Bank of Marin Bancorp
Form 10-Q
November 07, 2014

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

OR

o 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 x No o

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 x No o

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 o Accelerated filer x Non-accelerated filer o Smaller reporting company o

Indicate by check mark if the registrant is a shell company, as defined in Rule 12b-2 of the Exchange Act.
Yes o No x

As of October 31, 2014, there were 5,933,408 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 September 30, 2014 and December 31, 2013

(dollars in thousands, except share data; 2014 unaudited)	September 30, 2014	December 31, 2013
Assets		
Cash and due from banks	$46,424	$103,773
Investment securities		
Held-to-maturity, at amortized cost	118,843	122,495
Available-for-sale, at fair value (amortized cost $210,676 and $245,158 at September 30, 2014 and December 31, 2013, respectively)	211,582	243,998
Total investment securities	330,425	366,493
Loans, net of allowance for loan losses of $15,049 and $14,224 at September 30, 2014 and December 31, 2013, respectively	1,345,936	1,255,098
Bank premises and equipment, net	9,277	9,110
Goodwill	6,436	6,436
Core deposit intangible	3,925	4,503
Interest receivable and other assets	60,234	59,781
Total assets	$1,802,657	$1,805,194
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest-bearing	$717,720	$648,191
Interest-bearing		
Transaction accounts	89,891	137,748
Savings accounts	127,774	118,770
Money market accounts	485,626	520,525
Time accounts	150,613	161,868
Total deposits	1,571,624	1,587,102
Federal Home Loan Bank ("FHLB") borrowing	15,000	15,000
Subordinated debentures	5,131	4,969
Interest payable and other liabilities	15,228	17,236
Total liabilities	1,606,983	1,624,307
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 - 5,930,100 and 5,877,524 at September 30, 2014 and December 31, 2013, respectively	81,993	80,095
Retained earnings	113,115	101,464
Accumulated other comprehensive income (loss), net	566	(672)
Total stockholders' equity	195,674	180,887
Total liabilities and stockholders' equity	$1,802,657	$1,805,194

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three months ended		Nine months ended	
(in thousands, except per share amounts; unaudited)	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
Interest income				
Interest and fees on loans	$16,195	$13,049	$48,877	$40,050
Interest on investment securities				
Securities of U.S. government agencies	1,126	553	3,551	1,763
Obligations of state and political subdivisions	496	524	1,737	1,599
Corporate debt securities and other	254	311	778	974
Interest due from banks and other	37	34	125	45
Total interest income	18,108	14,471	55,068	44,431
Interest expense				
Interest on interest-bearing transaction accounts	25	12	74	35
Interest on savings accounts	12	9	34	25
Interest on money market accounts	126	101	415	295
Interest on time accounts	229	227	695	690
Interest on FHLB and overnight borrowings	79	80	235	243
Interest on subordinated debentures	106	—	316	—
Total interest expense	577	429	1,769	1,288
Net interest income	17,531	14,042	53,299	43,143
Provision for loan losses	—	(480)	750	390
Net interest income after provision for loan losses	17,531	14,522	52,549	42,753
Non-interest income				
Service charges on deposit accounts	552	509	1,636	1,545
Wealth Management and Trust Services	567	532	1,744	1,618
Debit card interchange fees	375	288	1,035	820
Merchant interchange fees	224	196	629	623
Earnings on Bank-owned life insurance	208	179	632	766
Gain on sale of securities	4	(35)	93	(35)
Other income	371	284	1,116	666
Total non-interest income	2,301	1,953	6,885	6,003
Non-interest expense				
Salaries and related benefits	6,108	5,389	19,270	16,117
Occupancy and equipment	1,381	1,040	4,044	3,165
Depreciation and amortization	383	343	1,202	1,032
Federal Deposit Insurance Corporation insurance	261	244	780	681
Data processing	748	612	2,856	1,857
Professional services	537	775	1,577	2,116
Other expense	1,932	1,704	5,921	5,253
Total non-interest expense	11,350	10,107	35,650	30,221
Income before provision for income taxes	8,482	6,368	23,784	18,535
Provision for income taxes	3,104	2,364	8,705	6,610
Net income	$5,378	$4,004	$15,079	$11,925
Net income per common share:				
Basic	$0.91	$0.74	$2.56	$2.20
Diluted	$0.89	$0.72	$2.51	$2.16

Weighted average shares used to compute net income per common share:				
Basic	5,903	5,433	5,887	5,414
Diluted	6,014	5,538	5,996	5,511
Dividends declared per common share	$0.20	$0.18	$0.58	$0.54
Comprehensive income:				
Net income	$5,378	$4,004	$15,079	$11,925
Other comprehensive income (loss)				
Change in net unrealized (loss) gain on available-for-sale securities	(344)	(621)	2,047	(2,591)
Reclassification adjustment for loss on sale of available-for-sale securities included in net income	4	35	19	35
Net change in unrealized (loss) gain on available-for-sale securities, before tax	(340)	(586)	2,066	(2,556)
Deferred tax (benefit) expense	(141)	(246)	828	(1,073)
Other comprehensive (loss) income, net of tax	(199)	(340)	1,238	(1,483)
Comprehensive income	$5,179	$3,664	$16,317	$10,442

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
for the year ended December 31, 2013 and the nine months ended September 30, 2014

