

Bank of Marin Bancorp  
Form 10-Q  
November 08, 2011

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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 September 30, 2011

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  
(State or other jurisdiction of incorporation)

20-8859754  
(IRS Employer Identification No.)

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

94947  
(Zip Code)

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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, 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer 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 October 31, 2011 there were 5,331,368 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

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BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CONDITION  
at September 30, 2011 and December 31, 2010

(in thousands, except share data; 2011 unaudited)

|   | September 30, 2011  | December 31, 2010   |
|---|---------------------|---------------------|
| <b>Assets</b>   |                     |                     |
| Cash and due from banks   | \$ 130,675          | \$ 65,724           |
| Short-term investments  | 2,111               | 19,508              |
| Cash and cash equivalents   | 132,786             | 85,232              |
| <b>Investment securities</b>  |                     |                     |
| Held to maturity, at amortized cost   | 39,077              | 34,917              |
| Available for sale (at fair market value, amortized cost \$156,531 and \$109,070 at September 30, 2011 and December 31, 2010, respectively) | 159,478             | 111,736             |
| Total investment securities   | 198,555             | 146,653             |
| <b>Loans, net of allowance for loan losses of \$13,224 and \$12,392 at September 30, 2011 and December 31, 2010, respectively</b>           |                     |                     |
| Bank premises and equipment, net  | 9,624               | 8,419               |
| Interest receivable and other assets  | 42,333              | 38,838              |
| <b>Total assets</b>   | <b>\$ 1,362,717</b> | <b>\$ 1,208,150</b> |
| <b>Liabilities and Stockholders' Equity</b>   |                     |                     |
| <b>Liabilities</b>  |                     |                     |
| <b>Deposits</b>   |                     |                     |
| Non-interest bearing  | \$ 373,844          | \$ 282,195          |
| Interest bearing  |                     |                     |
| Transaction accounts  | 128,916             | 105,177             |
| Savings accounts  | 74,392              | 56,760              |
| Money market accounts   | 417,505             | 371,352             |
| CDARS® time accounts  | 32,592              | 67,261              |
| Other time accounts   | 149,276             | 132,994             |
| Total deposits  | 1,176,525           | 1,015,739           |
| Federal Home Loan Bank borrowings   | 35,000              | 55,000              |
| Subordinated debenture  | 5,000               | 5,000               |
| Interest payable and other liabilities  | 13,191              | 10,491              |
| <b>Total liabilities</b>  | <b>1,229,716</b>    | <b>1,086,230</b>    |
| <b>Stockholders' Equity</b>   |                     |                     |
| Preferred stock, no par value, Authorized - 5,000,000 shares; none issued   | ---                 | ---                 |

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|   |                     |                     |
|---|---------------------|---------------------|
| Common stock, no par value, Authorized - 15,000,000 shares Issued and outstanding - 5,331,368 and 5,290,082 at September 30, 2011 and December 31, 2010, respectively | 56,670              | 55,383              |
| Retained earnings   | 74,622              | 64,991              |
| Accumulated other comprehensive income, net   | 1,709               | 1,546               |
| <b>Total stockholders' equity</b>   | <b>133,001</b>      | <b>121,920</b>      |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 1,362,717</b> | <b>\$ 1,208,150</b> |

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

**BANK OF MARIN BANCORP**  
**CONSOLIDATED STATEMENTS OF INCOME**

| (in thousands, except per share amounts; unaudited)        | Three months ended |               |                    | Nine months ended  |                    |
|--|--------------------|---------------|--------------------|--------------------|--------------------|
|  | September 30, 2011 | June 30, 2011 | September 30, 2010 | September 30, 2011 | September 30, 2010 |
| <b>Interest income</b>                                     |                    |               |                    |                    |                    |
| Interest and fees on loans                                 | \$ 15,567          | \$ 16,862     | \$ 14,296          | \$ 48,329          | \$ 42,146          |
| <b>Interest on investment securities</b>                   |                    |               |                    |                    |                    |
| Securities of U.S. Government agencies                     | 1,153              | 745           | 829                | 2,631              | 2,442              |
| Obligations of state and political subdivisions            | 298                | 303           | 284                | 903                | 855                |
| Corporate debt securities and other                        | 151                | 171           | 144                | 433                | 452                |
| Interest on Federal funds sold and short-term investments  | 56                 | 56            | 48                 | 152                | 98                 |
| <b>Total interest income</b>                               | <b>17,225</b>      | <b>18,137</b> | <b>15,601</b>      | <b>52,448</b>      | <b>45,993</b>      |
| <b>Interest expense</b>                                    |                    |               |                    |                    |                    |
| Interest on interest bearing transaction accounts          | 35                 | 48            | 32                 | 121                | 81                 |
| Interest on savings accounts                               | 21                 | 25            | 27                 | 75                 | 79                 |
| Interest on money market accounts                          | 326                | 341           | 602                | 1,004              | 2,128              |
| Interest on CDARS® time accounts                           | 50                 | 48            | 221                | 192                | 663                |
| Interest on other time accounts                            | 305                | 315           | 391                | 978                | 1,122              |
| Interest on borrowed funds                                 | 1,268              | 357           | 363                | 1,977              | 1,070              |
| <b>Total interest expense</b>                              | <b>2,005</b>       | <b>1,134</b>  | <b>1,636</b>       | <b>4,347</b>       | <b>5,143</b>       |
| <b>Net interest income</b>                                 | <b>15,220</b>      | <b>17,003</b> | <b>13,965</b>      | <b>48,101</b>      | <b>40,850</b>      |
| Provision for loan losses                                  | 500                | 3,000         | 1,400              | 4,550              | 4,300              |
| <b>Net interest income after provision for loan losses</b> | <b>14,720</b>      | <b>14,003</b> | <b>12,565</b>      | <b>43,551</b>      | <b>36,550</b>      |
| <b>Non-interest income</b>                                 |                    |               |                    |                    |                    |
| Service charges on deposit accounts                        | 478                | 468           | 446                | 1,389              | 1,355              |
| Wealth Management and Trust Services                       | 486                | 469           | 364                | 1,389              | 1,127              |
| Other income   | 601                | 644           | 497                | 1,967              | 1,679              |
| <b>Total non-interest income</b>                           | <b>1,565</b>       | <b>1,581</b>  | <b>1,307</b>       | <b>4,745</b>       | <b>4,161</b>       |
| <b>Non-interest expense</b>                                |                    |               |                    |                    |                    |
| Salaries and related benefits                              | 5,320              | 5,220         | 4,665              | 15,469             | 13,832             |
| Occupancy and equipment                                    | 1,021              | 1,093         | 880                | 3,021              | 2,692              |

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|  |          |          |          |           |          |
|--|----------|----------|----------|-----------|----------|
| Depreciation and amortization  | 329      | 314      | 335      | 951       | 1,033    |
| Federal Deposit Insurance Corporation insurance                      | 189      | 214      | 388      | 790       | 1,125    |
| Data processing  | 642      | 909      | 491      | 2,133     | 1,422    |
| Professional services  | 465      | 740      | 550      | 1,938     | 1,436    |
| Other expense  | 1,455    | 1,508    | 1,198    | 4,247     | 3,780    |
| Total non-interest expense   | 9,421    | 9,998    | 8,507    | 28,549    | 25,320   |
| Income before provision for income taxes                             | 6,864    | 5,586    | 5,365    | 19,747    | 15,391   |
| Provision for income taxes   | 2,631    | 2,147    | 2,006    | 7,566     | 5,747    |
| Net income   | \$ 4,233 | \$ 3,439 | \$ 3,359 | \$ 12,181 | \$ 9,644 |
| Net income per common share:   |          |          |          |           |          |
| Basic  | \$ 0.80  | \$ 0.65  | \$ 0.64  | \$ 2.30   | \$ 1.84  |
| Diluted  | \$ 0.79  | \$ 0.64  | \$ 0.63  | \$ 2.26   | \$ 1.82  |
| Weighted average shares used to compute net income per common share: |          |          |          |           |          |
| Basic  | 5,310    | 5,300    | 5,241    | 5,298     | 5,231    |
| Diluted  | 5,390    | 5,385    | 5,311    | 5,381     | 5,305    |
| Dividends declared per common share                                  | \$ 0.16  | \$ 0.16  | \$ 0.15  | \$ 0.48   | \$ 0.45  |

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, 2010 and the nine months ended September 30, 2011

| (dollars in thousands; 2011<br>unaudited )  | Preferred<br>Stock | Common Stock<br>Shares | Amount   | Retained<br>Earnings | Accumulated Other<br>Comprehensive<br>Income,<br>Net of Taxes | Total     |
|---|--------------------|------------------------|----------|----------------------|---|-----------|
| Balance at December 31, 2009  | ---                | 5,229,529              | \$53,789 | \$54,644             | \$ 618  | \$109,051 |
| Comprehensive income:   |                    |                        |          |                      |   |           |
| Net income  | ---                | ---                    | ---      | 13,552               | ---   | 13,552    |
| Other comprehensive income  |                    |                        |          |                      |   |           |
| Net change in unrealized gain<br>on available for sale securities<br>(net of tax effect of \$672) |                    |                        |          |                      |   |           |
|   | ---                | ---                    | ---      | ---                  | 928   | 928       |
| Comprehensive income  | ---                | ---                    | ---      | 13,552               | 928   | 14,480    |
| Stock options exercised   | ---                | 49,940                 | 895      | ---                  | ---   | 895       |
| Excess tax benefit -<br>stock-based compensation  | ---                | ---                    | 132      | ---                  | ---   | 132       |
| Stock issued under employee<br>stock purchase plan  | ---                | 563                    | 17       | ---                  | ---   | 17        |
| Restricted stock granted  | ---                | 6,150                  | ---      | ---                  | ---   | ---       |
| Restricted stock forfeited /<br>cancelled   | ---                | (2,320 )               | ---      | ---                  | ---   | ---       |
| Stock-based compensation -<br>stock options   | ---                | ---                    | 241      | ---                  | ---   | 241       |
| Stock-based compensation -<br>restricted stock  | ---                | ---                    | 109      | ---                  | ---   | 109       |
| Cash dividends paid on<br>common stock  | ---                | ---                    | ---      | (3,205 )             | ---   | (3,205 )  |
| Stock issued in payment of<br>director fees   | ---                | 6,220                  | 200      | ---                  | ---   | 200       |
| Balance at December 31, 2010  | ---                | 5,290,082              | \$55,383 | \$64,991             | \$ 1,546  | \$121,920 |
| Comprehensive income:   |                    |                        |          |                      |   |           |
| Net income  | ---                | ---                    | ---      | 12,181               | ---   | 12,181    |
| Other comprehensive income  |                    |                        |          |                      |   |           |
| Net change in unrealized gain<br>on available for sale securities<br>(net of tax effect of \$118) |                    |                        |          |                      |   |           |
|   | ---                | ---                    | ---      | ---                  | 163   | 163       |
| Comprehensive income  | ---                | ---                    | ---      | 12,181               | 163   | 12,344    |
| Stock options exercised   | ---                | 29,504                 | 651      | ---                  | ---   | 651       |
| Excess tax benefit -<br>stock-based compensation  | ---                | ---                    | 117      | ---                  | ---   | 117       |
| Stock issued under employee<br>stock purchase plan  | ---                | 832                    | 27       | ---                  | ---   | 27        |
| Restricted stock granted  | ---                | 5,675                  | ---      | ---                  | ---   | ---       |
| Restricted stock forfeited  | ---                | (315 )                 | ---      | ---                  | ---   | ---       |
|   | ---                | ---                    | 186      | ---                  | ---   | 186       |

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Stock-based compensation -  
stock options

|  |     |           |          |          |          |           |
|--|-----|-----------|----------|----------|----------|-----------|
| Stock-based compensation -<br>restricted stock | --- | ---       | 106      | ---      | ---      | 106       |
| Cash dividends paid on<br>common stock         | --- | ---       | ---      | (2,550 ) | ---      | (2,550 )  |
| Stock issued in payment of<br>director fees    | --- | 5,590     | 200      | ---      | ---      | 200       |
| Balance at September 30, 2011                  | --- | 5,331,368 | \$56,670 | \$74,622 | \$ 1,709 | \$133,001 |

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

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**BANK OF MARIN BANCORP**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
for the nine months ended September 30, 2011 and 2010

| (in thousands, unaudited)   | September 30, 2011 | September 30,<br>2010 |
|---|--------------------|-----------------------|
| <b>Cash Flows from Operating Activities:</b>                                      |                    |                       |
| Net income  | \$ 12,181          | \$ 9,644              |
| Adjustments to reconcile net income to net cash provided by operating activities: |                    |                       |
| Provision for loan losses   | 4,550              | 4,300                 |
| Compensation expense--common stock for director fees                              | 150                | 150                   |
| Stock-based compensation expense  | 292                | 332                   |
| Excess tax benefits from exercised stock options                                  | (96 )              | (70 )                 |
| Amortization of investment security premiums, net of accretion of discounts       | 984                | 848                   |
| Accretion of discount on acquired loans   | (3,395 )           | ---                   |
| Depreciation and amortization   | 951                | 1,033                 |
| Bargain purchase gain on acquisition, net of tax                                  | (85 )              | ---                   |
| Loss on sale of repossessed assets  | 36                 | 6                     |
| Loss on disposal of premise and equipment   | ---                | 3                     |
| Net change in operating assets and liabilities:                                   |                    |                       |
| Interest receivable   | (67 )              | 147                   |
| Interest payable  | (47 )              | 150                   |
| Deferred rent and other rent-related expenses                                     | 205                | 191                   |
| Other assets  | 1,306              | (336 )                |
| Other liabilities   | 435                | 283                   |
| Total adjustments   | 5,219              | 7,037                 |
| Net cash provided by operating activities   | 17,400             | 16,681                |
| <b>Cash Flows from Investing Activities:</b>                                      |                    |                       |
| Proceeds from sale of furniture and equipment                                     | 18                 | ---                   |
| Purchase of securities held-to-maturity   | (5,566 )           | ---                   |
| Purchase of securities available-for-sale   | (91,151 )          | (36,370 )             |
| Proceeds from paydowns/maturity of:   |                    |                       |
| Securities held-to-maturity   | 1,255              | 480                   |
| Securities available-for-sale   | 42,857             | 24,316                |
| Loans originated and principal collected, net                                     | 11,710             | (21,776 )             |
| Purchase of bank owned life insurance policies                                    | (2,500 )           | ---                   |
| Purchase of premises and equipment  | (2,139 )           | (1,577 )              |
| Proceeds from sale of repossessed assets  | 199                | 158                   |
| Cash receipt from acquisition   | 44,042             | ---                   |
| Net cash used in investing activities   | (1,275 )           | (34,769 )             |
| <b>Cash Flows from Financing Activities:</b>                                      |                    |                       |
| Net increase in deposits  | 66,705             | 79,217                |
| Proceeds from stock options exercised   | 651                | 244                   |
| Repayment of Federal Home Loan Bank borrowings                                    | (33,500 )          | ---                   |

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|   |            |           |
|---|------------|-----------|
| Cash dividends paid on common stock                                     | (2,550 )   | (2,361 )  |
| Stock issued under employee stock purchase plan                         | 27         | 12        |
| Excess tax benefits from exercised stock options                        | 96         | 70        |
| Net cash provided by financing activities                               | 31,429     | 77,182    |
| Net increase in cash and cash equivalents                               | 47,554     | 59,094    |
| Cash and cash equivalents at beginning of period                        | 85,232     | 38,660    |
| Cash and cash equivalents at end of period                              | \$ 132,786 | \$ 97,754 |
| Supplemental disclosure of non-cash investing and financing activities: |            |           |
| Loans transferred to repossessed assets                                 | \$ 301     | \$ 210    |
| Stock issued in payment of director fees                                | \$ 200     | \$ 200    |
| Acquisition:  |            |           |
| Fair value of assets acquired   | \$ 107,763 | ---       |
| Fair value of liabilities assumed                                       | \$ 107,678 | ---       |

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 the holding company 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.

