\$73,620	≥ 6.0%
Tier 1 Capital (to average assets)	\$ 153,349	10.85	% ≥\$56,557	≥ 4.0%	≥\$70,696	≥ 5.0%
As of December 31, 2012						
Total Capital (to risk-weighted assets)	\$ 162,554	13.60	% ≥\$95,652	≥ 8.0%	≥\$119,566	≥ 10.0%
Tier 1 Capital (to risk-weighted assets)	\$ 148,391	12.41	% ≥\$47,826	≥ 4.0%	≥\$71,739	≥ 6.0%
Tier 1 Capital (to average assets)	\$ 148,391	10.20	% ≥\$58,168	≥ 4.0%	≥\$72,710	≥ 5.0%

### Liquidity

The goal of liquidity management is to provide adequate funds to meet both loan demand and unexpected deposit withdrawals. We accomplish this goal by maintaining an appropriate level of liquid assets, and formal lines of credit with the FHLB, FRB and correspondent banks that enable us to borrow funds as needed. Our Asset/Liability Management Committee (“ALCO”), which is comprised of certain directors of the Bank, is responsible for establishing and monitoring our liquidity targets and strategies.

Management regularly adjusts our investments in liquid assets based upon our assessment of expected loan demand, expected deposit flows, yields available on interest-earning securities and the objectives of our asset/liability management program. ALCO has also developed a contingency plan should liquidity drop unexpectedly below internal requirements.

We obtain funds from the repayment and maturity of loans as well as deposit inflows, investment security maturities and pay-downs, Federal funds purchases, FHLB advances, and other borrowings. Our primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposits, maturity of certificate of deposits, repayment of borrowings and dividends to common stockholders.

We must retain and attract new deposits, which depends upon the variety and effectiveness of our customer account products, service and convenience, and rates paid to customers, as well as our financial strength. Any long-term decline in retail deposit funding would adversely impact our liquidity. The Transaction Account Guarantee (“TAG”) program, which fully insured non-interest bearing transactions, expired on December 31, 2012. We have not experienced any significant impact on our liquidity from the expiration of TAG. We do have borrowing capacity through FHLB and FRB which we have been able to draw upon recently due to the decrease in deposits and increase in our loan portfolio. Management anticipates our strong liquidity position will provide adequate liquidity to fund our operations. We have adequate collateral for such funding requirements.

As presented in the accompanying unaudited consolidated statements of cash flows, the sources of liquidity vary between periods. Our cash and cash equivalents at June 30, 2013 totaled \$32.2 million, an increase of \$3.8 million over December 31, 2012. The primary sources of funds during the first six months of 2013 included \$27.3 million in pay-downs and maturities of investment securities, \$17.2 million borrowed from the FHLB and \$7.4 million net cash provided by operating activities. The primary uses of funds were \$19.2 million in loan originations (net of principal collections) and a decline in deposits amounting to \$28.9 million which was primarily due to fluctuations in customer balances in the normal course of business, as well as declines in customer balances transferred for investment uses.

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The banking industry is still experiencing diminished loan demand from qualified borrowers and strong competition.

At June 30, 2013, our cash and cash equivalents and unpledged available-for-sale securities with estimated maturities within one year totaled \$38.4 million. The remainder of the unpledged available-for-sale securities portfolio of \$123.4 million provides additional liquidity. These liquid assets equaled 11.3% of our assets at June 30, 2013, compared to 12.7% at December 31, 2012.

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We anticipate that cash and cash equivalents on hand and other sources of funds will provide adequate liquidity for our operating, investing and financing needs and our regulatory liquidity requirements for the foreseeable future. Management monitors our liquidity position daily, balancing loan funding/payments with changes in deposit activity and overnight investments. Our emphasis on local deposits combined with our well capitalized equity position, provides a very stable funding base. In addition to cash and cash equivalents, we have substantial additional borrowing capacity including unsecured lines of credit totaling \$87.0 million with correspondent banks. Further, we have pledged a certain residential loan portfolio to secure our borrowing capacity with the FRB, which totaled \$26.5 million at June 30, 2013. As of June 30, 2013, there is no debt outstanding to correspondent banks or the FRB. We are also a member of the FHLB and have a line of credit (secured under terms of a blanket collateral agreement by a pledge of essentially all of our financial assets) in the amount of \$391.0 million, of which \$358.8 million was available at June 30, 2013. Borrowings under the line are limited to eligible collateral. The interest rates on overnight borrowings with both correspondent banks and the FHLB are determined daily and generally approximate the Federal Funds target rate.