(dollars in thousands; 2014 unaudited)	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income, Net of Taxes	Total
Balance at December 31, 2012	5,389,210	$58,573	$91,164	$2,055	$151,792
Net income	—	—	14,270	—	14,270
Other comprehensive loss	—	—	—	(2,727)	(2,727)
Stock options exercised	71,237	2,218	—	—	2,218
Excess tax benefit - stock-based compensation	—	125	—	—	125
Stock issued under employee stock purchase plan	870	34	—	—	34
Restricted stock granted	11,850	—	—	—	—
Restricted stock forfeited / cancelled	(3,998)	—	—	—	—
Stock-based compensation - stock options	—	175	—	—	175
Stock-based compensation - restricted stock	—	228	—	—	228
Cash dividends paid on common stock	—	—	(3,970)	—	(3,970)
Stock purchased by directors under director stock plan	160	6			6
Stock issued in payment of director fees	5,619	222	—	—	222
Stock issued to NorCal Community Bancorp shareholders	402,576	18,514	—	—	18,514
Balance at December 31, 2013	5,877,524	$80,095	$101,464	$(672)	$180,887
Net income	—	—	15,079	—	15,079
Other comprehensive income	—	—	—	1,238	1,238
Stock options exercised	40,123	1,146	—	—	1,146
Excess tax benefit - stock-based compensation	—	149	—	—	149
Stock issued under employee stock purchase plan	431	19	—	—	19
Restricted stock granted	8,523	—	—	—	—
Restricted stock forfeited / cancelled	(2,067)	—	—	—	—
Stock-based compensation - stock options	—	153	—	—	153
Stock-based compensation - restricted stock	—	183	—	—	183
Cash dividends paid on common stock	—	—	(3,428)	—	(3,428)
Stock purchased by directors under director stock plan	260	12	—	—	12
Stock issued in payment of director fees	5,306	236	—	—	236
Balance at September 30, 2014	5,930,100	$81,993	$113,115	$566	$195,674

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
for the nine months ended September 30, 2014 and 2013

(dollars in thousands, unaudited)	September 30, 2014	September 30, 2013
Cash Flows from Operating Activities:		
Net income	$15,079	$11,925
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	750	390
Compensation expense--common stock for director fees	170	166
Stock-based compensation expense	336	309
Excess tax benefits from exercised stock options	(104)	(86)
Amortization of core deposit intangible	578	—
Amortization of investment security premiums, net of accretion of discounts	1,982	2,401
Accretion of discount on acquired loans	(3,311)	(1,137)
Accretion of discount on subordinated debentures	162	—
Net amortization of deferred loan origination costs/fees	(382)	(662)
(Gain) loss on sale of investment securities	(93)	35
Depreciation and amortization	1,202	1,032
Gain on sale of repossessed assets	—	(43)
Earnings on bank owned life insurance policies	(632)	(766)
Net change in operating assets and liabilities:		
Interest receivable	122	408
Interest payable	(44)	(32)
Deferred rent and other rent-related expenses	165	50
Other assets	(44)	(2,276)
Other liabilities	(1,849)	2,926
Total adjustments	(992)	2,715
Net cash provided by operating activities	14,087	14,640
Cash Flows from Investing Activities:		
Purchase of available-for-sale securities	(16,353)	—
Proceeds from sale of available-for-sale securities	2,435	2,220
Proceeds from sale of held-to-maturity securities	2,146	—
Proceeds from paydowns/maturity of held-to-maturity securities	14,738	7,815
Proceeds from paydowns/maturity of available-for-sale securities	33,320	28,963
Loans originated and principal collected, net	(88,028)	(20,375)
Purchase of FHLB stock	(492)	—
Purchase of premises and equipment	(1,369)	(635)
Proceeds from sale of repossessed assets	—	270
Cash paid for low income housing tax credit investment	(208)	—
Net cash (used in) provided by investing activities	(53,811)	18,258
Cash Flows from Financing Activities:		
Net (decrease) increase in deposits	(15,478)	39,187
Proceeds from stock options exercised	1,146	1,736
Stock issued under employee and director stock purchase plans	—	34
Proceeds from stock issued under employee and director stock purchase plans	31	—
Cash dividends paid on common stock	(3,428)	(2,932)
Excess tax benefits from exercised stock options	104	86

Net cash (used in) provided by financing activities	(17,625)	38,111
Net (decrease) increase in cash and cash equivalents	(57,349)	71,009
Cash and cash equivalents at beginning of period	103,773	28,349
Cash and cash equivalents at end of period	$46,424	$99,358
Supplemental disclosure of cash flow information:		
Cash paid for interest	$1,660	$1,320
Cash paid for income taxes	$7,165	$7,889
Supplemental disclosure of non-cash investing and financing activities:		
Change in unrealized gain on available-for-sale securities	$(2,066)	$(2,556)
Securities transferred from available-for-sale to held-to-maturity	$14,297	$—
Subscription in low income housing tax credit investment	$1,000	$1,000
Stock issued in payment of director fees	$236	$222

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

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.

On November 29, 2013, we completed the merger of NorCal Community Bancorp ("NorCal"), parent company of Bank of Alameda, to enhance our market presence (the “Acquisition”). On the date of acquisition, Bancorp assumed ownership of NorCal Community Bancorp Trusts I and II, respectively (the "Trusts"), which were formed for the sole purpose of issuing trust preferred securities. Bancorp is not considered the primary beneficiary of the Trusts (variable interest entities), therefore the Trusts are not consolidated in our consolidated financial statements, but rather the subordinated debentures are shown as a liability on our consolidated statements of condition. Bancorp's investment in the common stock of the Trusts is accounted for under the equity method and is included in interest receivable and other assets on the consolidated statements of condition.

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 2013 Annual Report on Form 10-K. The results of operations for the three months and nine months ended September 30, 2014 are not necessarily indicative of the operating results for the full year.

The following table shows: 1) weighted average basic shares, 2) potentially diluted 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 potentially diluted 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 potentially diluted common shares included in year-to-date diluted EPS is a year-to-date weighted average of potentially diluted 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.