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 2010 Annual Report on Form 10-K. The results of operations for the three months and nine months ended September 30, 2011 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, non-vested restricted stock and stock warrant, and 3) weighted average diluted shares. Basic earnings per share (“EPS”) are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period. 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. We have two forms of our 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 stockholders and they both share equally in undistributed earnings.

| (in thousands, except per share data; unaudited)               | Three months ended |               |                    | Nine months ended  |                    |
|--|--------------------|---------------|--------------------|--------------------|--------------------|
|  | September 30, 2011 | June 30, 2011 | September 30, 2010 | September 30, 2011 | September 30, 2010 |
| Weighted average basic shares outstanding                      | 5,310              | 5,300         | 5,241              | 5,298              | 5,231              |
| Add: Potential common shares related to stock options          | 40                 | 43            | 42                 | 42                 | 46                 |
| Potential common shares related to non-vested restricted stock | 3                  | 3             | 3                  | 4                  | 3                  |
| Potential common shares related to warrant                     | 37                 | 39            | 25                 | 37                 | 25                 |
| Weighted average diluted shares outstanding                    | 5,390              | 5,385         | 5,311              | 5,381              | 5,305              |

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|   |         |          |          |          |          |
|---|---------|----------|----------|----------|----------|
| Net income available to common stockholders | \$4,233 | \$ 3,439 | \$ 3,359 | \$12,181 | \$ 9,644 |
| Basic EPS                                   | \$0.80  | \$ 0.65  | \$ 0.64  | \$2.30   | \$ 1.84  |
| Diluted EPS                                 | \$0.79  | \$ 0.64  | \$ 0.63  | \$2.26   | \$ 1.82  |

Weighted average anti-dilutive shares not included in the calculation of diluted EPS

|                             |     |    |     |    |     |
|-----------------------------|-----|----|-----|----|-----|
| Stock options               | 74  | 73 | 175 | 69 | 164 |
| Non-vested restricted stock | --- | 6  | --- | 4  | --- |
| Total anti-dilutive shares  | 74  | 79 | 175 | 73 | 164 |

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Note 2: Recently Issued Accounting Standards

In September 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-08 Intangibles – Goodwill and Other (Topic 350) Testing Goodwill for Impairment. The ASU simplifies how entities, both public and nonpublic, test goodwill for impairment. The amendments to Topic 350 permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carry amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. An entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. We do not expect this ASU to have a significant impact on our financial condition or results of operations.

In June 2011, the FASB issued ASU No. 2011-05 Comprehensive Income (Topic 220) Presentation of Comprehensive Income. The ASU improves the comparability, consistency, and transparency of financial reporting and increases the prominence of items reported in other comprehensive income. The amendments to Topic 220, Comprehensive Income, require entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Entities are no longer permitted to present components of other comprehensive income as part of the statement of changes in stockholders’ equity. Any adjustments for items that are reclassified from other comprehensive income to net income are to be presented on the face of the entities’ financial statement regardless of the method of presentation for comprehensive income. The amendments do not change items to be reported in comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor do the amendments change the option to present the components of other comprehensive income either net of related tax effects or before related tax effects. ASU 2011-05 is effective for fiscal years, and interim periods beginning on or after December 15, 2011. However, on October 21, 2011, the FASB met and discussed the operational concerns of stakeholders about the presentation requirements for reclassification adjustments in ASU No. 2011-05, and decided that the specific requirement to present items that are reclassified from other comprehensive income to net income alongside their respective components of net income and other comprehensive income will be deferred. We do not expect this ASU to have an impact on our financial condition or results of operations as it affects presentation only.

In May 2011, the FASB issued ASU No. 2011-04 Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The ASU improves the comparability of fair value measurements presented and disclosed in accordance with U.S. generally accepted accounting principles (“GAAP”) and International Financial Reporting Standards (“IFRS”)s) by changing the wording used to describe many of the requirements in U.S GAAP for measuring fair value and disclosure of information. The amendments to this ASU provide explanations on how to measure fair value but do not require any additional fair value measurements and do not establish valuation standards or affect valuation practices outside of financial reporting. The amendments clarify existing fair value measurements and disclosure requirements to include application of the highest and best use and valuation premises concepts; measuring fair value of an instrument classified in a reporting entity’s shareholders’ equity; and disclosure requirements regarding quantitative information about unobservable inputs categorized within Level 3 of the fair value hierarchy. In addition, clarification is provided for measuring the fair value of financial instruments that are managed in a portfolio and the application of premiums and discounts in a fair value measurement. For public entities, ASU 2011-04 is effective during interim and annual periods beginning after December 15, 2011. We do not expect this ASU to have a significant impact on our financial condition or results of operations.

In April 2011, the FASB issued ASU No. 2011-02, Receivables (Topic 310): A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring. The ASU clarifies which loan modifications constitute troubled debt

restructurings. It is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring (“TDR”), both for purposes of recording an impairment loss and for disclosure of a TDR. In evaluating whether a restructuring constitutes a TDR, a creditor must separately conclude that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. The amendments to ASU Topic 310, Receivables, clarify the guidance on a creditor’s evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. ASU No. 2011-02 is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. We have adopted this ASU in the third quarter of 2011 and provided the applicable disclosure in Note 6 herein.



In December 2010, the FASB issued ASU No. 2010-29, Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations to address diversity in practice about the interpretation of the pro forma revenue and earnings disclosure requirements for business combinations. This ASU is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning January 1, 2011. It requires a public entity to disclose pro forma revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma revenue and earnings of the combined entity for the comparable prior reporting period should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period. The amendments also expand the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. We have provided the applicable disclosure in Note 3 herein.

### Note 3: Acquisition

On February 18, 2011, we entered into a modified whole-bank purchase and assumption agreement without loss share (the "P&A Agreement") with the Federal Deposit Insurance Corporation (the "FDIC"), the receiver of Charter Oak Bank of Napa, California, to purchase certain assets and assume certain liabilities of the former Charter Oak Bank to enhance our market presence (the "Acquisition"). The purchase price reflected an asset discount of \$19.8 million and no deposit premium.

The P&A Agreement only covers designated assets and liabilities of Charter Oak Bank. Common stock of Charter Oak Bank, certain assets and certain liabilities, such as claims against any officer, director, employee, accountant, attorney, or any other person employed by the former Charter Oak Bank, were not purchased or assumed by us. In addition, loans of the former Charter Oak Bank at their book values totaling approximately \$24.4 million as of the acquisition date were retained by the FDIC. The excluded loans mainly represent loans delinquent more than sixty days or more as of the bid valuation date (October 18, 2010) and certain types of land and construction loans.

The assets acquired and liabilities assumed, both tangible and intangible, were recorded at their fair values as of acquisition date in accordance with ASC 805, Business Combinations. These fair value estimates are subject to change for up to one year after the acquisition date as additional information relative to acquisition date fair values becomes available. In addition, the tax treatment of FDIC-assisted acquisitions is complex and subject to interpretations that may result in future adjustments of deferred taxes as of the acquisition date.

In FDIC-assisted transactions, only certain assets and liabilities are transferred to the acquirer and, depending on the nature and amount of the acquirer's bid, the FDIC may be required to make a cash payment to the acquirer or the acquirer may be required to make payment to the FDIC. We received cash totaling \$32.6 million from the FDIC upon initial settlement of the transaction and recorded a receivable from the FDIC of \$196 thousand, for consideration of the net liabilities assumed (i.e., the net difference between the liabilities assumed and the assets acquired). The \$196 thousand receivable has been settled in August 2011.

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The following table presents the net liabilities assumed from Charter Oak and the estimated fair value adjustments, which resulted in a bargain purchase gain as of the acquisition date as the loans were purchased at a discount:

| (Dollars in thousands, unaudited)                      | Acquisition Date<br>(February 18, 2011) |
|--|---|
| Book value of net liabilities assumed from Charter Oak |   |
| Bank   | \$ (15,750 )                            |
| Cash received from the FDIC upon initial settlement    | 32,588                                  |
| Receivable from the FDIC                               | 196                                     |
| Fair value adjustments:                                |   |
| Loans  | (17,406 )                               |
| Core deposit intangible asset                          | 725                                     |
| Vehicles and equipment                                 | 16                                      |
| Deferred tax liabilities                               | (62 )                                   |
| Deposits   | (220 )                                  |
| Advances from the Federal Home Loan Bank               | (2 )                                    |
| Total purchase accounting adjustments                  | (16,949 )                               |
| Bargain purchase gain, net of tax                      | \$ 85                                   |

The bargain purchase gain represents the excess of the estimated fair value of the assets acquired over the estimated fair value of the liabilities assumed. We did not immediately acquire the banking facilities, including outstanding lease agreements, furniture, fixtures and equipment, as part of the P&A Agreement as of the acquisition date. We have since acquired all data processing equipment and the Napa branch fixed assets totaling \$206 thousand, and renegotiated a new lease with the landlord. The smaller St. Helena branch acquired from Charter Oak Bank was closed effective April 29, 2011.

The following table reflects the estimated fair values of the assets acquired and liabilities assumed related to the Acquisition, including cash received and receivable from the FDIC on the acquisition date:

| (Dollars in thousands, unaudited)                     | Acquisition Date<br>(February 18, 2011) |
|---|---|
| Assets:   |   |
| Cash and due from banks                               | \$ 34,144                               |
| Interest bearing deposits in banks                    | 5,663                                   |
| Federal funds sold                                    | 4,235                                   |
| Total cash and cash equivalents                       | 44,042                                  |
| Loans   | 61,765                                  |
| Core deposit intangible                               | 725                                     |
| Other assets (including the receivable from the FDIC) | 1,231                                   |
| Total assets acquired                                 | 107,763                                 |
| Liabilities:  |   |
| Deposits:   |   |
| Noninterest bearing                                   | 27,874                                  |
| Interest bearing                                      | 65,987                                  |
| Total deposits  | 93,861                                  |
| Advances from the Federal Home Loan Bank              | 13,502                                  |
| Deferred tax liabilities                              | 62                                      |

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|   |         |
|---|---------|
| Other liabilities   | 253     |
| Total liabilities assumed   | 107,678 |
|   |         |
| Bargain purchase gain, net of tax (included in other non-interest income) | \$ 85   |

The following is a description of the methods used to determine the fair values of significant assets and liabilities at acquisition date presented above.

#### Loans

The fair values for acquired loans were developed based upon the present values of the expected cash flows utilizing market-derived discount rates. Expected cash flows for each acquired loan were projected based on contractual cash flows adjusted for expected prepayment, expected default (i.e. probability of default and loss severity), and principal recovery.

For purchased non-credit-impaired loans, prepayment rates were applied to the principal outstanding based on the following assumptions depending on type of loan:

For commercial and agriculture loans, a ten percent constant prepayment rate (“CPR”) was assumed based on current research associated with these loan types;

A one percent CPR was assumed for commercial real estate, construction and land loans as research data indicate limited prepayment activity over the life of these loans;

For single family residential loans, a twenty percent CPR was used, based on current research associated with these loan types;

For home equity lines of credit, a CPR of fifteen percent was assumed based on the refinance likelihood and other research; and,

For other consumer loans, a CPR of one and a half percent was used based on current capital markets research data for consumer unsecured credit.

Prepayment assumptions were not factored into the calculation of expected cash flows on purchased credit-impaired loans. For purchased non-credit impaired loans, the total gross contractual amounts receivable were \$69.7 million as of the acquisition date.

Loans with similar characteristics were grouped together and were treated in the aggregate when applying the discount rate on the expected cash flows. Aggregation factors considered include 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. The discount rates used for the similar groups of loans are based on current market rates for new originations of comparable loans, where available, and include adjustments for credit and liquidity factors. To the extent comparable market rates are not readily available, a discount rate was derived based on the assumptions of a market participant's cost of funds, servicing costs, and return requirements for comparable risk assets.

#### Deposits

The fair values used for the transaction, savings and money market deposits are equal to the amount payable on demand at the reporting date. The fair values for time deposits are estimated using a discounted cash flow calculation that applies interest rates offered by market participants as of the acquisition date on time deposits with similar maturity terms as the discount rates. The core deposit intangible assets recognized as a result of the acquisition of core deposits are deductible for income tax purposes over fifteen years.

#### Advances from the Federal Home Loan Bank

The advances from the Federal Home Loan Bank San Francisco (“FHLB”) were recorded at their estimated fair value, which was based on quoted prices supplied by the FHLB. Subsequent to the acquisition dates, all of these advances were repaid in full.

Pro Forma Results of Operations

The contribution of the acquired operations of the former Charter Oak Bank to our results of operations for the period February 18 to September 30, 2011 is as follows: revenue of \$7.5 million, expenses of \$3.5 million (including a provision for loan losses of \$1.0 million), resulting in income after income taxes of \$2.5 million. These amounts include the bargain purchase gain, Acquisition-related third-party costs, accretion of the discount on the acquired loans, gains on payoff of Purchased Credit Impaired (“PCI”) loans and amortization of the fair value mark on time deposits and the core deposit intangible amortization. Charter Oak Bank’s results of operations prior to the acquisition date are not included in our operating results for 2011. The contribution discussed above excludes allocated overhead and allocated cost of funds.