Undisbursed loan commitments, which are not reflected on the consolidated statements of condition, totaled \$271.2 million at June 30, 2013 at rates ranging from 1.70% to 18.00%. This amount included \$159.4 million under commercial lines of credit (these commitments are contingent upon customers maintaining specific credit standards), \$82.7 million under revolving home equity lines, \$5.5 million under undisbursed construction loans, \$13.4 million under standby letters of credit, and a remaining \$10.1 million under personal and other lines of credit. These commitments, to the extent used, are expected to be funded primarily through the repayment of existing loans, deposit growth and existing balance sheet liquidity. Over the next twelve months \$86.5 million of time deposits will mature. We expect these funds to be replaced with new time deposits.

Since Bancorp is a holding company and does not conduct regular banking operations, its primary sources of liquidity are dividends from the Bank. Under the California Financial Code, payment of a dividend from the Bank to Bancorp without advance regulatory approval is restricted to the lesser of the Bank's retained earnings or the amount of the Bank's undistributed net profits from the previous three fiscal years. The primary uses of funds for Bancorp are shareholder dividends and ordinary operating expenses. Bancorp held \$4.0 million of cash at June 30, 2013. While Bancorp obtained a dividend distribution from the Bank of \$5.0 million in February of 2013, a dividend from the Bank to Bancorp will be needed later in 2013 to cover merger consideration and costs associated with the acquisition of NorCal Community Bancorp. The acquisition is expected to close in the fourth quarter of 2013 and is subject to a number of conditions, including receipt of regulatory approvals and approval of NorCal Community Bancorp's shareholders. For more information on this transaction, please see the 8-K Reports filed with the Security and Exchange Commission on July 1 and July 5, 2013. For other important factors regarding the Norcal acquisition, please see the Forward Looking Statements and Risk Factors sections of this Form 10-Q.

### ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

Market risk is defined as the risk of loss arising from an adverse change in the market value of financial instruments caused by fluctuations in market prices or rates. Our most significant form of market risk is interest rate risk. The risk is inherent in our investment, borrowing, lending and deposit gathering activities. Management, together with ALCO, has sought to manage rate sensitivity and maturities of assets and liabilities to minimize the exposure of our earnings and capital to changes in interest rates. Additionally, interest rate risk exposure is managed with the goal of minimizing the impact of interest rate volatility on our net interest margin. Interest rate changes can create fluctuations in the net interest margin due to an imbalance in the timing of repricing or maturity of assets or liabilities.

Sensitivity of net interest income ("NII") and capital to interest rate changes results from differences in the maturity or repricing of asset and liability portfolios. To mitigate interest rate risk, the structure of the Consolidated Statement of Condition is managed with the objective of correlating the movements of interest rates on loans and investments with

those of deposits and borrowings. The asset and liability policy sets limits on the acceptable amount of change to NII and capital in changing interest rate environments. We use simulation models to forecast NII.

From time to time, we enter into certain interest rate swap contracts designated as fair value hedges to mitigate the changes in the fair value of specified long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans caused by changes in interest rates. See Note 10 to the Consolidated Financial Statements in this Form 10-Q.

Exposure to interest rate risk is reviewed at least quarterly by the ALCO and the Board of Directors. They utilize interest rate sensitivity simulation models as a tool for achieving these objectives and for developing ways in which to improve profitability. A simplified statement of condition is prepared on a quarterly basis as a starting point, using as inputs,

actual loans, investments, borrowings and deposits. If potential changes to net equity value and net interest income resulting from hypothetical interest changes are not within the limits established by the Board of Directors, Management may adjust the asset and liability mix to bring interest rate risk within approved limits.

Subsequent to 2009, there have been no changes in the Fed Funds target rate which has been kept at a historically low level of 0-25bp. Since the prior quarter, the yield curve has steepened and rates along the intermediate to long end of the yield curve have increased notably. It is expected to benefit us when market yields in new loans respond to this yield curve movement, although it may be on a lag basis. The effect of market competition on loan pricing is not yet alleviated. While we have been focused on loan growth, investment yields will elevate should we purchase bonds going forward. However, our existing investment portfolio has experienced a sharp decline in market value due to rise in the yield curve. Based on current prepayment projections, the estimated effective duration of the investment portfolio was 3.1 at June 30, 2013, compared to 3.0 at both March 31, 2013 and December 31, 2012. An effective duration of 3.1 suggests a further decrease of our investment market value of 3.1 percent for an immediate 1 percent parallel upward shift in interest rates. We remain asset sensitive. Our earnings and net interest margin are expected to increase when short term rates rise. In addition to our solid core deposit base, we have mitigated earnings sensitivity to a certain extent through the use of interest rate swaps.