(shares and dollars in thousands; except per share data; unaudited)	Three months ended September 30, 2014	September 30, 2013	Nine months ended September 30, 2014	September 30, 2013
Weighted average basic shares outstanding	5,903	5,433	5,887	5,414
Potentially diluted common shares related to stock options	41	46	42	43
Potentially diluted common shares related to unvested restricted stock	4	4	4	4
Potentially diluted common shares related to the warrant	66	55	63	50
Weighted average diluted shares outstanding	6,014	5,538	5,996	5,511
Net income	$5,378	$4,004	$15,079	$11,925
Basic EPS	$0.91	$0.74	$2.56	$2.20
Diluted EPS	$0.89	$0.72	$2.51	$2.16
Weighted average anti-dilutive shares not included in the calculation of diluted EPS	51	51	48	48

Note 2: Recently Issued Accounting Standards

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 Fed 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. This ASU did not 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 an entity to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss ("NOL") carryforward, or similar tax loss or tax credit carryforward, rather than as a liability, when (1) the uncertain tax position would reduce the NOL or other carryforward under the tax law of the applicable jurisdiction and (2) the entity intends to and is able to use the deferred tax asset for that purpose. Otherwise, the unrecognized tax benefit should be presented as a liability and should not be combined with deferred tax assets. ASU 2013-11 is effective prospectively for fiscal years, and interim periods beginning after December 15, 2013 for public entities. We adopted this ASU in the first quarter of 2014 and the adoption did not have an impact on our financial condition or results of operations.

In January 2014, the FASB issued ASU No. 2014-01, Investments - Equity Method and Joint Ventures (Topic 323) Accounting for Investments in Qualified Affordable Housing Projects. This ASU permits entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, the initial cost of the investment is amortized in proportion to the tax credits and other tax benefits received and the net investment performance is recognized in the income statement as part of income tax expense (benefit). We adopted this ASU in the first quarter of 2014 and elected to account for all low income housing investments using the proportional amortization method instead of cost method. The change in accounting policy did not have a significant impact on our financial condition or results of operations.

In January 2014, the FASB issued ASU No. 2014-04, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40) Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. Current accounting literature on troubled debt restructurings include guidance on when a creditor obtains one or more collateral assets in satisfaction of all or part of the receivable. The accounting literature indicates that a creditor should reclassify a collateralized mortgage loan such that the loan should be de-recognized and the collateral asset recognized when it is determined that there has been in substance a repossession or foreclosure by the creditor. However, in substance repossession or foreclosure and physical possession are not currently defined and there is diversity about when a creditor should de-recognize the loan receivable and recognize the real estate property. This ASU clarifies when an in substance repossession or foreclosure occurs. ASU 2014-04 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014 for public entities. We do not expect this ASU to have a significant impact on our financial condition or results of operations.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) effective on a retrospective basis for annual reporting periods beginning after December 15, 2016. Since this ASU does not apply to financial instruments, we do not expect this ASU to have a significant impact on our financial condition or results of operations.

In June 2014, the FASB issued ASU No. 2014-11, Transfers and Servicing (Topic 860) Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. This ASU changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. It also requires additional disclosures about repurchase agreements and other similar transactions. The new guidance aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. This ASU is effective for the first interim or annual period beginning after December 15, 2014. Since we currently do not enter into repurchase agreements, we do not expect this ASU to have a significant impact on our financial condition or results of operations.

In June 2014, the FASB issued ASU No. 2014-12, Compensation - Stock Compensation (Topic 718) Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. This ASU provides guidance for entities that grant their employees share-based payment awards where a performance target that affects vesting could be achieved after the requisite service period. That is the case when an employee is eligible to retire or otherwise terminate employment before the end of the period in which a performance target could be achieved and still be eligible to vest in the award if and when the performance target is achieved. This ASU stipulates that compensation expense should be recognized in the period where the performance target becomes probable of being achieved as opposed to the date that the award was granted. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. We do not expect this ASU to have a significant impact on our financial condition or results of operations, as we currently do not grant share-based payment awards where a performance target that affects vesting could be achieved after the requisite service period.

Note 3: Acquisition

On November 29, 2013, we completed the merger of NorCal, parent company of Bank of Alameda, to enhance our market presence. The merger added $173.8 million in loans, $241.0 million in deposits and $53.7 million in investment securities to Bank of Marin as well as four branch offices serving Alameda, Emeryville, and Oakland in California. Effective October 31, 2014, the Emeryville branch was closed after Management determined that our customers and the business community can be easily supported from our Oakland location. The assets acquired and liabilities assumed, both tangible and intangible, were recorded at their fair values as of the acquisition date in accordance with ASC 805, Business Combinations. We have up to a year from the acquisition date to obtain additional information that existed at the acquisition date and affected the identification and measurement of assets acquired and liabilities assumed. As of September 30, 2014, there have been no additional information nor significant changes in the acquisition-date fair value of assets acquired or liabilities assumed. The acquisition was treated as a "reorganization" within the definition of section 368(a) of the Internal Revenue Code and is generally considered tax-free for U.S. federal income tax purposes.

As a result of the Acquisition, we recorded $6.4 million in goodwill, which represents the excess of the total purchase price paid over the fair value of the assets acquired, net of the fair values of liabilities assumed. Goodwill mainly reflects expected value created through the combined operations of Bank of Alameda and Bank of Marin and our expanded footprint in the East Bay. It is evaluated for impairment annually. We determined that the fair value of our traditional community banking activities (provided through our branch network) exceeded its carrying amount. Therefore, no impairment on goodwill has been recorded. The goodwill is not deductible for tax purposes.

Core deposit intangible represents estimated future benefits of acquired deposits and is booked separately from the related deposits. We recorded a core deposit intangible asset of $4.6 million on November 29, 2013, of which $69 thousand was amortized in 2013 and $578 thousand was amortized in the first nine months of 2014. It is amortized on an accelerated basis over an estimated ten-year life. The core deposit intangible asset is evaluated periodically for impairment, and no impairment loss was recognized as of September 30, 2014.

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.

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with our monthly and/or quarterly valuation process.