We acquired only certain assets and assumed certain liabilities from the former Charter Oak Bank. A significant portion of the former Charter Oak Bank's operations, including certain delinquent loans, its St. Helena facilities and its central operations and administrative functions were not retained by us. Therefore, disclosure of supplemental pro forma financial information, especially prior period comparison is deemed neither practical nor meaningful given the troubled nature of Charter Oak Bank prior to the date of Acquisition.

Acquisition-related expenses are recognized as incurred and continue until all systems have been converted and operational functions become fully integrated. We incurred third-party acquisition-related expenses in the following line items in the consolidated statements of income for the three-month and nine-month periods ended September 30, 2011 as follows:

| Acquisition-related Expenses<br>(in thousands) | Three months ended<br>September 30,<br>2011 | Three months ended<br>June 30, 2011 | Nine months ended<br>September 30,<br>2011 |
|--|---|-------------------------------------|--|
| Professional services                          | \$ -  | \$ 153                              | \$ 457                                     |
| Data processing                                | 47  | 378                                 | 455  |
| Other <sup>1</sup>                             | (37 )                                       | 111                                 | 88   |
| Total  | \$ 10                                       | \$ 642                              | \$ 1,000                                   |

<sup>1</sup>Third-quarter 2011 expenses are offset by a \$37 thousand final FDIC settlement reimbursement.

#### Note 4: Fair Value of Assets and Liabilities

##### Fair Value Hierarchy and Fair Value Measurement

We group our assets and liabilities that are recorded at fair value in three levels, 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 includes management judgment and estimation which may be significant.

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

| (in thousands)  | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|----------------|--|---|---|
| Description of Financial Instruments  |                |  |   |   |
| Balance at September 30, 2011 (unaudited):  |                |  |   |   |
| Securities available for sale:  |                |  |   |   |
| Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government agencies | \$ 116,602     | \$ ---   | \$ 116,602                                    | \$ ---                                    |
| Debentures of government sponsored agencies   | \$ 25,092      | \$ ---   | \$ 25,092                                     | \$ ---                                    |
| Corporate collateralized mortgage obligations   | \$ 17,784      | \$ ---   | \$ 17,784                                     | \$ ---                                    |
| Derivative financial liabilities (interest rate contracts)  | \$ 4,415       | \$ ---   | \$ 4,415                                      | \$ ---                                    |
| Balance at December 31, 2010:   |                |  |   |   |
| Securities available for sale:  |                |  |   |   |
| Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government agencies | \$ 95,258      | \$ ---   | \$ 95,258                                     | \$ ---                                    |
| Corporate collateralized mortgage obligations   | \$ 15,870      | \$ ---   | \$ 15,870                                     | \$ ---                                    |
| Equity securities   | \$ 608         | \$ 608   | \$ -  | \$ ---                                    |
| Derivative financial liabilities (interest rate contracts)  | \$ 2,470       | \$ ---   | \$ 2,470                                      | \$ ---                                    |

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, and credit spreads (Level 2). Level 1 securities include those traded on active markets, including U.S. Treasury securities and equity securities. Level 2 securities include U.S. agencies' debt securities, mortgage-backed securities, and corporate collateralized mortgage obligations.

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 London Interbank Offered Rate ("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), the present value of expected future cash flows discounted at a market-based interest rate for similar loans (Level 2), or the current appraised value of the underlying collateral securing the loan if the loan is collateral dependent (Level 3). 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.



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The following table presents the carrying value of financial instruments by level within the fair value hierarchy as of September 30, 2011 and December 31, 2010, for which a non-recurring change in fair value has been recorded.

| (in thousands)<br>Description of<br>Financial<br>Instruments | Carrying<br>Value | Quoted  | Other                             | Significant                             | Losses  | Losses   | Losses  | Losses   |
|--|-------------------|---|-----------------------------------|---|---|--|---|--|
|  |                   | Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets (Level<br>1) | Observable<br>Inputs (Level<br>2) | Unobservable<br>Inputs (Level<br>3) (a) | for the<br>three<br>months<br>ended<br>September<br>30, 2011<br>(b) | for the<br>nine<br>months<br>ended<br>September<br>30, 2011<br>(b) | for the<br>three<br>months<br>ended<br>September<br>30, 2010<br>(b) | for the<br>nine<br>months<br>ended<br>September<br>30, 2010<br>(b) |
| At September 30, 2011<br>(unaudited):                        |                   |   |                                   |   |   |  |   |  |
| Impaired loans<br>carried at fair<br>value (c)               | \$ 4,354          | \$ ---  | \$ ---                            | \$ 4,354                                | \$ 674  | \$ 4,757   | \$ 1,502  | \$ 3,702   |
| Other real estate<br>owned                                   | \$ 151            | \$ ---  | \$ ---                            | \$ 151                                  | \$ ---  | \$ ---   | \$ ---  | \$ ---   |
| At December 31,<br>2010:                                     |                   |   |                                   |   |   |  |   |  |
| Impaired loans<br>carried at fair<br>value (c)               | \$ 8,635          | \$ ---  | \$ ---                            | \$ 8,635                                |   |  |   |  |

(a) Represents collateral-dependent loan principal balances that had been generally written down to the appraised value or estimated market value of the underlying collateral, net of specific valuation allowance of \$925 thousand and \$936 thousand at September 30, 2011 and December 31, 2010, respectively. The carrying value of loans fully charged-off, which includes unsecured lines of credit, overdrafts and all other loans, is zero.

(b) Represents net charge-offs during the period presented and the specific valuation allowance established on loans during the period.

(c) Represents the portion of impaired loans that have been written down to their estimated fair value.

Disclosures about Fair Value of Financial Instruments

The table below is a summary of fair value estimates for financial instruments as of September 30, 2011 and December 31, 2010, excluding financial instruments recorded at fair value on a recurring basis (summarized in a separate table). The carrying amounts in the following table are recorded in the 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.

| (in thousands; 2011 amounts unaudited) | September 30, 2011  |               | December 31, 2010   |               |
|--|---------------------|---------------|---------------------|---------------|
|  | Carrying<br>Amounts | Fair<br>Value | Carrying<br>Amounts | Fair<br>Value |
| Financial assets                       |                     |               |                     |               |
| Cash and cash equivalents              | \$ 132,786          | \$ 132,786    | \$ 85,232           | \$ 85,232     |
| Investment securities held to maturity | 39,077              | 41,236        | 34,917              | 35,090        |

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|                                   |           |           |           |           |
|-----------------------------------|-----------|-----------|-----------|-----------|
| Loans, net                        | 979,419   | 1,003,999 | 929,008   | 952,763   |
| Interest receivable               | 4,274     | 4,274     | 4,207     | 4,207     |
| Financial liabilities             |           |           |           |           |
| Deposits                          | 1,176,525 | 1,177,434 | 1,015,739 | 1,016,401 |
| Federal Home Loan Bank borrowings | 35,000    | 36,371    | 55,000    | 57,090    |
| Subordinated debenture            | 5,000     | 4,885     | 5,000     | 4,994     |
| Interest payable                  | 367       | 367       | 414       | 414       |

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 & political subdivisions, 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, 2011, 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 Borrowings - The fair value is estimated by discounting the future cash flows using current rates offered by the FHLB for similar credit advances corresponding to the remaining duration of our fixed-rate credit advances.

Subordinated Debenture - The fair value of the subordinated debenture is estimated by discounting the future cash flows (interest payment at a rate of three-month LIBOR plus 2.48%) using current market rates at which similar bonds would be issued with similar credit ratings as ours and similar remaining maturities. We have used the spread of the ten-year BBB rated U.S. Bank Composite over LIBOR to calculate this credit-risk-related discount of future cash flows.

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 primarily of U.S. government agency securities, including mortgage-backed securities (“MBS”) and collateralized mortgage obligations (“CMOs”) issued or guaranteed by FNMA, FHLMC, or GNMA. Our portfolio also includes obligations of state and political subdivisions, debentures issued by government-sponsored agencies such as FHLB, as well as corporate CMOs and equity securities, as reflected in the table below.

| (in thousands;<br>September 30, 2011<br>unaudited)    | September 30, 2011 |               |                |                        | December 31, 2010 |               |                |                        |
|---|--------------------|---------------|----------------|------------------------|-------------------|---------------|----------------|------------------------|
|   | Amortized<br>Cost  | Fair<br>Value | Gross<br>Gains | Unrealized<br>(Losses) | Amortized<br>Cost | Fair<br>Value | Gross<br>Gains | Unrealized<br>(Losses) |
| <b>Held-to-maturity</b>                               |                    |               |                |                        |                   |               |                |                        |
| Obligations of state<br>and political<br>subdivisions | \$ 39,077          | \$ 41,236     | \$ 2,203       | \$ (44 )               | \$34,917          | \$ 35,090     | \$ 666         | \$ (493 )              |
| <b>Available-for-sale</b>                             |                    |               |                |                        |                   |               |                |                        |
| Securities of U. S.<br>government                     |                    |               |                |                        |                   |               |                |                        |

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agencies:

|  |            |            |          |           |            |            |          |           |
|--|------------|------------|----------|-----------|------------|------------|----------|-----------|
| MBS pass-through securities issued by FNMA and FHLMC | 27,645     | 28,749     | 1,104    | ---       | 16,119     | 16,424     | 419      | (114 )    |
| CMOs issued by FNMA                                  | 11,294     | 11,740     | 446      | ---       | 12,770     | 13,236     | 466      | ---       |
| CMOs issued by FHLMC                                 | 21,248     | 21,892     | 644      | ---       | 19,725     | 20,177     | 452      | ---       |
| CMOs issued by GNMA                                  | 53,080     | 54,221     | 1,141    | ---       | 44,607     | 45,421     | 884      | (70 )     |
| Debentures of government sponsored agencies          | 25,001     | 25,092     | 91       | ---       | ---        | ---        | ---      | ---       |
| Corporate CMOs                                       | 18,263     | 17,784     | 135      | (614 )    | 15,849     | 15,870     | 185      | (164 )    |
| Equity security                                      | ---        | ---        | ---      | ---       | ---        | 608        | 608      | ---       |
| Total available for sale                             | 156,531    | 159,478    | 3,561    | (614 )    | 109,070    | 111,736    | 3,014    | (348 )    |
| Total investment securities                          | \$ 195,608 | \$ 200,714 | \$ 5,764 | \$ (658 ) | \$ 143,987 | \$ 146,826 | \$ 3,680 | \$ (841 ) |

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As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock at a zero 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. The conversion rate will be determined upon the final resolution of the Visa Inc. covered litigation described in Note 13 to the Consolidated Financial Statements in our 2010 Form 10-K. The stock was re-classified from available-for-sale securities to cost-basis accounting in March 2011 as the stock is still currently restricted from resale based on new information received from Visa Inc. Hence, the unrealized gain on the stock, net of tax, at December 31, 2010 was reversed from other comprehensive income. The fair value of the Class B common stock we own was \$709 thousand and \$608 thousand at September 30, 2011 and December 31, 2010, respectively, based on the Class A as-converted rate of 0.4881 and 0.5102, respectively.

The amortized cost and fair value of investment securities by contractual maturity at September 30, 2011 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;<br>unaudited)          | September 30, 2011 |            |                    |            |
|---------------------------------------|--------------------|------------|--------------------|------------|
|                                       | Held to Maturity   |            | Available for Sale |            |
|                                       | Amortized<br>Cost  | Fair Value | Amortized<br>Cost  | Fair Value |
| Within one year                       | \$ 3,028           | \$ 3,029   | \$ ---             | \$ ---     |
| After one but within<br>five years    | 7,666              | 7,950      | 23,442             | 23,637     |
| After five years<br>through ten years | 20,923             | 22,483     | 17,255             | 17,512     |
| After ten years                       | 7,460              | 7,774      | 115,834            | 118,329    |
| Total                                 | \$ 39,077          | \$ 41,236  | \$ 156,531         | \$ 159,478 |

At September 30, 2011, investment securities carried at \$39.8 million were pledged with the State of California: \$39.1 million to secure public deposits in compliance with the Local Agency Security Program and \$704 thousand to provide collateral for trust deposits. In addition, at September 30, 2011, investment securities carried at \$1.1 million were pledged to collateralize an internal Wealth Management Services checking account and \$5.9 million were pledged to collateralize interest rate swaps as discussed in Note 11.

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

For each security in an unrealized loss position, we assess whether we intend to sell the security, or it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired and that we do not intend to sell and will not be required to sell prior to recovery of our amortized cost basis, we separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is calculated as the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is deemed to be due to factors that are not credit related and is recognized in other comprehensive income.

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 issuers 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.



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Fifteen and twenty-nine investment securities were in unrealized loss positions at September 30, 2011 and December 31, 2010, respectively. They are summarized and classified according to the duration of the loss period as follows:

| September 30, 2011<br>(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 |
| Held-to-maturity Obligations of state & political subdivisions | \$4,344                | \$(16 )         | \$1,773                | \$(28 )         | \$6,117                             | \$(44 )         |
| Available-for-sale Securities of                               |                        |                 |                        |                 |                                     |                 |
| U.S. government agencies                                       | ---                    | ---             | ---                    | ---             | ---                                 | ---             |
| Corporate CMOs   | 12,218                 | (614 )          | ---                    | ---             | 12,218                              | (614 )          |
| Total available for sale                                       | 12,218                 | (614 )          | -                      | -               | 12,218                              | (614 )          |
| Total temporarily impaired securities                          | \$16,562               | \$(630 )        | \$1,773                | \$(28 )         | \$18,335                            | \$(658 )        |
| December 31, 2010<br>(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 |
| Held-to-maturity Obligations of state & political subdivisions | \$11,622               | \$(250 )        | \$1,687                | \$(243 )        | \$13,309                            | \$(493 )        |
| Available-for-sale Securities of                               |                        |                 |                        |                 |                                     |                 |
| U.S. government agencies                                       | 12,888                 | (184 )          | ---                    | ---             | 12,888                              | (184 )          |
| Corporate CMOs   | 7,070                  | (164 )          | ---                    | ---             | 7,070                               | (164 )          |
| Total available for sale                                       | 19,958                 | (348 )          | ---                    | ---             | 19,958                              | (348 )          |
| Total temporarily impaired securities                          | \$31,580               | \$(598 )        | \$1,687                | \$(243 )        | \$33,267                            | \$(841 )        |

The unrealized losses associated with debt securities of U.S. government agencies are primarily driven by changes in interest rates and not due to the credit quality of the securities. Further, securities backed by GNMA, FNMA, or FHLMC have the guarantee of the full faith and credit of the U.S. Federal Government. Obligations of U.S. states and political subdivisions in our portfolio are all investment grade without delinquency history. The security in a loss position for more than twelve continuous months relates to one debenture issued by a local subdivision with payments collected through property tax assessments in an affluent community. This security will continue to be monitored as part of our ongoing impairment analysis, but is expected to perform. As a result, we concluded that this security was not other-than-temporarily impaired at September 30, 2011.