#### ITEM 4. Controls and Procedures

We maintain a system of disclosure controls and procedures that is designed to provide reasonable assurance that information required to be disclosed is accumulated and communicated to management in an appropriate manner to allow timely decisions regarding required disclosure. Management, including the Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, reviewed this system of disclosure controls and procedures and believes that our disclosure controls and procedures (as that term is defined in Rule 13a-15(e) of the Exchange Act) were effective, as of the end of the period covered by this report, in recording, processing, summarizing and reporting information required to be disclosed in reports that we file or submit under the Securities and Exchange Act of 1934, within the time periods specified in the Securities and Exchange Commission's rules and forms. No significant changes were made in our internal controls over financial reporting during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II OTHER INFORMATION

### ITEM 1 Legal Proceedings

We may be party to legal actions which arise from time to time as part of the normal course of our business. We believe, after consultation with legal counsel, that we have meritorious defenses in these actions, and that litigation contingency liability, if any, will not have a material adverse effect on our financial position, results of operations, or cash flows.

We are responsible for our proportionate share of certain litigation indemnifications provided to Visa U.S.A. by its member banks in connection with lawsuits related to anti-trust charges and interchange fees. For further details, see Note 13 to the Consolidated Financial Statements in Item 8 of our 2012 Form 10-K and Note 9 to the Consolidated Financial Statements in this Form 10-Q herein.

### ITEM 1A Risk Factors

In addition to the other information contained in this Report, including the matters addressed under the section "Forward Looking Statements," and the risks which can be found in our Annual Report on Form 10-K for the year ended December 31, 2012, you should carefully consider the following risk factors in connection with the proposed acquisition of NorCal Community Bancorp ("NorCal").

The market price of our common stock after the merger may be affected by factors different from those affecting our shares currently.

The results of operations of the combined company and the market price of our common stock after the completion of the merger may be affected by factors different from those currently affecting the independent results of our operations.

Regulatory approvals may not be received, may take longer than expected or may impose conditions that are not presently anticipated.

Before the merger may be completed, Bancorp and NorCal must satisfy a number of conditions. These conditions include obtaining various regulatory approvals or consents, including from the Federal Deposit Insurance Corporation and the State of California. In deciding whether to grant these approvals, the relevant governmental authorities will make a determination of whether, among other things, the merger is in the public interest. These regulatory entities may impose conditions on the completion of the merger or require changes to the terms of the merger. Although we do not currently expect that any material conditions or changes would be imposed, there can be no assurance that they will not be. Such conditions or changes could have the effect of delaying completion of the merger or imposing additional costs on or limiting the revenues of the combined company following the merger, any of which might have a material adverse effect on us following the merger. In addition, we or NorCal may elect not to consummate the merger if: (A) any required regulatory approval has been denied by the relevant regulatory authority and such denial has become final and nonappealable, (B) any such approval includes any condition, restriction or requirement that would (i) have a material adverse effect on NorCal's business or, (ii) would restrict our business after the closing of the merger such that it would have a material adverse effect on us, or (iii) require the sale by us or NorCal of any material portion of assets, or (C) if a regulatory authority has issued a final, nonappealable injunction permanently enjoining or otherwise prohibiting the completion of the merger.

We May Be Unable to Integrate Operations Successfully or to Achieve Expected Cost Savings.



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Our earnings, financial condition and prospects after the merger will depend in part on our ability to integrate the operations and management of NorCal and to continue to implement our own business plan. There is no assurance that we will be able to do so. Among the issues that we could face are:

• unexpected problems with operations, personnel, technology or credit;

• loss of customers and employees of NorCal;

• difficulty in working with NorCal's employees and customers;

• the assimilation of NorCal's operations, site and personnel; and

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instituting and maintaining uniform standards, controls, procedures and policies.

Further, although the boards of directors of both parties anticipate cost savings as a result of the merger, we may not be fully able to realize those savings. Any cost savings that are realized may be offset by losses in revenues or other charges to earnings.

We Expect to Incur Significant Costs Associated with the Merger.

We estimate that we have incurred or will incur significant transaction costs associated with the merger, a portion of which will be incurred whether or not the merger closes. We believe the combined company may incur charges to operations, which are not currently reasonably estimable, in the quarter in which the merger is completed or subsequent quarters, to reflect costs associated with integrating the two banks. There is no assurance that the combined company will not incur additional material charges in subsequent quarters to reflect additional costs associated with the merger, including charges associated with the impairment of any goodwill booked in connection with the merger.

The Failure of the Loan Portfolios to Perform as Expected May Unfavorably Impact Us.