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

(dollars 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 September 30, 2014 (unaudited):				
Securities available-for-sale:				
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies	$169,903	$—	$167,160	$2,743
Debentures of government-sponsored agencies	$14,552	$—	$14,552	$—
Privately-issued collateralized mortgage obligations	$7,843	$—	$7,843	$—
Obligations of state and political subdivisions	$14,271	$—	$14,271	$—
Corporate bonds	$5,013	$—	5,013	$—
Derivative financial assets (interest rate contracts)	$313	$—	$313	$—
Derivative financial liabilities (interest rate contracts)	$1,537	$—	$1,537	$—
At December 31, 2013:				
Securities available-for-sale:				
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies	$190,604	$—	$190,604	$—
Debentures of government-sponsored agencies	$21,312	$—	$21,312	$—
Privately-issued collateralized mortgage obligations	$10,874	$—	$10,874	$—
Obligations of state and political subdivisions	$15,771	$—	$15,771	$—
Corporate bonds	$5,437	$—	$5,437	$—
Derivative financial assets (interest rate contracts)	$961	$—	$961	$—
Derivative financial liabilities (interest rate contracts)	$2,519	$—	$2,519	$—

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 September 30, 2014 and December 31, 2013, there are no securities that are considered Level 1 securities. As of September 30, 2014, we have one available-for-sale security that is considered Level 3 security. The security is a U.S. government agency obligation collateralized by a small pool of business equipment loans guaranteed by the Small Business Administration program. This security is not actively traded and is owned only by a few investors. The significant unobservable data that is reflected in the fair value measurement include dealer quotes, projected prepayment speeds/average life and credit information, among other things. It was transferred to Level 3 security during the second quarter of 2014 and the decrease in unrealized gain during the third quarter is $8 thousand.

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 and OIS rates (for the very short term), quoted prices for LIBOR futures contracts, observable market prices for LIBOR and OIS 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. We project spot rates at reset days specified by each swap to determine future cash flows, then discount to present value using either LIBOR or OIS curves depending on the collateral posted as of the measurement date. When the value of any collateral placed with counterparties is less than the interest rate derivative liability, an additional discount is applied to reflect our potential credit risk to counterparties. We have used the spread between the Standard & Poor's BBB rated U.S. Bank Composite rate and LIBOR for the closest maturity term corresponding to the duration of the swaps to derive the credit-risk-related component of the discount rate of future cash flows from the collateral shortfall.

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 September 30, 2014 and December 31, 2013.

(dollars in thousands) Description of Financial Instruments	Carrying Value[1]	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) [1]
At September 30, 2014 (unaudited):				
Impaired loans carried at fair value:				
Installment and other consumer	64	—	—	64
Total	$64	$—	$—	$64
At December 31, 2013:				
Impaired loans carried at fair value:				
Construction	3,037	—	—	3,037
Installment and other consumer	35	—	—	35
Total	$3,072	$—	$—	$3,072

[1] 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 $15 thousand and $363 thousand at September 30, 2014 and December 31, 2013, respectively. The carrying value of loans fully charged-off, which includes unsecured lines of credit, overdrafts and all other loans, is zero.

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 impaired loans and other real estate owned ("OREO").

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. 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. Appraised values may be adjusted to reflect changes in market conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by Management on a case-by-case basis. There have been no significant changes in the valuation techniques during the quarter and nine-month period ended September 30, 2014.

OREO represents collateral acquired through foreclosure and is initially recorded at fair value as established by a current appraisal, adjusted for disposition costs. Subsequently, OREO is measured at lower of cost or fair value. OREO values are reviewed on an ongoing basis and any subsequent decline in fair value is recorded as a foreclosed asset expense in the current period. The value of OREO is determined based on independent appraisals, similar to the process used for impaired loans, discussed above, and is generally classified as Level 3. At September 30, 2014 and December 31, 2013, we had $461 thousand of OREO acquired from Bank of Alameda as part of the Acquisition. There was no change in the estimated fair value of the OREO from the date of the Acquisition through September 30, 2014.

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.

Disclosures about Fair Value of Financial Instruments

The table below is a summary of fair value estimates for financial instruments as of September 30, 2014 and December 31, 2013, 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.

	September 30, 2014			December 31, 2013		
(dollars in thousands; 2014 unaudited)	Carrying Amounts	Fair Value	Fair Value Hierarchy	Carrying Amounts	Fair Value	Fair Value Hierarchy
Financial assets						
Cash and cash equivalents	$46,424	$46,424	Level 1	$103,773	$103,773	Level 1
Investment securities held-to-maturity	118,843	121,177	Level 2	122,495	123,858	Level 2
Loans, net	1,345,936	1,361,745	Level 3	1,255,098	1,245,475	Level 3
Interest receivable	5,645	5,645	Level 2	5,767	5,767	Level 2
Financial liabilities						
Deposits	1,571,624	1,572,582	Level 2	1,587,102	1,588,278	Level 2
Federal Home Loan Bank borrowings	15,000	15,501	Level 2	15,000	15,665	Level 2
Subordinated debentures	5,131	5,187	Level 3	4,969	4,950	Level 3
Interest payable	209	209	Level 2	253	253	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 mortgage-backed securities, 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 September 30, 2014 and December 31, 2013, we did not hold any held-to-maturity securities whose fair value was measured using significant unobservable inputs.

Loans - The fair value of loans with variable interest rates approximates current carrying value, because loan 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 the portion of loan discount attributable 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 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.

Subordinated Debentures - As part of the Acquisition, we assumed two tranches of subordinated debentures from NorCal. See Note 7 for further information. The fair values of the subordinated debentures were estimated by discounting the future cash flows (interest payment at a rate of three-month LIBOR plus 3.05% and 1.40%, respectively) to their present values using current market rates at which similar bonds would be issued with similar credit ratings as ours and similar remaining maturities. Each future quarterly interest payment was discounted at the spot rate for the corresponding term based on comparable trust preferred securities, plus an illiquidity premium of 3.00%. In July 2010, the Dodd-Frank Act was signed into law and limits the ability of certain bank holding companies to treat trust preferred security debt issuances as Tier 1 capital. This law effectively closed the trust-preferred securities markets for new issuance and led to the absence of observable or comparable transactions in the market place. Due to the use of unobservable inputs in the valuation of trust preferred securities, we consider the fair value to be a Level 3 measurement.