The unrealized losses associated with corporate CMO's are primarily related to securities backed by residential mortgages. Most of these securities were AAA rated by at least one major rating agency. We estimate loss projections for each security by assessing loans collateralizing the security and determining expected default rates and loss severities. Based upon our assessment of expected credit losses of each security given the performance of the underlying collateral and credit enhancements where applicable, we concluded that these securities were not

other-than-temporarily impaired at September 30, 2011.

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 \$5.4 million and \$5.0 million of FHLB stock recorded at cost in other assets at September 30, 2011 and December 31, 2010, respectively. On August 11, 2011, FHLB declared a cash dividend for the second quarter of 2011 at an annualized dividend rate of 0.26%. Management expects to be able to redeem this stock at cost, and therefore does not believe the FHLB stock to be other-than-temporarily impaired.



Note 6: Loans and Allowance for Loan Losses

Credit Quality of Loans

Outstanding loans by class and payment aging as of September 30, 2011 and December 31, 2010 are as follows:

Loan Aging Analysis by Class As of September 30, 2011 and December 31, 2010

| (Dollars in thousands; September 30, 2011 unaudited) | Commercial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Total      |
|--|------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|------------|
| September 30, 2011                                   |            |  |                                  |              |             |                   |                                |            |
| 30-59 days past due                                  | \$ 922     | \$ 399                                 | \$ 330                           | \$ 2,911     | \$ 195      | \$ -              | \$ 32                          | \$ 4,789   |
| 60-89 days past due                                  | 177        | -                                      | -                                | -            | -           | -                 | 1                              | 178        |
| Greater than 90 days past due (non-accrual)          |            |  |                                  |              |             |                   |                                |            |
| 2  | 3,147      | 2,169                                  | -                                | 3,028        | 583         | 1,400             | 413                            | 10,740     |
| Total past due                                       | 4,246      | 2,568                                  | 330                              | 5,939        | 778         | 1,400             | 446                            | 15,707     |
| Current  | 168,143    | 157,990                                | 420,097                          | 48,867       | 96,545      | 62,450            | 22,844                         | 976,936    |
| Total loans 3  | \$ 172,389 | \$ 160,558                             | \$ 420,427                       | \$ 54,806    | \$ 97,323   | \$ 63,850         | \$ 23,290                      | \$ 992,643 |
| Non-accrual loans to total loans                     | 1.8 %      | 1.4 %                                  | -                                | 5.5 %        | 0.6 %       | 2.2 %             | 1.8 %                          | 1.1 %      |
| December 31, 2010                                    |            |  |                                  |              |             |                   |                                |            |
| 30-59 days past due                                  | \$ 20      | \$ -                                   | \$ -                             | \$ -         | \$ 25       | \$ -              | \$ 307                         | \$ 352     |
| 60-89 days past due                                  | -          | -                                      | -                                | -            | -           | -                 | -                              | -          |
| Greater than 90 days past due (non-accrual)          |            |  |                                  |              |             |                   |                                |            |
| 2  | 2,486      | 632                                    | -                                | 9,297        | -           | 148               | 362                            | 12,925     |
| Total past due                                       | 2,506      | 632                                    | -                                | 9,297        | 25          | 148               | 669                            | 13,277     |
| Current  | 151,330    | 141,958                                | 383,553                          | 68,322       | 86,907      | 69,843            | 26,210                         | 928,123    |
| Total loans 3  | \$ 153,836 | \$ 142,590                             | \$ 383,553                       | \$ 77,619    | \$ 86,932   | \$ 69,991         | \$ 26,879                      | \$ 941,400 |
| Non-accrual loans to total loans                     | 1.6 %      | 0.4 %                                  | -                                | 12.0 %       | -           | 0.2 %             | 1.3 %                          | 1.4 %      |

1. 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.
2. September 30, 2011 amounts include \$2.6 million PCI loans that have stopped accreting interest and exclude accreting PCI loans of \$3.9 million, as their accretable yield interest recognition is independent from the underlying contractual loan delinquency status. There were no accruing loans past due more than 90 days at September 30, 2011 or December 31, 2010.
3. Amounts were net of deferred loan fees of \$1.6 million and \$2.8 million at September 30, 2011 and December 31, 2010, 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 or other business assets such as accounts receivable or inventory and incorporate a personal guarantee; however, 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 our credit extensions.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans discussed above. We underwrite these loans primarily as cash flow loans and secondarily as loans secured by real estate. 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. Underwriting standards for these loans typically meet a minimum debt coverage ratio of 1.20:1.00, and a loan-to-value of 65% or less. Furthermore, substantially all of our loans are guaranteed by the owners of the properties. Commercial real estate loans may be more 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 experience nominal 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 evaluating the borrower's financial strength, reputation, prior payment record and obtaining independent appraisal reviews. The construction industry can be severely impacted by several major factors, including: 1) the inherent volatility of real estate markets; 2) vulnerability to weather delays, 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. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project.

Consumer loans primarily consist of home equity lines of credit and loans, 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, minimizes risk. Additionally, trend and outlook reports are reviewed by Management on a regular basis. Underwriting standards for home equity loans include, but are not limited to, a maximum loan-to-value percentage of 75% of loans that are \$1,250,000 or less (and even more conservatively for homes with values in excess of this amount), collection remedies, 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, has been cautious compared to traditional residential mortgages due to the unique ownership structure and the interest-only feature 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 direct auto loans and installment loans. Personal unsecured loans are offered to consumers with additional underwriting procedures in place, including net worth, and borrowers' verified liquid assets analysis. In general, personal loans usually have a higher degree of risk than other types of loans.

We use a risk rating system as a tool used to evaluate asset quality, and to identify and monitor credit risk in individual loans, and ultimately in the portfolio. Definitions of risk grades of "Special Mention" or worse loans are consistent with those used by the banking regulators. 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-dependant.

We regularly review our credits for accuracy of risk grades whenever new financial 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 \$2.5 million are required to submit rent rolls or property income statements at least annually. It has been our practice to obtain rent rolls or property income statements for loans \$750 thousand or greater for the last two years.
  - 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 September 30, 2011 and December 31, 2010:

Credit Quality Indicators As of September 30, 2011 and December 31, 2010

| (Dollars in thousands; September 30, 2011 unaudited) | Commercial | 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, 2011

|             |            |            |            |           |           |           |           |          |            |
|-------------|------------|------------|------------|-----------|-----------|-----------|-----------|----------|------------|
| Pass        | \$ 142,911 | \$ 139,650 | \$ 408,939 | \$ 32,426 | \$ 93,316 | \$ 57,032 | \$ 22,221 | \$ 2,065 | \$ 898,560 |
| Special     |            |            |            |           |           |           |           |          |            |
| Mention     | 8,705      | 10,971     | 3,148      | 2,681     | 230       | 2,016     | -         | 151      | 27,902     |
| Substandard | 19,142     | 6,732      | 6,628      | 19,492    | 3,535     | 4,432     | 933       | 4,020    | 64,914     |
| Doubtful    | -          | -          | -          | 207       | 242       | 370       | 136       | 312      | 1,267      |
| Total loans | \$ 170,758 | \$ 157,353 | \$ 418,715 | \$ 54,806 | \$ 97,323 | \$ 63,850 | \$ 23,290 | \$ 6,548 | \$ 992,643 |

December 31, 2010

|             |            |            |            |           |           |           |           |      |            |
|-------------|------------|------------|------------|-----------|-----------|-----------|-----------|------|------------|
| Pass        | \$ 120,428 | \$ 135,443 | \$ 369,976 | \$ 57,779 | \$ 84,830 | \$ 64,570 | \$ 26,280 | \$ - | \$ 859,306 |
| Special     |            |            |            |           |           |           |           |      |            |
| Mention     | 17,009     | 454        | 330        | 10,253    | 447       | -         | -         | -    | 28,493     |
| Substandard | 16,169     | 6,693      | 13,247     | 9,587     | 1,655     | 5,421     | 427       | -    | 53,199     |
| Doubtful    | 230        | -          | -          | -         | -         | -         | 172       | -    | 402        |
| Total loans | \$ 153,836 | \$ 142,590 | \$ 383,553 | \$ 77,619 | \$ 86,932 | \$ 69,991 | \$ 26,879 | \$ - | \$ 941,400 |

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.

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.

As a result of adopting the amendments in ASU No. 2011-02 discussed in Note 2, Management reassessed all loan modifications that occurred on or after January 1, 2011 for potential identification as TDRs. Management has identified TDRs for which the related allowance for loan losses had previously been measured under the general allowance for loan losses methodology. Upon identifying those receivables as TDRs, they are newly considered as impaired under the guidance in ASC Section 310-10-35. The amendments in ASU No. 2011-02 require prospective application of the impairment guidance in ASC Section 310-10-35 for those receivables newly identified as impaired. At the end of the first interim period of adoption (September 30, 2011), the recorded investment in receivables for which the allowance for loan losses had been previously measured under a general allowance for loan losses methodology and now considered impaired was \$3.1 million, and the related specific allowance, based on a current evaluation of loss, was \$11 thousand.

The table below, by loan class, presents the following information for all TDR loans as of September 30, 2011: 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. Modifications generally involved reductions in the interest rate, payment extensions and forbearances. As of December 31, 2010, there were \$1.2 million of TDR loans (mostly installment and other consumer loans which were performing). There were no TDRs within the last year that subsequently defaulted in the three-month and nine-month periods ended September 30, 2011.

|   | Number of<br>Contracts<br>Modified | As of September 30, 2011<br>Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment <sup>1</sup> |
|---|------------------------------------|---|---|
| Troubled Debt Restructurings              |                                    |   |   |
| Commercial                                | 24                                 | \$ 6,081  | \$ 5,089  |
| Commercial real estate,<br>owner-occupied | 2                                  | 1,366   | 1,403   |
| Construction                              | 2                                  | 817   | 814   |
| Home equity                               | 1                                  | 153   | 164   |
| Other residential                         | 2                                  | 848   | 848   |
| Installment and other consumer            | 13                                 | 1,607   | 1,561   |
| Total                                     | 44                                 | \$ 10,872   | \$ 9,879  |

<sup>1</sup> Includes \$5.1 million of TDR loans that were accruing interest as of September 30, 2011.

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Impaired loan balances and their related allowance by major classes of loans

The table below summarizes information on impaired loans and their related allowance:

| (Dollars in thousands;<br>September 30,<br>2011 unaudited)                                | Commercial<br>owner-occupied | Commercial<br>real estate,<br>investor | Commercial<br>real estate,<br>investor | Construction | Home<br>equity | Other<br>residential | Installment<br>and other<br>consumer | Total     |
|---|------------------------------|--|--|--------------|----------------|----------------------|--------------------------------------|-----------|
| Recorded investment in impaired loans:  |                              |  |  |              |                |                      |                                      |           |
| With no specific allowance recorded   | \$ 2,945                     | \$ 1,980                               | \$ ---                                 | \$ 2,794     | \$ 24          | \$ 609               | \$ 277                               | \$ 8,629  |
| With a specific allowance recorded  | 2,953                        | 1,330                                  | 1,089                                  | 524          | 723            | 1,638                | 1,697                                | 9,954     |
| Total recorded investment in impaired loans   | \$ 5,898                     | \$ 3,310                               | \$ 1,089                               | \$ 3,318     | \$ 747         | \$ 2,247             | \$ 1,974                             | \$ 18,583 |
| Unpaid principal balance of impaired loans:   |                              |  |  |              |                |                      |                                      |           |
| With no specific allowance recorded   | \$ 6,040                     | \$ 4,377                               | \$ ---                                 | \$ 5,571     | \$ 24          | \$ 609               | \$ 319                               | \$ 16,940 |
| With a specific allowance recorded  | 3,382                        | 2,930                                  | 2,633                                  | 524          | 1,317          | 1,638                | 1,697                                | 14,121    |
| Total unpaid principal balance of impaired loans  | \$ 9,422                     | \$ 7,307                               | 2,633                                  | \$ 6,095     | \$ 1,341       | \$ 2,247             | \$ 2,016                             | \$ 31,061 |
| Specific allowance  | \$ 826                       | \$ 197                                 | \$ 6                                   | \$ 207       | \$ 190         | \$ 389               | \$ 313                               | \$ 2,128  |
| Average recorded investment in impaired loans during the quarter ended September 30, 2011 | 6,121                        | 4,229                                  | 355                                    | 3,115        | 1,077          | 267                  | 500                                  | 15,664    |
| Interest income recognized on impaired loans during the quarter ended September 30, 2011  | 14                           | ---                                    | ---                                    | ---          | 2              | 40                   | 5                                    | 61        |



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|   |       |       |     |       |     |     |     |        |
|---|-------|-------|-----|-------|-----|-----|-----|--------|
| Average recorded investment in impaired loans during the nine months ended September 30, 2011 | 3,999 | 1,979 | 120 | 6,083 | 437 | 185 | 504 | 13,307 |
| Interest income recognized on impaired loans during the nine months ended September 30, 2011  | 62    | ---   | --- | ---   | 10  | 40  | 14  | 126    |