Our performance and prospects after the merger will be dependent to a significant extent on the performance of the combined loan portfolios of Bank of Marin and Bank of Alameda, and ultimately on the financial condition of their respective borrowers and other customers. The existing loan portfolios of the two banks differ to some extent in the types of borrowers, industries and credits represented. In addition, there are differences in the documentation, classifications, credit ratings and management of the portfolios. As a result, our overall loan portfolio after the merger will have a different risk profile than the loan portfolio of either Bank of Marin or Bank of Alameda before the merger. The performance of the two loan portfolios will be adversely affected if any of such factors is worse than currently anticipated. In addition, to the extent that present customers are not retained by NorCal and Bank of Alameda, or additional expenses are incurred in retaining them, there could be adverse effects on our future consolidated results of operations following the merger. Realization of improvement in profitability is dependent, in part, on the extent to which the revenues of NorCal are maintained and enhanced.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds

We did not have any unregistered sales of our equity securities during the three months ended June 30, 2013.

ITEM 3 Defaults Upon Senior Securities

None.

ITEM 4 Mine Safety Disclosures

Not applicable.

ITEM 5 Other Information

None.



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ITEM 6 Exhibits

The following exhibits are filed as part of this report or hereby incorporated by references to filings previously made with the SEC.

Exhibit Number	Exhibit Description	Incorporated by Reference				Herewith
		Form	File No.	Exhibit	Filing Date	
2.01	Modified Whole Bank Purchase and Assumption Agreement dated February 18, 2011 among Federal Deposit Insurance Corporation, Receiver of Charter Oak Bank, Napa, California, Federal Deposit Insurance Corporation, and Bank of Marin	8-K	001-33572	99.2	February 28, 2011	
2.02	Agreement and Plan of Merger with NorCal Community Bancorp, dated July 1, 2013	8-K	001-33572	2.1	July 5, 2013	
3.01	Articles of Incorporation, as amended	10-Q	001-33572	3.01	November 7, 2007	
3.02	Bylaws, as amended	10-Q	001-33572	3.02	May 9, 2011	
4.01	Rights Agreement dated as of July 2, 2007	8-A12B	001-33572	4.1	July 2, 2007	
4.02	Form of Warrant for Purchase of Shares of Common Stock, as amended	POS AM S-3	333-156782	4.4	December 20, 2011	
10.01	2007 Employee Stock Purchase Plan	S-8	333-144810	4.1	July 24, 2007	
10.02	1989 Stock Option Plan	S-8	333-144807	4.1	July 24, 2007	
10.03	1999 Stock Option Plan	S-8	333-144808	4.1	July 24, 2007	
10.04	2007 Equity Plan	S-8	333-144809	4.1	July 24, 2007	
10.05	2010 Director Stock Plan	S-8	333-167639	4.1	June 21, 2010	
10.06	Form of Indemnification Agreement for Directors and Executive Officers dated August 9, 2007	10-Q	001-33572	10.06	November 7, 2007	
10.07	Form of Employment Agreement dated January 23, 2009	8-K	001-33572	10.1	January 26, 2009	
10.08	2010 Director Stock Plan	S-8	333-167639	4.1	June 21, 2010	
10.09	2010 Annual Individual Incentive Compensation Plan	8-K	001-33572	99.1	October 21, 2010	
10.10	Salary Continuation Agreement with four executive officers, Russell Colombo, Chief Executive Officer, Kevin Coonan, Chief Credit Officer, and Peter Pelham, Director of Retail Banking, dated January 1, 2011	8-K	001-33572	10.1 10.2 10.3 10.4	January 6, 2011	
10.11	2007 Form of Change in Control Agreement	8-K	001-33572	10.1	October 31, 2007	
10.12	Information Technology Services Agreement with Fidelity Information Services, LLC, dated July 11, 2012	8-K	001-33572	10.1	July 17, 2012	
11.01	Earnings Per Share Computation - included in Note 1 to the Consolidated Financial Statements					Filed
14.01	Code of Ethical Conduct	8-K	001-33572	14.01	January 26, 2008	
31.01						Filed

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	Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	
31.02	Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed
32.01	Certification pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002	Filed
101.01*	XBRL Interactive Data File	Furnished

\* As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

SIGNATURES

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

Bank of Marin Bancorp  
(registrant)

August 8, 2013  
Date

/s/ Russell A. Colombo  
Russell A. Colombo  
President &  
Chief Executive Officer  
(Principal Executive Officer)

August 8, 2013  
Date

/s/ Larry R. Olafson  
Larry R. Olafson  
Interim Chief Financial Officer  
(Principal Financial Officer)

August 8, 2013  
Date

/s/ Cecilia Situ  
Cecilia Situ  
First Vice President &  
Manager of Finance & Treasury  
(Principal Accounting Officer)