Commitments - Loan commitments and standby letters of credit generate ongoing fees, which are recognized over the term of the commitment period. Given the uncertainty in the likelihood and timing of a commitment being drawn upon, the carrying value of the related unamortized commitment fees and the reserve for these off-balance sheet commitments are determined to approximate fair value, 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:

	September 30, 2014				December 31, 2013			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
(dollars in thousands; 2014 unaudited)	Cost	Value	Gains	(Losses)	Cost	Value	Gains	(Losses)
Held-to-maturity								
Obligations of state and political subdivisions	$65,089	$66,943	$1,935	$(81)	$80,381	$81,429	$1,764	$(716)
Corporate bonds	40,363	40,691	340	(12)	42,114	42,429	375	(60)
MBS pass-through securities issued by FHLMC and FNMA	13,391	13,543	152	—	—	—	—	—
Total held-to-maturity	118,843	121,177	2,427	(93)	122,495	123,858	2,139	(776)
Available-for-sale								
Securities of U.S. government agencies:								
MBS pass-through securities issued by FHLMC and FNMA	100,978	101,345	555	(188)	124,063	123,033	616	(1,646)
CMOs issued by FNMA	15,608	15,600	65	(73)	18,573	18,438	60	(195)
CMOs issued by FHLMC	33,288	33,243	96	(141)	23,710	23,679	144	(175)
CMOs issued by GNMA	19,359	19,715	364	(8)	24,944	25,454	609	(99)
Debentures of government-sponsored agencies	14,727	14,552	111	(286)	21,845	21,312	108	(641)
Privately issued CMOs	7,627	7,843	220	(4)	10,649	10,874	257	(32)
Obligations of state and political subdivisions	14,156	14,271	137	(22)	15,948	15,771	14	(191)
Corporate bonds	4,933	5,013	83	(3)	5,426	5,437	25	(14)
Total available-for-sale	210,676	211,582	1,631	(725)	245,158	243,998	1,833	(2,993)
Total investment securities	$329,519	$332,759	$4,058	$(818)	$367,653	$367,856	$3,972	$(3,769)

As part of our ongoing review of our investment securities portfolio, we reassessed the classification of certain MBS pass-through securities issued by FHLMC and FNMA that are qualified for Community Reinvestment Act ("CRA") credit. Effective January 31, 2014, we transferred $14.2 million of these CRA qualified MBS, which we intend and have the ability to hold to maturity, from available-for-sale securities to held-to-maturity at fair value. The unrealized pre-tax holding gain of $84 thousand at the date of transfer remained in accumulated other comprehensive income and is amortized over the remaining lives of the securities as an adjustment to yield.

The amortized cost and fair value of investment debt securities by contractual maturity at September 30, 2014 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.

	September 30, 2014				December 31, 2013			
	Held-to-Maturity		Available-for-Sale		Held-to-Maturity		Available-for-Sale	
(dollars in thousands; 2014 unaudited)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	$25,111	$25,272	$2,377	$2,389	$8,731	$8,784	$5,522	$5,521
After one year but within five years	63,192	64,436	39,599	39,793	88,255	89,095	42,229	42,338
After five years through ten years	15,900	16,669	19,241	19,031	24,244	24,786	26,232	25,478
After ten years	14,640	14,800	149,459	150,369	1,265	1,193	171,175	170,661
Total	$118,843	$121,177	$210,676	$211,582	$122,495	$123,858	$245,158	$243,998

We sold two available-for-sale and six held-to-maturity securities in the first nine months of 2014 with total proceeds of $2.4 million and $2.1 million, respectively, and incurred a loss of $11 thousand and a net gain of $104 thousand, respectively. The sales of the held-to-maturity securities were due to evidence of significant deterioration in issuer creditworthiness since purchase. Two available-for-sale securities were sold in January 2013 with proceeds of $1.1 million and a small net gain of $339.

Investment securities carried at $67.4 million and $61.8 million at September 30, 2014 and December 31, 2013, respectively, were pledged to the State of California: $66.5 million and $61.1 million to secure public deposits in compliance with the Local Agency Security Program at September 30, 2014 and December 31, 2013, respectively, and $860 thousand and $732 thousand to provide collateral for trust deposits at September 30, 2014 and December 31, 2013, 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 September 30, 2014 and December 31, 2013.

Other-Than-Temporarily Impaired Debt Securities

We have evaluated the credit ratings of our investment securities and their issuer and/or insurers. Based on our evaluation, Management has determined that no investment security in our investment portfolio is other-than-temporarily impaired. We do not have the intent, and it is more likely than not that we will not have to sell securities temporarily impaired at September 30, 2014 before recovery of the cost basis.

Twenty-eight and ninety-five investment securities were in unrealized loss positions at September 30, 2014 and December 31, 2013, respectively. Those securities are summarized and classified according to the duration of the loss period in the table below:

September 30, 2014	< 12 continuous months		> 12 continuous months		Total securities in a loss position	
(dollars in thousands; unaudited)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity						
Obligations of state & political subdivisions	$5,636	$(27)	4,280	(54)	$9,916	$(81)
Corporate bonds	—	—	3,550	(12)	3,550	(12)
Total held-to-maturity	5,636	(27)	7,830	(66)	13,466	(93)
Available-for-sale						
MBS pass-through securities issued by FNMA and FHLMC	20,670	(188)	—	—	20,670	(188)
CMOs issued by FNMA	4,346	(73)	—	—	4,346	(73)
CMOs issued by FHLMC	23,886	(141)	—	—	23,886	(141)
CMOs issued by GNMA	3,474	(8)	—	—	3,474	(8)
Debentures of government-sponsored agencies	493	(2)	9,717	(284)	10,210	(286)
Privately issued CMOs	318	(4)	—	—	318	(4)
Obligations of state & political subdivisions	2,804	(22)	—	—	2,804	(22)
Corporate bonds	989	(3)	—	—	989	(3)
Total available-for-sale	56,980	(441)	9,717	(284)	66,697	(725)
Total temporarily impaired securities	$62,616	$(468)	$17,547	$(350)	$80,163	$(818)