December 31, 2010

|   |          |        |        |           |       |        |          |          |
|---|----------|--------|--------|-----------|-------|--------|----------|----------|
| Recorded investment in impaired loans:      |          |        |        |           |       |        |          |          |
| With no specific allowance recorded         | \$ 959   | \$ 633 | \$ --- | \$ 8,742  | \$--- | \$ --- | \$ 73    | \$10,407 |
| With a specific allowance recorded          | 1,526    | ---    | \$ --- | 555       | 259   | 148    | 1,214    | 3,702    |
| Total recorded investment in impaired loans | \$ 2,485 | \$ 633 | \$ --- | \$ 9,297  | \$259 | \$ 148 | \$ 1,287 | \$14,109 |
| Unpaid principal balance of impaired loans: |          |        |        |           |       |        |          |          |
| With no specific allowance recorded         | \$ 959   | \$ 689 | \$ --- | \$ 11,485 | \$--- | \$ --- | \$ 115   | \$13,248 |
| With a specific allowance recorded          | 2,570    | ---    | ---    | 555       | 259   | 148    | 1,214    | 4,746    |
| Total recorded investment in impaired loans | \$ 3,529 | \$ 689 | \$ --- | \$ 12,040 | \$259 | \$ 148 | \$ 1,329 | \$17,994 |
| Specific allowance                          | \$ 667   | \$ --- | \$ --- | \$ 3      | \$25  | \$ 93  | \$ 290   | \$1,078  |

|   |       |       |     |       |     |    |       |        |
|---|-------|-------|-----|-------|-----|----|-------|--------|
| Average recorded investment in impaired loans during the year ended December 31, 2010 | 1,326 | 3,086 | --- | 6,326 | 191 | 39 | 1,212 | 12,180 |
|---|-------|-------|-----|-------|-----|----|-------|--------|

|   |    |    |     |     |   |   |    |     |
|---|----|----|-----|-----|---|---|----|-----|
| Interest income<br>recognized on<br>impaired loans<br>during the year<br>ended December<br>31, 2010 | 85 | 22 | --- | 336 | 8 | 5 | 66 | 522 |
|---|----|----|-----|-----|---|---|----|-----|

The gross interest income that would have been recorded had non-accrual loans been current totaled \$178 thousand, \$177 thousand and \$253 thousand in the quarters ended September 30, 2011, June 30, 2011 and September 30, 2010, respectively, and totaled \$575 thousand and \$732 thousand for the first nine months of 2011 and 2010, 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 page 25, "PCI Loans" 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, 2011 totaled approximately \$2.0 million. At September 30, 2011, there were no significant 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 for the three months and nine months ended September 30, 2011, as well as the related ALLL disaggregated by impairment evaluation method as of September 30, 2011 and December 31, 2010:

Allowance for Loan Losses and Recorded Investment in Loans

| (Dollars in thousands;<br>2011 unaudited) | Commercial<br>owner-occupied | Commercial<br>real estate,<br>investor-occupied | Commercial<br>real estate,<br>investor-occupied | Construction | Home<br>equity | Other<br>residential | Installment<br>and<br>other<br>consumer | Unallocated | Total |
|---|------------------------------|---|---|--------------|----------------|----------------------|---|-------------|-------|
|---|------------------------------|---|---|--------------|----------------|----------------------|---|-------------|-------|

For the three months ended September 30, 2011:

Allowance for loan losses:

|                      |         |         |         |         |        |       |        |       |          |
|----------------------|---------|---------|---------|---------|--------|-------|--------|-------|----------|
| Beginning balance    | \$4,091 | \$1,130 | \$4,088 | \$1,947 | \$802  | \$706 | \$890  | \$266 | \$13,910 |
| Provision (reversal) | (392 )  | 178     | 297     | (108 )  | 315    | 244   | 65     | (99 ) | 500      |
| Charge-offs          | (395 )  | (98 )   | -       | (250 )  | (288 ) | -     | (182 ) | -     | (1,213)  |
| Recoveries           | 4       | -       | -       | 9       | -      | -     | 4      | -     | 17       |
| Ending balance       | \$3,308 | \$1,210 | \$4,385 | \$1,598 | \$829  | \$950 | \$777  | \$167 | \$13,264 |

For the nine months ended September 30, 2011:

Allowance for loan losses:

|                      |          |         |         |         |        |       |        |       |          |
|----------------------|----------|---------|---------|---------|--------|-------|--------|-------|----------|
| Beginning balance    | \$3,114  | \$1,037 | \$4,134 | \$1,694 | \$643  | \$738 | \$835  | \$197 | \$12,392 |
| Provision (reversal) | 2,431    | 271     | 251     | 346     | 731    | 212   | 338    | (30 ) | 4,550    |
| Charge-offs          | (2,268 ) | (98 )   | -       | (451 )  | (545 ) | -     | (411 ) | -     | (3,773)  |
| Recoveries           | 31       | -       | -       | 9       | -      | -     | 15     | -     | 55       |
| Ending balance       | \$3,308  | \$1,210 | \$4,385 | \$1,598 | \$829  | \$950 | \$777  | \$167 | \$13,264 |

As of September 30, 2011:

|  |         |         |         |         |       |       |       |       |          |
|--|---------|---------|---------|---------|-------|-------|-------|-------|----------|
| Ending ALLL related to loans collectively evaluated for impairment | \$2,482 | \$1,013 | \$4,379 | \$1,391 | \$639 | \$561 | \$464 | \$167 | \$11,036 |
|--|---------|---------|---------|---------|-------|-------|-------|-------|----------|

|  |       |     |     |       |       |       |       |     |         |
|--|-------|-----|-----|-------|-------|-------|-------|-----|---------|
| Ending ALLL related to loans individually evaluated for impairment | \$823 | \$3 | \$- | \$207 | \$190 | \$389 | \$313 | \$- | \$1,925 |
|--|-------|-----|-----|-------|-------|-------|-------|-----|---------|

|  |     |       |     |     |     |     |     |     |       |
|--|-----|-------|-----|-----|-----|-----|-----|-----|-------|
| Ending ALLL related to purchased credit-impaired loans | \$3 | \$194 | \$6 | \$- | \$- | \$- | \$- | \$- | \$203 |
|--|-----|-------|-----|-----|-----|-----|-----|-----|-------|

Loans outstanding:

|                                       |           |           |           |          |          |          |          |     |           |
|---------------------------------------|-----------|-----------|-----------|----------|----------|----------|----------|-----|-----------|
| Collectively evaluated for impairment | \$165,993 | \$157,248 | \$418,715 | \$51,488 | \$96,576 | \$61,603 | \$21,316 | \$- | \$972,931 |
| Individually evaluated for impairment | 4,765     | 105       | -         | 3,318    | 747      | 2,247    | 1,974    | -   | 13,156    |

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|                           |           |           |           |          |          |          |          |     |       |
|---------------------------|-----------|-----------|-----------|----------|----------|----------|----------|-----|-------|
| Purchased credit-impaired | 1,631     | 3,205     | 1,712     | -        | -        | -        | -        | -   | 6,54  |
| Total                     | \$172,389 | \$160,558 | \$420,427 | \$54,806 | \$97,323 | \$63,850 | \$23,290 | \$- | \$992 |

|   |      |   |      |   |      |   |      |   |      |   |      |   |      |   |   |      |
|---|------|---|------|---|------|---|------|---|------|---|------|---|------|---|---|------|
| Ratio of allowance for loan losses to total loans | 1.92 | % | 0.75 | % | 1.04 | % | 2.92 | % | 0.85 | % | 1.49 | % | 3.34 | % | - | 1.33 |
|---|------|---|------|---|------|---|------|---|------|---|------|---|------|---|---|------|

|  |     |   |    |   |    |    |   |     |   |    |   |     |   |    |     |
|--|-----|---|----|---|----|----|---|-----|---|----|---|-----|---|----|-----|
| Allowance for loan losses to non-accrual loans | 105 | % | 56 | % | NM | 53 | % | 142 | % | 68 | % | 188 | % | NM | 123 |
|--|-----|---|----|---|----|----|---|-----|---|----|---|-----|---|----|-----|

As of December 31, 2010:

|  |         |         |         |         |       |       |       |       |        |
|--|---------|---------|---------|---------|-------|-------|-------|-------|--------|
| Ending ALLL related to loans collectively evaluated for impairment | \$2,447 | \$1,037 | \$4,134 | \$1,691 | \$618 | \$645 | \$545 | \$197 | \$11,3 |
|--|---------|---------|---------|---------|-------|-------|-------|-------|--------|

|  |       |     |     |     |      |      |       |     |        |
|--|-------|-----|-----|-----|------|------|-------|-----|--------|
| Ending ALLL related to loans individually evaluated for impairment | \$667 | \$- | \$- | \$3 | \$25 | \$93 | \$290 | \$- | \$1,07 |
|--|-------|-----|-----|-----|------|------|-------|-----|--------|

Loans outstanding:

|                                       |           |           |           |          |          |          |          |     |       |
|---------------------------------------|-----------|-----------|-----------|----------|----------|----------|----------|-----|-------|
| Collectively evaluated for impairment | \$151,351 | \$141,957 | \$383,553 | \$68,322 | \$86,673 | \$69,843 | \$25,592 | \$- | \$927 |
|---------------------------------------|-----------|-----------|-----------|----------|----------|----------|----------|-----|-------|

|                                       |       |     |   |       |     |     |       |   |      |
|---------------------------------------|-------|-----|---|-------|-----|-----|-------|---|------|
| Individually evaluated for impairment | 2,485 | 633 | - | 9,297 | 259 | 148 | 1,287 | - | 14,1 |
|---------------------------------------|-------|-----|---|-------|-----|-----|-------|---|------|

|       |           |           |           |          |          |          |          |     |       |
|-------|-----------|-----------|-----------|----------|----------|----------|----------|-----|-------|
| Total | \$153,836 | \$142,590 | \$383,553 | \$77,619 | \$86,932 | \$69,991 | \$26,879 | \$- | \$941 |
|-------|-----------|-----------|-----------|----------|----------|----------|----------|-----|-------|

|   |      |   |      |   |      |   |      |   |      |   |      |   |      |   |   |      |
|---|------|---|------|---|------|---|------|---|------|---|------|---|------|---|---|------|
| Ratio of allowance for loan losses to total loans | 2.02 | % | 0.73 | % | 1.08 | % | 2.18 | % | 0.74 | % | 1.05 | % | 3.11 | % | - | 1.32 |
|---|------|---|------|---|------|---|------|---|------|---|------|---|------|---|---|------|

|  |     |   |     |   |    |    |   |    |     |   |     |   |   |    |
|--|-----|---|-----|---|----|----|---|----|-----|---|-----|---|---|----|
| Allowance for loan losses to non-accrual loans | 125 | % | 164 | % | NM | 18 | % | NM | 499 | % | 231 | % | - | 96 |
|--|-----|---|-----|---|----|----|---|----|-----|---|-----|---|---|----|

1. Total excludes \$2.6 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.

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Activity in the allowance for loan losses for the three months and nine months ended September 30, 2010 follows:

| (Dollars in thousands; unaudited)                                   | Three months ended<br>September 30, 2010 | Nine months ended<br>September 30, 2010 |
|---|--|---|
| Allowance for loan losses:  |  |   |
| Beginning balance   | \$ 11,773                                | \$ 10,618                               |
| Provision   | 1,400                                    | 4,300                                   |
| Charge-offs   | (1,159 )                                 | (2,947 )                                |
| Recoveries  | 9  | 52                                      |
| Ending balance  | \$ 12,023                                | \$ 12,023                               |
| Average recorded investment in impaired loans during the period     |  |   |
|   | \$ 12,219                                | \$ 12,142                               |
| At September 30, 2010   |  |   |
| Total loans outstanding, before deducting allowance for loan losses |  | \$ 938,134                              |
| Ratio of allowance for loan losses to total loans                   |  | 1.28 %                                  |
| Allowance for loan losses to non-accrual loans                      |  | 113.33 %                                |
| Non-accrual loans to total loans                                    |  | 1.13 %                                  |

#### Purchased Credit-Impaired Loans

We evaluated loans purchased in the Acquisition 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 in the Acquisition 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), if at the acquisition date the borrower had revolving privileges, 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 elect 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 as described in the guidance for accounting for loan origination fees and costs that is included in FASB ASC 310-20 (formerly FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases).

The following table presents the fair value of loans pursuant to accounting standards for purchased credit-impaired loans and other purchased loans as of the acquisition date:

| (Dollars in thousands; unaudited) | February 18, 2011                     |                             | Total |
|-----------------------------------|---------------------------------------|-----------------------------|-------|
|                                   | Purchased<br>credit-impaired<br>loans | Other<br>purchased<br>loans |       |
|                                   |                                       |                             |       |

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|  |           |                        |           |
|--|-----------|------------------------|-----------|
| Contractually required payments including interest | \$24,316  | \$69,702               | \$94,018  |
| Less: nonaccretable difference                     | (13,044 ) | ---                    | (13,044 ) |
| Cash flows expected to be collected (undiscounted) | 11,272    | 69,702                 | 80,974    |
| Accretable yield                                   | (1,902 )  | (17,307 ) <sup>1</sup> | (19,209 ) |
| Fair value of purchased loans                      | \$9,370   | \$52,395               | \$61,765  |

<sup>1</sup> \$5.8 million of the \$17.3 million represents the difference between the contractual principal amounts due and the fair value. This discount is to be accreted to interest income over the remaining lives of the loans. The remaining \$11.5 million is the contractual interest to be earned over the life of the loans.

For the PCI loans, the accretable yield initially represents the excess of the cash flows expected to be collected at acquisition over the fair value of the loans at the acquisition date, and is accreted into interest income over the estimated remaining life of the purchased credit-impaired loans using the effective yield method, provided that the timing and amount of future cash flows is reasonably estimable. The accretable yield is affected by:

- (1) Changes in interest rate indices for variable rate loans – Expected future cash flows are based on the variable rates in effect at the time of the regular evaluations of cash flows expected to be collected;
- (2) Changes in prepayment assumptions – Prepayments affect the estimated life of the loans which may change the amount of interest income, and possibly principal, expected to be collected;
- (3) Changes in the expected principal and interest payments over the estimated life – Updates to expected cash flows are driven by the credit outlook and actions taken with borrowers. Changes in expected future cash flows from loan modifications are included in the regular evaluations of cash flows expected to be collected.

When the timing and/or amounts of expected cash flows on such loans are not reasonably estimable, no interest is accreted and the loan is reported as a nonperforming loan; otherwise, if the timing and amounts of expected cash flows for purchased credit-impaired loans are reasonably estimable, then interest is accreted and the loans are reported as performing loans. The initial estimated cash flows expected to be collected are updated each quarter based on current assumptions regarding default rates, loss severities, and other factors that are reflective of current market conditions. Probable decreases in expected cash flows after acquisition result in the recognition of impairment, which would be recorded as a specific allowance for loan losses or a charge-off to the allowance. Probable and significant increases in expected cash flows would first reverse any related allowance for loan losses and any remaining increases would be recognized prospectively as interest income over the estimated remaining lives of the loans. The impact of changes in variable interest rates is recognized prospectively as adjustments to interest income.

The non-accretable difference represents the difference between the undiscounted contractual cash flows and the undiscounted expected cash flows, and also reflects the estimated credit losses in the acquired loan portfolio at the acquisition date and can fluctuate due to changes in expected cash flows during the life of the PCI loans.

The following table reflects the outstanding balance and related carrying value of PCI loans as of the acquisition date (February 18, 2011) and September 30, 2011:

| PCI Loans<br>(Dollars in thousands; unaudited) | February 18, 2011              |                   | September 30, 2011             |                   |
|--|--------------------------------|-------------------|--------------------------------|-------------------|
|  | Unpaid<br>principal<br>balance | Carrying<br>value | Unpaid<br>principal<br>balance | Carrying<br>value |
| Commercial                                     | \$10,860                       | \$3,706           | \$4,473                        | \$1,631           |
| Commercial real estate                         | 10,139                         | 5,664             | 9,685                          | 4,917             |
| <b>Total purchased credit-impaired loans</b>   | <b>\$20,999</b>                | <b>\$9,370</b>    | <b>\$14,158</b>                | <b>\$6,548</b>    |

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

| Accretable Yield<br>(Dollars in thousands, unaudited) | Three<br>months<br>ended | Three<br>months<br>ended | Nine<br>months<br>ended |
|---|--------------------------|--------------------------|-------------------------|
|   | September<br>30, 2011    | June 30,<br>2011         | September<br>30, 2011   |
| Balance at beginning of period                        | \$3,367                  | \$1,787                  | \$---                   |

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|  |         |         |         |
|--|---------|---------|---------|
| Additions  | ---     | ---     | 1,902   |
| Removals 1   | (323 )  | (6 )    | (368 )  |
| Accretion  | (412 )  | (291 )  | (779 )  |
| Reclassifications (to)/from nonaccretable difference 2 | 1,533   | 1,877   | 3,410   |
| Balance at end of period                               | \$4,165 | \$3,367 | \$4,165 |

1 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.

2 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 equal to the amount of our line of credit, which totaled \$247.0 million and \$241.1 million at September 30, 2011 and December 31, 2010, respectively. In addition, we pledge a certain residential loan portfolio, which totaled \$42.5 million and \$40.0 million at September 30, 2011 and December 31, 2010, respectively, to secure our borrowing capacity with the Federal Reserve Bank (“FRB”). Also see Note 8 below.

## Note 7: Intangible Assets

The table below reflects our identifiable intangible asset arising from the Acquisition and accumulated amortization at September 30, 2011.

| (in thousands; unaudited) | September 30, 2011    |                          |                     |
|---------------------------|-----------------------|--------------------------|---------------------|
|                           | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Core deposit intangible   | \$ 725                | \$ (30 )                 | \$ 695              |

The core deposit intangible is being amortized on a straight-line basis over fifteen years and the estimated amortization expense is \$42 thousand for the year ending December 31, 2011, \$48 thousand each year ending December 31, 2012 through 2015 and \$491 thousand thereafter.

## Note 8: Borrowings

**Federal Funds Purchased** – We have unsecured lines of credit totaling \$77.0 million with correspondent banks for overnight borrowings. In general, interest rates on these lines approximate the Federal funds target rate. At September 30, 2011 and December 31, 2010, we had no overnight borrowings outstanding under these credit facilities.

**Federal Home Loan Bank Borrowings** – As of September 30, 2011 and December 31, 2010, we had lines of credit with the FHLB totaling \$246.9 million and \$219.2 million, respectively, based on eligible collateral of certain loans. At September 30, 2011 and December 31, 2010, we had no FHLB overnight borrowings.

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 September 30, 2011. Interest-only payments are required every three months until maturity. Although the entire principal is due on February 5, 2018, the FHLB has the unconditional right to accelerate the due date on November 5, 2011 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.

On December 16, 2008, we entered into a five-year borrowing agreement under the FHLB line of credit for \$20.0 million at a fixed rate of 2.54%. On September 19, 2011, we prepaid the \$20.0 million borrowing to reduce our excess liquidity that resulted from strong deposit growth. The prepayment penalty of \$924 thousand was recorded as interest expense on the consolidated statement of income.

On January 23, 2009, we entered into a three-year borrowing agreement under the FHLB line of credit for \$20.0 million at a fixed rate of 2.29%, which remained outstanding at September 30, 2011. Interest-only payments are required every month until maturity.

At September 30, 2011, \$211.9 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 September 30, 2011 and December 31, 2010, we had borrowing capacity under this line totaling \$42.5 and \$40.2 million, respectively, and had no outstanding borrowings with the FRB.

Subordinated Debt – On September 17, 2004 we issued a 15-year, \$5.0 million subordinated debenture through a pooled trust preferred program. Interest-only payments are paid quarterly until maturity on September 17, 2019. We have the right to redeem the debenture, in whole or in part, at the redemption price at principal amounts in multiples of \$1.0 million on any interest payment date. The interest rate on the debenture changes quarterly at the three-month LIBOR plus 2.48%. The rate at September 30, 2011 was 2.83%. The debenture is subordinated to the claims of depositors and our other creditors.

#### Note 9: Stockholders' Equity

##### Preferred Stock

Pursuant to the U.S. Treasury Capital Purchase Program (the “TCPP”), 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 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 allows 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. The warrant remains outstanding, and was subsequently adjusted for cash dividend increases to represent a right to purchase 154,773 shares of common stock at \$27.14 per share 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 stockholders, recorded as a reduction of retained earnings.

| (in thousands except per share data, unaudited) | Three months ended |               |                    | Nine months ended  |                    |
|---|--------------------|---------------|--------------------|--------------------|--------------------|
|   | September 30, 2011 | June 30, 2011 | September 30, 2010 | September 30, 2011 | September 30, 2010 |
| Cash dividends to common stockholders           | \$852              | \$851         | \$789              | \$2,550            | \$2,361            |
| Cash dividends per common share                 | \$0.16             | \$0.16        | \$0.15             | \$0.48             | \$0.45             |

##### 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 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 non-vested 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 non-vested 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 increase to common stock with a corresponding decrease in current taxes payable.

Note 10: 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 statement of condition was \$264.7 million at September 30, 2011 at rates ranging from 1.91% to 18.00%. This amount included \$148.4 million under commercial lines of credit (these commitments are contingent upon customers maintaining specific credit standards), \$77.0 million under revolving home equity lines, \$17.0 million under undisbursed construction loans, \$13.0 million under standby letters of credit, and a remaining \$9.3 million under personal and other lines of credit. We have set aside an allowance for losses in the amount of \$529 thousand for these commitments as of September 30, 2011, which is recorded in interest payable and other liabilities.

Operating Leases

We rent certain premises and equipment under long-term non-cancelable operating leases expiring at various dates through the year 2024. Commitments under these leases approximate \$655 thousand, \$2.7 million, \$2.7 million, \$2.5 million and \$2.6 million for 2011 (October through December), 2012, 2013, 2014, and 2015 respectively, and \$16.8 million for all years thereafter.

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. Also refer to Note 13 to the Consolidated Financial Statements of the Bancorp's 2010 Annual Report on Form 10-K.

Note 11: 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 balance sheet 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 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 balance sheet 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 September 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 results in an insignificant amount of hedge ineffectiveness recognized in interest income.

Our credit exposure, if any, on interest rate swaps is limited to the net favorable value (net of any collateral pledged) 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 are 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. The aggregate fair value of all derivative instruments that are in a liability position and have collateral requirements on September 30, 2011 is \$4.4 million, for which we have posted collateral in the form of securities available for sale totaling \$5.9 million.

As of September 30, 2011, we had six interest rate swap agreements, which are scheduled to mature in September 2018, April 2019, June 2020, August 2020, June 2022 and June 2031. 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 \$68 thousand as of September 30, 2011. Information on our derivatives follows:

| (in thousands; September 30,<br>2011 unaudited) | Asset derivatives     |                      | Liability derivatives |                      |
|---|-----------------------|----------------------|-----------------------|----------------------|
|   | September<br>30, 2011 | December<br>31, 2010 | September 30,<br>2011 | December 31,<br>2010 |
| Fair value hedges                               |                       |                      |                       |                      |
| Interest rate contracts notional amount         | ---                   | ---                  | \$ 26,697             | \$ 23,132            |
| Credit risk amount                              | ---                   | ---                  | ---                   | ---                  |
| Interest rate contracts fair value (1)          | ---                   | ---                  | 4,415                 | 2,470                |
| Balance sheet location                          | Other assets          | Other assets         | Other liabilities     | Other liabilities    |

| (in thousands; unaudited)   | Three months ended    |                  |                       |
|---|-----------------------|------------------|-----------------------|
|   | September<br>30, 2011 | June 30,<br>2011 | September<br>30, 2010 |
| Decrease in value of designated interest rate swaps recognized in interest income | \$(1,724 )            | \$(575 )         | \$(853 )              |
| Payment on interest rate swaps recorded in interest income                        | (280 )                | (248 )           | (225 )                |

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|  |         |         |         |
|--|---------|---------|---------|
| Increase in value of hedged loans recognized in interest income                                | 1,776   | 375     | 561     |
| (Decrease) increase in value of yield maintenance agreement recognized against interest income | (75 )   | 169     | 303     |
| Net loss on derivatives recognized in interest income (2)                                      | \$(303) | \$(279) | \$(214) |

| (in thousands; unaudited)   | Nine months ended  |                    |
|---|--------------------|--------------------|
|   | September 30, 2011 | September 30, 2010 |
| Decrease in value of designated interest rate swaps recognized in interest income   | \$ (1,945 )        | \$ (1,980 )        |
| Payment on interest rate swaps recorded in interest income                          | (765 )             | (648 )             |
| Increase in value of hedged loans recognized in interest income                     | 1,812              | 1,715              |
| Increase in value of yield maintenance agreement recognized against interest income | 56                 | 294                |
| Net loss on derivatives recognized in interest income (2)                           | \$ (842)           | \$ (619)           |

(1) See Note 4 for valuation methodology.

(2) Ineffectiveness of (\$23) thousand, (\$31) thousand, and \$11 thousand was recorded in interest income during the three months ended September 30, 2011, June 30, 2011 and September 30, 2010, respectively. Ineffectiveness of (\$77) thousand, and \$29 thousand was recorded in interest income during the nine months ended September 30, 2011 and September 30, 2010, respectively. The full change in value of swaps was included in the assessment of hedge effectiveness.



## 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 third quarter of 2011 compared to the third quarter of 2010 and to the prior quarter (second quarter of 2011), as well as the nine-month period ended September 30, 2011 compared to the same period in 2010. 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 2010 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, estimated fair values related to the assets acquired and liabilities assumed of the former Charter Oak Bank; general economic conditions; the current financial downturn in the U.S. and abroad; changes in interest rates, deposit flows, real estate values 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. These and other important factors are detailed in the Risk Factors section of this report and our 2010 Form 10-K as filed with the SEC, copies of which are available from us at no charge. 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.

### Executive Summary

Our third quarter 2011 earnings of \$4.2 million were up 26% from \$3.4 million in the third quarter of 2010 and 23% from \$3.4 million in the second quarter of 2011. Diluted earnings per share were \$0.79, up \$0.15 from the second quarter of 2011 and up \$0.16 from the same quarter a year ago. Earnings for the first nine months of 2011 totaled \$12.2 million, up 26%, from \$9.6 million in the same period a year ago. Year to date diluted earnings per share were \$2.26, up \$0.44 from \$1.82 for the same period a year ago.

Year-to-date 2011 results include the impact of the FDIC-assisted acquisition of certain assets and the assumption of certain liabilities of the former Charter Oak Bank on February 18, 2011 (the "Acquisition"). As discussed in Note 3, we acquired \$61.8 million of loans at fair value without loss share and assumed \$93.9 million of deposits at fair value. As

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part of the Acquisition, we also acquired \$44.0 million cash and equivalents, including cash received from the FDIC upon settlement, and recorded an \$85 thousand gain on bargain purchase, net of tax.

The increase in year-to-date earnings over the same period last year primarily reflects \$4.0 million in pre-tax earnings contributed by the Acquisition, as well as a reduction in cost of deposits. The increase was partially offset by the pre-payment penalty of \$924 thousand related to a \$20 million FHLB advance at 2.54%. The FHLB advance was paid off in a conscious effort to address excess liquidity.

Total loans reached \$992.6 million at September 30, 2011, representing an increase of \$51.2 million, or 5.4%, over December 31, 2010. This growth was significantly impacted by loans purchased as part of the Acquisition, partially offset by the successful resolution through payoffs of several high credit risk loans, as well as the prepayment of certain large credits in a low interest rate environment.

Non-performing loans decreased to \$10.7 million or 1.08% of our loans at September 30, 2011, from \$12.9 million, or 1.37% at December 31, 2010. PCI loans totaled \$6.5 million at September 30, 2011 (including loans totaling \$3.9 thousand that are accreting interest) compared to \$7.9 million as of June 30, 2011.

The provision for loan losses totaled \$500 thousand in the third quarter of 2011, representing a decrease of \$900 thousand from the same quarter a year ago, and down \$2.5 million from the second quarter of 2011. The provision for loan losses totaled \$4.6 million and \$4.3 million in the first nine months of 2011 and 2010, respectively. Net charge-offs in the third quarter of 2011 and 2010 both totaled \$1.2 million, compared to \$2.1 million in the prior quarter. The allowance for loan losses of \$13.2 million totaled 1.33% of loans at September 30, 2011, compared to 1.28% and 1.41% at September 30, 2010 and June, 2011, respectively. The decrease in the allowance for loan losses as a percentage of loans from the prior quarter primarily reflects third quarter charge-offs of loans with previously established specific reserves.

Total deposits grew \$160.8 million, or 15.8%, over December 31, 2010 to \$1.2 billion. The higher level of deposits reflects growth in most deposit categories, except for CDARS® time deposits, which decreased \$34.7 million. Demand deposits comprised 31.8% of total deposits at September 30, 2011, compared to 27.8% at December 31, 2010.

The tax-equivalent net interest margin was 4.76% in the third quarter of 2011, compared to 5.51% in the second quarter of 2011 and 4.88% in the same quarter last year. The pre-payment penalty on the FHLB advance reduced the net interest margin by 28 basis points in the third quarter of 2011. In addition, a lower level of gains on PCI loan payoffs, a lower level of accretion on acquired loans, as well as a higher level of liquidity contributed to the decline. The tax equivalent net interest margin was 5.25% and 4.96% in the first nine months of 2011 and 2010, respectively.