December 31, 2013	< 12 continuous months		> 12 continuous months		Total securities in a loss position	
(dollars in thousands)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity						
Obligations of state & political subdivisions	$ 13,933	$ (419)	$ 9,033	$ (297)	$ 22,966	$ (716)
Corporate bonds	3,017	(11)	4,963	(49)	7,980	(60)
Total held-to-maturity	16,950	(430)	13,996	(346)	30,946	(776)
Available-for-sale						
MBS pass-through securities issued by FNMA and FHLMC	90,914	(1,297)	3,172	(349)	94,086	(1,646)
CMOs issued by FNMA	17,535	(195)	—	—	17,535	(195)
CMOs issued by FHLMC	17,899	(175)	—	—	17,899	(175)
CMOs issued by GNMA	3,966	(99)	—	—	3,966	(99)
Debentures of government-sponsored agencies	16,872	(641)	—	—	16,872	(641)
Privately issued CMOs	4,634	(31)	159	(1)	4,793	(32)
Obligations of state & political subdivisions	11,516	(191)	—	—	11,516	(191)
Corporate bonds	1,479	(14)	—	—	1,479	(14)
Total available-for-sale	164,815	(2,643)	3,331	(350)	168,146	(2,993)
Total temporarily impaired securities	$ 181,765	$ (3,073)	$ 17,327	$ (696)	$ 199,092	$ (3,769)

As of September 30, 2014, there were five investment positions that had been in a continuous loss position for more than twelve months. These securities consisted of a debenture of government-sponsored agency, obligations of U.S. state and political subdivisions, and a corporate bond. We have evaluated each of the bonds and believe that the decline in fair value is primarily driven by factors other than credit. 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. MBS are supported by the U.S. Federal government to protect us from credit losses. Additionally, the obligations of state and political subdivisions and corporate bonds were deemed creditworthy based on our review of the issuers' recent financial information and their insurers, if any. Based upon our assessment of expected credit losses given the performance of the underlying collateral and the credit enhancements, we concluded that the security was not other-than-temporarily impaired at September 30, 2014.

Twenty-three investment securities in our portfolio were in a temporary loss position for less than twelve months as of September 30, 2014. They consisted of a debenture issued by government agency, MBS, obligations of U.S. state and political subdivisions, and a corporate bond. 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 credit losses. The other temporarily impaired securities are deemed creditworthy after our internal analysis. Additionally, all are rated as investment grade by at least one major rating agency. As a result of this impairment analysis, we concluded that these securities were not other-than-temporarily impaired at September 30, 2014.

Non-Marketable Securities

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 borrowings 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 $8.2 million and $7.8 million of FHLB stock recorded at cost in other assets on the consolidated statements of condition at September 30, 2014 and December 31, 2013, respectively. The carrying amounts of these investments are reasonable estimates of fair value because the securities are restricted to member banks and they do not have a readily determinable market value. 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. On October 29, 2014, the FHLB announced a cash dividend for the third quarter of 2014 at an annualized dividend rate of 7.4% to be distributed in mid-November.

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. Converting this Class B common stock to Class A common stock at a conversion rate of 0.4206, the value would be $1.5 million and $1.6 million at September 30, 2014 and December 31, 2013, respectively. The conversion rate is subject to further reduction upon the final settlement of the covered litigation against Visa Inc. and its member banks. See Note 9 herein.

We invest in low income housing tax credit funds as a limited partner, which totaled $1.8 million and $1.0 million as of September 30, 2014 and December 31, 2013, respectively. Starting 2014, we have elected to account for all low income housing investments using the proportional amortization method instead of cost method and recognized $40 thousand of low income housing tax credit as a component of income tax benefit for the nine months ended September 30, 2014 .

Note 6: Loans and Allowance for Loan Losses

Credit Quality of Loans

Outstanding loans by class and payment aging as of September 30, 2014 and December 31, 2013 are as follows:

Loan Aging Analysis by Class as of September 30, 2014 and December 31, 2013

(dollars in thousands; 2014 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential [1]	Installment and other consumer	Total
September 30, 2014								
30-59 days past due	$3	$—	$—	$—	$—	$—	$279	$282
60-89 days past due	—	—	—	—	—	—	17	17
Greater than 90 days past due (non-accrual) [2]	193	1,403	2,505	5,173	436	—	128	9,838
Total past due	196	1,403	2,505	5,173	436	—	424	10,137
Current	201,320	233,090	671,923	40,775	109,219	75,992	18,529	1,350,848
Total loans [3]	$201,516	$234,493	$674,428	$45,948	$109,655	$75,992	$18,953	$1,360,985
Non-accrual loans to total loans	0.1 %	0.6 %	0.4 %	11.3 %	0.4 %	— %	0.7 %	0.7 %
December 31, 2013								
30-59 days past due	$18	$—	$—	$—	$240	$717	$17	$992
60-89 days past due	—	—	—	—	—	—	3	3
Greater than 90 days past due (non-accrual) [2]	1,187	1,403	2,807	5,218	234	660	169	11,678
Total past due	1,205	1,403	2,807	5,218	474	1,377	189	12,673
Current	182,086	239,710	622,212	26,359	97,995	71,257	17,030	1,256,649
Total loans [3]	$183,291	$241,113	$625,019	$31,577	$98,469	$72,634	$17,219	$1,269,322
Non-accrual loans to total loans	0.6 %	0.6 %	0.4 %	16.5 %	0.2 %	0.9 %	1.0 %	0.9 %

[1] Our residential loan portfolio includes no sub-prime loans, nor is it our 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.