Non-interest income in the third quarter of 2011 totaled \$1.6 million compared to \$1.3 million from the same period last year and remained relatively unchanged from the prior quarter. Non-interest income for the first nine months of 2011 totaled \$4.7 million, an increase of \$584 thousand, or 14% from the first nine months of 2010. The increases from the three-and nine-month periods ended September 30, 2011 relate to higher Wealth Management and Trust Services fees and higher debit card interchange fees.

Non-interest expense totaled \$9.4 million in the third quarter of 2011, an increase of \$914 thousand, or 10.7%, from the same quarter a year ago. The increase primarily reflects higher personnel costs and higher occupancy and equipment cost associated with branch expansion, as well as data processing costs associated with the Acquisition. Non-interest expense decreased of \$577 thousand, or 5.8%, from the prior quarter due to the absence of one-time Acquisition related third-party costs, which totaled \$642 thousand in the prior quarter. Non-interest expense totaled \$28.5 million and \$25.3 million in the first nine months of 2011 and 2010, respectively, representing a 12.8% increase. The increases primarily reflect higher personnel costs associated with branch expansion, as well as one time Acquisition related third-party costs of approximately \$1.0 million, partially offset by lower FDIC insurance expense due to a change in the FDIC assessment base.

## 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 net charge-offs. 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 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 identified 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 determined 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, 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 historical charge-off history. Allowances for changing environmental factors are Management's best estimate of the probable impact these changes have had 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

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 and 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 included in the estimated cash flows. The initial estimate of cash flows to be collected was derived from assumptions such as default rates and loss severities.

In conjunction with the Acquisition, 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 judgment in determining which loans are PCI loans. Evidence of credit quality deterioration as of the purchase date may include statistics 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), if at the acquisition date the borrower had revolving privileges, are not considered PCI loans as 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 must apply judgment to develop our estimates of cash flows for PCI loans given the impact of real estate value changes, changing loss severities and prepayment speeds.

For purposes of accounting for the PCI loans purchased in the Acquisition, we elected not to apply the pooling method but to account for these loans individually. If we have probable decreases in cash flows expected to be collected (other than due to decreases in interest rate indices), we charge the provision for credit losses, resulting in an increase to the allowance for loan losses. Disposals of loans, which may include sales of loans to third parties, receipt of payments in full or part by the borrower, and foreclosure of the collateral, result in removal of the loan from the PCI loan portfolio at its carrying amount. 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.

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 nonperforming loans prior to Acquisition were no longer classified as nonperforming because, at Acquisition, we believed that we would fully collect the new carrying value of these loans. Subsequent to Acquisition, specific allowances are allocated to PCI loans that have experienced credit deterioration through an increase to the allowance for loan losses. When there is doubt as to the timing and amount of future cash flows to be collected, PCI are classified as non-performing loans. It is important to note that judgment is required to classify PCI loans as performing or non-performing, and is dependent on having a reasonable expectation about the timing and amount of cash flows expected to be collected.

For the acquired loans not considered PCI loans, we elect to 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 3 and 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, that the position will be sustained upon examination. For tax positions that meet the more-likely-than-not threshold, we may recognize only the largest amount of tax benefit that is greater than fifty percent likely of being realized upon ultimate settlement with the taxing authority. Management believes that all of our tax positions taken meet the more-likely-than-not recognition threshold. To the extent tax authorities disagree with these tax positions, our effective tax rates could be materially affected in the period of settlement with the taxing authorities.

### 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, derivatives, and loans held for sale, if any, 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 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 and minimize the use of unobservable 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 Consolidated Financial Statements in this Form 10-Q.

## RESULTS OF OPERATIONS

## Overview

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

| (dollars in thousands, except per share data; unaudited) | As of and for the three months ended |               |                    | As of and for the nine months ended |                    |  |
|--|--------------------------------------|---------------|--------------------|-------------------------------------|--------------------|--|
|  | September 30, 2011                   | June 30, 2011 | September 30, 2010 | September 30, 2011                  | September 30, 2010 |  |
| For the period:  |                                      |               |                    |                                     |                    |  |
| Net income   | \$4,233                              | \$3,439       | \$3,359            | \$12,181                            | \$9,644            |  |
| Net income per share                                     |                                      |               |                    |                                     |                    |  |
| Basic  | \$0.80                               | \$0.65        | \$0.64             | \$2.30                              | \$1.84             |  |
| Diluted  | \$0.79                               | \$0.64        | \$0.63             | \$2.26                              | \$1.82             |  |
| Return on average equity                                 | 12.78 %                              | 10.78 %       | 11.32 %            | 12.74 %                             | 11.27 %            |  |
| Return on average assets                                 | 1.23 %                               | 1.04 %        | 1.10 %             | 1.24 %                              | 1.10 %             |  |
| Common stock dividend payout ratio                       | 20.00 %                              | 24.62 %       | 23.44 %            | 20.87 %                             | 24.46 %            |  |
| Efficiency ratio   | 56.13 %                              | 53.80 %       | 55.70 %            | 54.02 %                             | 56.25 %            |  |
| At period end:   |                                      |               |                    |                                     |                    |  |
| Book value per common share                              | \$24.95                              | \$24.25       | \$22.56            | \$24.95                             | \$22.56            |  |
| Total assets   | \$1,362,717                          | \$1,337,393   | \$1,219,214        | \$1,362,717                         | \$1,219,214        |  |
| Total loans  | \$992,643                            | \$986,634     | \$938,134          | \$992,643                           | \$938,134          |  |
| Total deposits   | \$1,176,525                          | \$1,138,906   | \$1,023,278        | \$1,176,525                         | \$1,023,778        |  |
| Loan-to-deposit ratio                                    | 84.4 %                               | 86.6 %        | 91.7 %             | 84.4 %                              | 91.7 %             |  |

## 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 interest-earning assets with interest expense and 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.

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Average Statements of Condition and Analysis of Net Interest Income

|   | Three months ended<br>September 30, 2011 |                                |                | Three months ended<br>June 30, 2011 |                                |                | Three months ended<br>September 30, 2010 |                                |                |
|---|--|--------------------------------|----------------|-------------------------------------|--------------------------------|----------------|--|--------------------------------|----------------|
|   | Average<br>Balance                       | Interest<br>Income/<br>Expense | Yield/<br>Rate | Average<br>Balance                  | Interest<br>Income/<br>Expense | Yield/<br>Rate | Average<br>Balance                       | Interest<br>Income/<br>Expense | Yield/<br>Rate |
| (Dollars in thousands; unaudited)                   |  |                                |                |                                     |                                |                |  |                                |                |
| <b>Assets</b>                                       |  |                                |                |                                     |                                |                |  |                                |                |
| Interest-bearing due from banks (1)                 | \$94,153                                 | \$56                           | 0.23%          | \$89,952                            | \$56                           | 0.25%          | \$65,461                                 | \$48                           | 0.29%          |
| Investment securities                               |  |                                |                |                                     |                                |                |  |                                |                |
| U.S. Government agencies (2)                        | 142,459                                  | 1,153                          | 3.24%          | 117,057                             | 745                            | 2.55%          | 94,255                                   | 829                            | 3.52%          |
| Corporate CMOs and other (2)                        | 18,053                                   | 151                            | 3.35%          | 16,401                              | 171                            | 4.17%          | 12,333                                   | 144                            | 4.67%          |
| Obligations of state and political subdivisions (3) | 35,064                                   | 449                            | 5.12%          | 34,986                              | 460                            | 5.26%          | 30,068                                   | 431                            | 5.73%          |
| Loans and banker's acceptances (1) (3) (4)          | 982,165                                  | 15,676                         | 6.25%          | 979,550                             | 16,955                         | 6.85%          | 935,116                                  | 14,374                         | 6.01%          |
| <b>Total interest-earning assets (1)</b>            | <b>1,271,894</b>                         | <b>17,485</b>                  | <b>5.38%</b>   | <b>1,237,946</b>                    | <b>18,387</b>                  | <b>5.88%</b>   | <b>1,137,233</b>                         | <b>15,826</b>                  | <b>5.45%</b>   |
| Cash and non-interest-bearing due from banks        | 46,799                                   |                                |                | 45,133                              |                                |                | 34,464                                   |                                |                |
| Bank premises and equipment, net                    | 9,484                                    |                                |                | 8,971                               |                                |                | 8,524                                    |                                |                |
| Interest receivable and other assets, net           | 32,825                                   |                                |                | 38,391                              |                                |                | 32,056                                   |                                |                |
| <b>Total assets</b>                                 | <b>\$1,361,002</b>                       |                                |                | <b>\$1,330,441</b>                  |                                |                | <b>\$1,212,277</b>                       |                                |                |
| <b>Liabilities and Stockholders' Equity</b>         |  |                                |                |                                     |                                |                |  |                                |                |
| Interest-bearing transaction accounts               | \$129,862                                | \$35                           | 0.11%          | \$127,544                           | \$48                           | 0.15%          | \$102,982                                | \$32                           | 0.12%          |
| Savings accounts                                    | 72,288                                   | 21                             | 0.12%          | 69,357                              | 25                             | 0.14%          | 52,091                                   | 27                             | 0.21%          |
| Money market accounts                               | 413,186                                  | 326                            | 0.31%          | 395,159                             | 341                            | 0.35%          | 388,549                                  | 602                            | 0.61%          |
| CDARS® time accounts                                | 32,139                                   | 50                             | 0.62%          | 31,879                              | 48                             | 0.60%          | 78,318                                   | 221                            | 1.12%          |
| Other time accounts                                 | 150,199                                  | 305                            | 0.81%          | 156,008                             | 315                            | 0.81%          | 130,276                                  | 391                            | 1.19%          |
| FHLB fixed-rate advances                            | 52,391                                   | 1,232                          | 9.33%          | 55,000                              | 320                            | 2.33%          | 55,000                                   | 323                            | 2.33%          |
| Subordinated debenture (1)                          | 5,000                                    | 36                             | 2.82%          | 5,000                               | 37                             | 2.93%          | 5,000                                    | 40                             | 3.13%          |
|   | 855,065                                  | 2,005                          | 0.93%          | 839,947                             | 1,134                          | 0.54%          | 812,216                                  | 1,636                          | 0.80%          |

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|   |              |        |              |        |              |        |  |
|---|--------------|--------|--------------|--------|--------------|--------|--|
| Total interest-bearing liabilities            |              |        |              |        |              |        |  |
| Demand accounts                               | 364,502      |        | 346,469      |        | 271,591      |        |  |
| Interest payable and other liabilities        | 10,035       |        | 16,062       |        | 10,744       |        |  |
| Stockholders' equity                          | 131,400      |        | 127,963      |        | 117,726      |        |  |
| Total liabilities & stockholders' equity      | \$ 1,361,002 |        | \$ 1,330,441 |        | \$ 1,212,277 |        |  |
| Tax-equivalent net interest income/margin (1) | \$ 15,480    | 4.76 % | \$ 17,253    | 5.51 % | \$ 14,190    | 4.88 % |  |
| Reported net interest income/margin (1)       | \$ 15,220    | 4.68 % | \$ 17,003    | 5.43 % | \$ 13,965    | 4.81 % |  |
| Tax-equivalent net interest rate spread       |              | 4.45 % |              | 5.34 % |              | 4.65 % |  |

| (Dollars in thousands; unaudited)                   | Nine months ended September 30, 2011 |                  |        | Nine months ended September 30, 2010 |                  |        |
|---|--------------------------------------|------------------|--------|--------------------------------------|------------------|--------|
|   | Average                              | Interest Income/ | Yield/ | Average                              | Interest Income/ | Yield/ |
|   | Balance                              | Expense          | Rate   | Balance                              | Expense          | Rate   |
| <b>Assets</b>                                       |                                      |                  |        |                                      |                  |        |
| Interest-bearing due from banks (1)                 | \$ 81,609                            | \$ 152           | 0.25 % | \$ 37,292                            | \$ 96            | 0.34 % |
| Federal funds sold                                  | 86                                   | ---              | 0.01 % | 4,076                                | 2                | 0.06 % |
| <b>Investment securities</b>                        |                                      |                  |        |                                      |                  |        |
| U.S. Government agencies (2)                        | 117,413                              | 2,631            | 2.99 % | 90,507                               | 2,442            | 3.60 % |
| Corporate CMOs and other (2)                        | 16,783                               | 433              | 3.44 % | 13,017                               | 452              | 4.63 % |
| Obligations of state and political subdivisions (3) | 34,984                               | 1,370            | 5.22 % | 30,265                               | 1,298            | 5.98 % |
| Loans and banker's acceptances (1) (3) (4)          | 975,548                              | 48,621           | 6.57 % | 928,807                              | 42,358           | 5.49 % |
| Total interest-earning assets (1)                   | 1,226,423                            | 53,207           | 5.72 % | 1,103,964                            | 46,648           | 5.57 % |
| <b>Cash and non-interest-bearing due from banks</b> |                                      |                  |        |                                      |                  |        |
|   | 44,684                               |                  |        | 33,648                               |                  |        |
| Bank premises and equipment, net                    | 8,977                                |                  |        | 8,167                                |                  |        |
| Interest receivable and other assets, net           | 34,136                               |                  |        | 30,964                               |                  |        |
| Total assets  | \$ 1,314,220                         |                  |        | \$ 1,176,743                         |                  |        |
| <b>Liabilities and Stockholders' Equity</b>         |                                      |                  |        |                                      |                  |        |
| Interest-bearing transaction accounts               | \$ 123,436                           | \$ 121           | 0.13 % | \$ 96,837                            | \$ 81            | 0.11 % |
| Savings accounts                                    | 67,963                               | 75               | 0.15 % | 50,551                               | 79               | 0.21 % |

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|  |              |           |        |              |           |        |
|--|--------------|-----------|--------|--------------|-----------|--------|
| Money market accounts                      | 396,626      | 1,004     | 0.34 % | 394,084      | 2,128     | 0.72 % |
| CDARS® time accounts                       | 39,402       | 192       | 0.65 % | 71,762       | 663       | 1.24 % |
| Other time accounts                        | 151,612      | 978       | 0.86 % | 122,126      | 1,122     | 1.23 % |
| FHLB borrowings                            | 54,683       | 1,868     | 4.57 % | 55,000       | 958       | 2.33 % |
| Subordinated debenture                     |              |           |        |              |           |        |
| (1)  | 5,000        | 109       | 2.87 % | 5,000        | 112       | 2.95 % |
| Total interest-bearing liabilities         | 838,722      | 4,347     | 0.69 % | 795,360      | 5,143     | 0.86 % |
| Demand accounts                            | 334,747      |           |        | 257,736      |           |        |
| Interest payable and other liabilities     | 12,904       |           |        | 9,208        |           |        |
| Stockholders' equity                       | 127,847      |           |        | 114,439      |           |        |
| Total liabilities & stockholders' equity   | \$ 1,314,220 |           |        | \$ 1,176,743 |           |        |
| Tax-equivalent net interest income /margin |              |           |        |              |           |        |
| (1)  |              | \$ 48,860 | 5.25 % |              | \$ 41,505 | 4.96 % |
| Reported net interest income/margin (1)    |              | \$ 48,101 | 5.17 % |              | \$ 40,850 | 4.88 % |
| Tax-equivalent net interest rate spread    |              |           | 5.03 % |              |           | 4.71 % |

(1) 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.