[2] Amounts include $1.4 million of Purchased Credit Impaired ("PCI") loans that had stopped accreting interest at both September 30, 2014 and December 31, 2013, and exclude accreting PCI loans of $3.8 million and $5.7 million at September 30, 2014 and December 31, 2013, respectively, as their accretable yield interest recognition is independent from the underlying contractual loan delinquency status. There were no accruing loans more than ninety days past due at September 30, 2014 or December 31, 2013.

[3] Amounts include net deferred loan costs of $406 thousand and $24 thousand at September 30, 2014 and December 31, 2013, respectively. Amounts are also net of unaccreted purchase discounts on non-PCI loans of $4.9 million and $7.6 million at September 30, 2014 and December 31, 2013, respectively.

Our commercial loans are generally made to established small and mid-sized businesses to provide financing for their working capital needs, equipment purchases, acquisitions, or refinancings. Management examines historical, current, and projected cash flows to determine the ability of the borrower to repay obligations as agreed. Commercial loans are made based primarily 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. We target stable local businesses with guarantors that have proven to be resilient in periods of economic stress. Typically, the 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 of the business conducted on the property securing the loan. Underwriting standards for commercial real estate loans include, but are not limited to, conservative debt coverage and loan-to-value ratios. 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. When a vacancy has occurred, strong guarantors have historically carried the loans until a replacement tenant could be found. The owner's substantial equity investment provides a strong economic incentive to continue to support the commercial real estate projects. As a result, we have experienced a relatively low level of loss and delinquencies 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 independent appraisals. The construction industry can be impacted by significant events, including: the inherent volatility of real estate markets and vulnerability to delays due to weather, change orders, ability to obtain construction permits, labor or material shortages, and price hikes. Estimates of construction costs and of the completed project value 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 (tenants-in-common) loans, and installment and other consumer loans. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. Diversification, relatively small loan amounts that are spread across many individual borrowers, also 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 conservative loan-to-value ratio, the number of such loans a borrower can have at one time, and documentation requirements. Installment and other consumer loans are nearly evenly split between mobile home loans and floating home loans along with a small number of personal 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 Federal Deposit Insurance Corporation ("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 condition, 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. 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(s) 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. 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:

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Generally, commercial borrowers 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 $500 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 an analysis of loans by internally assigned grades, including the PCI loans, at September 30, 2014 and December 31, 2013:

(dollars in thousands; 2014 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
Credit Risk Profile by Internally Assigned Grade:									
September 30, 2014									
Pass	$ 186,922	$ 209,600	$ 654,889	$ 39,358	$ 104,794	$ 72,732	$ 17,937	$ 2,203	$ 1,288,435
Special Mention	7,749	10,471	9,359	856	1,849	1,704	417	1,146	33,551
Substandard	6,511	11,826	7,995	5,723	2,945	1,556	599	1,844	38,999
Total loans	$ 201,182	$ 231,897	$ 672,243	$ 45,937	$ 109,588	$ 75,992	$ 18,953	$ 5,193	$ 1,360,985
December 31, 2013									
Pass	$ 162,625	$ 216,537	$ 609,157	$ 25,069	$ 93,792	$ 69,176	$ 16,336	$ 1,340	$ 1,194,032
Special Mention	13,990	16,533	8,570	725	2,164	1,047	227	894	44,150
Substandard	6,343	3,224	5,413	5,768	2,444	2,411	656	4,881	31,140
Total loans	$ 182,958	$ 236,294	$ 623,140	$ 31,562	$ 98,400	$ 72,634	$ 17,219	$ 7,115	$ 1,269,322

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 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.

The table below summarizes outstanding TDR loans by loan class as of September 30, 2014 and December 31, 2013. The summary includes those TDRs that are on non-accrual status and those that continue to accrue interest.

(dollars in thousands; 2014 unaudited)	As of	
Recorded investment in Troubled Debt Restructurings [1]	September 30, 2014	December 31, 2013
Commercial and industrial	$4,337	$5,117
Commercial real estate, owner-occupied	8,491	4,333
Commercial real estate, investor	527	534
Construction	6,654	6,335
Home equity	703	506
Other residential	1,552	2,063

Installment and other consumer	1,724	1,693
Total	$23,988	$20,581

[1] Includes $16.9 million and $12.9 million of TDR loans that were accruing interest as of September 30, 2014 and December 31, 2013, respectively. Includes $1.8 million of acquired loans at both September 30, 2014 and December 31, 2013, respectively.

The tables below present 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 tables below exclude 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 September 30, 2014:				
Commercial and industrial	2	$ 513	$ 596	$596
Commercial real estate, owner-occupied	1	4,226	4,216	4,206
Home equity	1	74	74	74
Other residential	1	815	$ 814	$814
Total	5	$ 5,628	$ 5,700	$5,690
Troubled Debt Restructurings during the three months ended September 30, 2013:				
Commercial and industrial	3	$ 587	$ 560	$558
Commercial real estate, owner occupied	1	2,961	2,956	2,951
Commercial real estate, investor	1	539	538	536
Construction	2	11	9	9
Total	7	$ 4,098	$ 4,063	$4,054
Troubled Debt Restructurings during the nine months ended September 30, 2014:				
Commercial and industrial [1]	7	$1,336	$1,460	$1,431
Commercial real estate, owner-occupied	1	4,226	4,216	4,206
Other residential	1	815	814	814
Home equity	2	224	224	222
Installment and other consumer	6	281	278	270
Total	17	$6,882	$6,992	$6,943
Troubled Debt Restructurings during the nine months ended September 30, 2013:				
Commercial and Industrial [2]	5	$1,086	$1,057	$991
Commercial real estate, owner-occupied	1	2,961	2,956	2,951
Commercial real estate, investor	1	539	538	536
Construction	1	4,745	4,766	4,806
Installment and other consumer	2	11	9	9
Total	10	$9,342	$9,326	$9,293

[1] Excludes one contract modified and subsequently paid off during the nine months ended September 30, 2014 in the amount of $905 thousand pre-modification and post-modification.
[2] Excludes two contracts modified and subsequently paid off during the nine months ended September 30, 2013. The pre-modification and post-modification outstanding recorded investment balances were both $218 thousand.

Modifications during the nine months ended September 30, 2014 primarily involved maturity extensions and interest rate concessions, while modifications during the nine months ended September 30, 2013 were primarily due to extensions of maturity. During the first nine months of 2014 and 2013, there were no defaults on loans that had been modified as troubled debt restructuring within the prior twelve-month period. We report 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 tables below summarize 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; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
September 30, 2014								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 1,212	$ 5,609	$ 3,032	$ 5,173	$ 550	$ 528	$ 240	$ 16,344
With a specific allowance recorded	3,125	2,882	—	1,492	302	1,024	1,563	10,388
Total recorded investment in impaired loans	$ 4,337	$ 8,491	$ 3,032	$ 6,665	$ 852	$ 1,552	$ 1,803	$ 26,732
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	$ 1,258	$ 7,266	$ 5,023	$ 7,863	$ 1,036	$ 528	$ 240	$ 23,214
With a specific allowance recorded	3,220	2,882	—	1,682	302	1,024	1,564	10,674
Total unpaid principal balance of impaired loans	$ 4,478	$ 10,148	$ 5,023	$ 9,545	$ 1,338	$ 1,552	$ 1,804	$ 33,888
Specific allowance	$ 817	$ 100	$ —	$ 3	$ 29	$ 98	$ 286	$ 1,333
Average recorded investment in impaired loans during the quarter ended September 30, 2014	$ 5,292	$ 6,982	$ 3,090	$ 6,678	$ 857	$ 1,440	$ 1,847	$ 26,186
Interest income recognized on impaired loans during the quarter ended September 30, 2014	$ 88	$ 54	$ 7	$ 23	$ 5	$ 14	$ 19	$ 210
Average recorded investment in impaired loans during the nine months ended September 30, 2014	$ 5,818	$ 5,980	$ 3,186	$ 6,568	$ 730	$ 1,726	$ 1,876	$ 25,884
Interest income recognized on impaired loans during the nine months ended September 30, 2014	$ 309	$ 220	$ 21	$ 67	$ 14	$ 56	$ 56	$ 743

Average recorded investment in impaired loans during the quarter ended September 30, 2013	$ 5,933	$ 3,526	$ 6,389	$ 8,479	$775	$2,576	$1,842	$29,520
Interest income recognized on impaired loans during the quarter ended September 30, 2013	$ 102	$ 63	$ 7	$ 21	$5	$22	$16	$236
Average recorded investment in impaired loans during the nine months ended September 30, 2013	$ 7,584	$ 2,861	$ 6,178	$ 7,138	$1,022	$2,744	$1,881	$29,408
Interest income recognized on impaired loans during the nine months ended September 30, 2013	$ 343	$ 170	$ 7	$ 233	$25	$67	$50	$895

(dollars in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
December 31, 2013								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 977	$ 1,403	$ 3,341	$ 2,806	$349	$1,254	$112	$10,242
With a specific allowance recorded	4,725	4,085	—	3,927	157	809	1,750	$15,453
Total recorded investment in impaired loans	$ 5,702	$ 5,488	$ 3,341	$ 6,733	$506	$2,063	$1,862	$25,695
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	$ 977	$ 3,060	$ 5,333	$ 5,547	$835	$1,254	$154	$17,160
With a specific allowance recorded	4,930	5,088	—	4,114	157	809	1,750	16,848
Total recorded investment in impaired loans	$ 5,907	$ 8,148	$ 5,333	$ 9,661	$992	$2,063	$1,904	$34,008
Specific allowance	$ 1,170	$ 90	$ —	$ 341	$1	$23	$364	$1,989

The gross interest income that would have been recorded, had non-accrual loans been current, totaled $182 thousand and $291 thousand in the quarters ended September 30, 2014, and September 30, 2013, respectively, and totaled $567 thousand and $827 thousand for the nine months ended September 30, 2014 and September 30, 2013, 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 September 30, 2014 totaled approximately $5.5 million. At September 30, 2014, there were $1.2 million outstanding commitments to extend credit on impaired loans, including loans to borrowers whose terms have been modified in troubled debt restructurings.

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, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
For the three months ended September 30, 2014									
Allowance for loan losses:									
Beginning balance	$ 3,125	$ 1,979	$ 6,713	$ 571	$944	$ 454	$ 481	$ 633	$14,900
Provision (reversal)	(263)	9	(26)	(33)	(18)	(8)	90	249	—
Charge-offs	—	—	—	—	—	—	(2)	—	(2)
Recoveries	44	5	5	96	1	—	—	—	151
Ending balance	$ 2,906	$ 1,993	$ 6,692	$ 634	$927	$ 446	$ 569	$ 882	$15,049
For the nine months ended September 30, 2014									
Allowance for loan losses:									
Beginning balance	$ 3,056	$ 2,012	$ 6,196	$ 633	$875	$ 317	$ 629	$ 506	$14,224
Provision (reversal)	(208)	(24)	455	109	49	129	(136)	376	750
Charge-offs	(66)	—	—	(204)	—	—	(6)	—	(276)
Recoveries	124	5	41	96	3	—	82	—	351
Ending balance	$ 2,906	$ 1,993	$ 6,692	$ 634	$927	$ 446	$ 569	$ 882	$15,049

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
As of September 30, 2014:									
Ending ALLL related to loans collectively evaluated for impairment	$ 2,089	$ 1,893	$ 6,692	$ 631	$ 898	$ 348	$ 283	$ 882	$ 13,716
Ending ALLL related to loans individually evaluated for impairment	$ 814								