(2) 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.

(3) 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.

(4) 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.

### Third Quarter of 2011 Compared to Third Quarter of 2010

The tax-equivalent net interest margin was 4.76% in the third quarter of 2011, compared to 4.88% in the same quarter last year. The decrease in the net interest margin primarily reflects a \$924 thousand pre-payment penalty on an FHLB advance (twenty-eight basis points impact), lower yields on investment securities and a higher level of liquidity, partially offset by the acquisition of loans from the former Charter Oak Bank and a reduction in the cost of deposits. The net interest spread decreased twenty basis points over the same period for the same reasons.

In the third quarter of 2011, two PCI loans paid off early where the payoff amounts exceeded the recorded investment by \$448 thousand, which favorably impacted our net interest margin by fourteen basis points. Accretion on the acquired non-PCI loans contributed twelve basis points to the net interest margin in the third quarter of 2011.

Total average interest-earning assets increased \$134.7 million, or 11.8%, in the third quarter of 2011, compared to the third quarter of 2010. The increase primarily relates to an increase of \$58.9 million in average investment securities, \$47.0 million in average loans (mainly due to the Acquisition), and an increase of \$28.7 million in interest-bearing due from banks.

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. 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 September 30, 2011.

The average yield on interest-earning assets decreased seven basis points in the third quarter of 2011 compared to the third quarter of 2010. The yield on the loan portfolio, which comprised 77.2% and 82.2% of average interest-earning assets in the quarters ended September 30, 2011 and 2010, respectively, increased twenty-four basis points from the third quarter of 2010. The increase primarily reflects the effect of early payoffs on PCI loans discussed above, as well as the accretion on the acquired non-PCI loans. The decrease in yields on investment securities is mainly due to lower yields on recently purchased securities in this low interest rate environment and acceleration of the amortization of premiums on Corporate CMO securities. In addition, we have experienced a shift in the relative composition of interest-earnings assets from higher-yielding loans to lower-yielding liquid assets.

The average balance of interest-bearing liabilities increased \$42.8 million, or 5.3%, in the third quarter of 2011 compared to the same period a year ago, primarily due to \$40.8 million of average interest-bearing deposit accounts related to the Acquisition. The increase in average interest-bearing deposits reflects increases of \$26.9 million in interest-bearing transaction accounts, \$24.6 million in money market accounts, and \$20.2 million in savings accounts, partially offset by a decrease of \$26.3 million in time deposits (including CDARS®).

The rate on interest-bearing liabilities increased thirteen basis points in the third quarter of 2011 compared to the same quarter a year ago, primarily due to a \$924 thousand pre-payment penalty on an FHLB advance, partially offset by lower deposit rates. The mix of deposits reflects a shift towards demand accounts from money market and time accounts, which also contributed to our lower cost of deposits compared to the same quarter a year ago. The rates on CDARS® time deposits, other time deposits, money market accounts, and savings accounts decreased fifty basis points, thirty-eight basis points, thirty basis points and nine basis points, respectively, compared to the same quarter a year ago as offering rates were lowered and time deposits repriced downward.

### Third Quarter of 2011 Compared to Second Quarter of 2011

The tax equivalent net interest margin decreased seventy-five basis points from the prior quarter. The decrease in the net interest margin reflects the \$924 thousand pre-payment penalty on an FHLB advance, the effect of fewer early payoffs on PCI loans, the impact of a lower level of accretion on the acquired non-PCI loans, as well as a higher level

of liquidity. The net interest spread decreased eighty-nine basis points compared to the last quarter for the same reasons.

The early payoffs on PCI loans (discussed above) favorably impacted our net interest margin by fourteen basis points in the third quarter of 2011, compared to thirty-nine basis points in the second quarter of 2011. Accretion on the acquired non-PCI loans contributed twelve basis points and twenty-eight basis points to the net interest margin in the third and second quarter of 2011, respectively. The level of accretion is expected to continue to decline.

Total average interest-earning assets increased \$33.9 million, or 2.7%, in the third quarter of 2011 compared to the prior quarter, reflecting increases of \$27.1 million in average investment securities and \$4.2 million in interest-bearing due from banks.

The average yield on interest-earning assets decreased fifty basis points in the third quarter of 2011 compared to the prior quarter. The loan portfolio as a percentage of average interest earning assets, declined to 77.2% at September 30, 2011, from 79.1% at June 30, 2011, due to a change in the mix of interest-earning assets, reflecting a higher level of liquid assets due to strong deposit growth, as well as the de-emphasis of the construction loan portfolio. Soft loan demand and intense competition for quality loans also put pressure on loan growth. The yields on loans decreased sixty basis points from the prior quarter, primarily reflecting the effect of fewer early payoffs on PCI loans and the impact of a lower level of accretion on the acquired non-PCI loans, discussed above. The decrease in yield is also attributable to the downward pricing pressure on loans. The decrease in yields on investment securities is mainly due to lower yields on recently purchased securities in this low interest rate environment.

The average balance of interest-bearing liabilities increased \$15.1 million, or 1.8%, in the third quarter of 2011 compared to the prior quarter. The increase in interest-bearing liabilities primarily reflects increases of \$18.0 million in money market accounts, \$2.9 million in savings accounts, and \$2.3 million in interest-bearing transaction accounts, partially offset by a decrease of \$5.5 million in time deposits (including CDARS®). Average FHLB borrowings decreased \$2.6 million due to the early pay-off of a \$20 million FHLB fixed-rate advance at 2.54% on September 19, 2011. The prepayment penalty of \$924 thousand reduced the net interest margin by twenty-eight basis points for the third quarter of 2011.

The mix of deposits reflects a shift from time deposits (including CDARS®) to demand and money market accounts. The overall rate on interest-bearing liabilities increased thirty-nine basis points in the third quarter of 2011, compared to the prior quarter, primarily due to the \$924 thousand pre-payment penalty on the FHLB advance. This increase is partially offset by a slightly lower rate on the subordinated debenture and lower offering rates on interest-bearing transaction accounts and savings accounts.

#### Nine Months 2011 Compared to Nine Months 2010

The tax-equivalent net interest margin increased to 5.25% in the first nine months of 2011, up twenty-nine basis points from the first nine months of 2010. The increase in the net interest margin primarily reflects accretion on the acquired non-PCI loans, gains on payoffs of PCI loans, and a reduction in the cost of deposits, partially offset by the pre-payment penalty on the FHLB advance discussed above.

Accretion on the acquired non-PCI loans contributed twenty-eight basis points to the year-to-date net interest margin. The early payoffs on five PCI loans (discussed above) favorably impacted our net interest margin by eighteen basis points in the first nine months of 2011.

Average interest-earning assets increased \$122.5 million, or 11.1%, in the first nine months of 2011 compared to the same period last year. The increase primarily relates to an increase of \$46.7 million in average loans (mainly due to the Acquisition), \$44.3 million in average interest-bearing due from banks and an increase of \$35.4 million of average investment securities, partially offset by a decrease of \$4.0 million in Federal funds sold.



The average yield on interest-earning assets increased fifteen basis points in the first nine months of 2011, compared to the same period a year ago. The increase is primarily due to a higher yield on loans, partially offset by the higher level of liquidity and a reduction in the yields on investment securities.

The yield on the loan portfolio, which comprised 79.5% and 84.1% of average earning assets in the nine months ended September 30, 2011 and 2010, respectively, increased 108 basis points in the first nine months of 2011, compared to the first nine months of 2010. The increase in yield primarily reflects the accretion on the acquired non-PCI loans as well as the early payoffs on PCI loans discussed above.

The decrease in yields on investment securities is mainly due to lower yields on recently purchased securities in this low interest rate environment and acceleration of the amortization of premiums on Corporate CMO securities. The yield on Corporate CMO's and other securities decreased 119 basis points in the first nine months of 2011 from the same period a year ago, the yield on obligations of state and political subdivisions decreased seventy-six basis points, and the yield on U.S. Government agency securities decreased sixty-one basis points.

The average balance of interest-bearing liabilities increased \$43.4 million, or 5.5%, in the first nine months of 2011 compared to the same period last year. The increase in interest-bearing liabilities primarily reflects increases of \$29.5 million in other time accounts, \$26.6 million in interest-bearing transaction accounts, \$17.4 million in savings accounts, and \$2.5 million in money market accounts, partially offset by decreases of \$32.4 million in CDARS® accounts. As the FDIC permanently increased the deposit insurance coverage limit and the public concern for safety and soundness of banks eased, it appears that the CDARS® time deposits are a less attractive deposit option. The mix of deposits reflects a shift towards demand accounts from money market and time accounts.

The overall rate on interest-bearing liabilities decreased seventeen basis points in the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010, primarily due to lower deposit rates on CDARS® time deposits, money market and other time accounts, a more favorable deposit mix, as well as a slightly lower rate on the subordinated debenture. This decrease is partially offset by the \$924 thousand pre-payment penalty on an FHLB advance discussed earlier.

#### 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 through the provision for loan losses charged to expense. For further discussion, see the section captioned "Critical Accounting Policies."

Our provision for loan losses totaled \$500 thousand in the third quarter of 2011, compared to \$3.0 million in the second quarter of 2011 and \$1.4 million in the third quarter of 2010, and totaled \$4.6 million and \$4.3 million for the first nine months of 2011 and 2010, respectively. The decrease to the provision for loan losses in the third quarter of 2011 compared to the prior quarter and the same quarter a year ago reflects fewer newly identified loans requiring specific reserves and a decrease in the construction loan portfolio, which is assigned a higher allowance factor.

The allowance for loan losses as a percentage of loans was 1.33% at September 30, 2011 compared to 1.41% at June 30, 2011 and 1.32% at December 31, 2010. The decrease in the allowance for loan losses as a percentage of loans from the prior quarter primarily reflects third-quarter charge-offs of loans with previously established specific reserves. The ratio of allowance for loan losses to non-accrual loans increased from 95.9% at December 31, 2010 to 123.1% at September 30, 2011, primarily due to a lower level of non-accrual loans, as well as a higher level of specific reserves on impaired loans. Impaired loan balances totaled \$18.6 million, \$10.2 million, and \$14.1 million at September 30, 2011, June 30, 2011 and December 31, 2010, respectively, with a specific valuation allowance of \$2.1 million, \$2.6 million and \$1.1 million, respectively.

Net charge-offs in the third quarter of 2011 totaled \$1.2 million and remained relatively unchanged from the same quarter a year ago, and declined from \$2.1 million in the prior quarter. The decrease in net charge-offs in the quarter ended September 30, 2011 compared to the prior quarter relates to fewer newly identified problem loans with collateral value shortfalls in the third quarter of 2011. Net charge-offs totaled \$3.7 million and \$2.9 million in the first nine months of 2011 and 2010, respectively. The increase in net charge-offs for the nine months ended September 30, 2011 compared to the first nine months of 2010 is related to write-offs of unsecured commercial loans, as well as

declines in the values of real estate collateral securing several problem loans. The percentage of net charge-offs to average loans was 0.12% in the third quarter of 2011, compared to 0.22% in the second quarter of 2011 and 0.12% in the third quarter of 2010, and totaled 0.38% and 0.31% in the nine-month periods ended September 30, 2011 and 2010, respectively.

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Non-interest Income

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

| (dollars in thousands; unaudited)       | Three months ended |               |                    | September 30, 2011 compared to June 30, 2011 |                             |                            | September 30, 2011 compared to September 30, 2010 |                            |                             |
|---|--------------------|---------------|--------------------|--|-----------------------------|----------------------------|---|----------------------------|-----------------------------|
|   | September 30, 2011 | June 30, 2011 | September 30, 2010 | Amount Increase (Decrease)                   | Percent Increase (Decrease) | Amount Increase (Decrease) | Percent Increase (Decrease)                       | Amount Increase (Decrease) | Percent Increase (Decrease) |
|   | September 30, 2011 | June 30, 2011 | September 30, 2010 | Amount Increase (Decrease)                   | Percent Increase (Decrease) | Amount Increase (Decrease) | Percent Increase (Decrease)                       | Amount Increase (Decrease) | Percent Increase (Decrease) |
| Service charges on deposit accounts     | \$478              | \$468         | \$ 446             | \$10   | 2.1 %                       | \$32                       | 7.2 %   |                            |                             |
| Wealth Management and Trust Services    | 486                | 469           | 364                | 17   | 3.6 %                       | 122                        | 33.5 %  |                            |                             |
| Other non-interest income               |                    |               |                    |  |                             |                            |   |                            |                             |
| Earnings on Bank-owned life insurance   | 193                | 193           | 172                | -  | 0.0 %                       | 21                         | 12.2 %  |                            |                             |
| Customer banking fees and other charges | 30                 | 27            | 37                 | 3  | 11.1 %                      | (7 )                       | (18.9 %)  |                            |                             |
| Debit card interchange fees             | 221                | 204           | 126                | 17   | 8.3 %                       | 95                         | 75.4 %  |                            |                             |
| Other income                            | 157                | 220           | 162                | (63 )  | (28.6 %)                    | (5 )                       | (3.1 %)   |                            |                             |
| Total other non-interest income         | 601                | 644           | 497                | (43 )  | (6.7 %)                     | 104                        | 20.9 %  |                            |                             |
| Total non-interest income               | \$1,565            | \$1,581       | \$ 1,307           | \$(16 )                                      | (1.0 %)                     | \$258                      | 19.7 %  |                            |                             |

| (dollars in thousands; unaudited)       | Nine months ended  |                    | Amount              |                     | Percent             |                     |
|---|--------------------|--------------------|---------------------|---------------------|---------------------|---------------------|
|   | September 30, 2011 | September 30, 2010 | Increase (Decrease) | Increase (Decrease) | Increase (Decrease) | Increase (Decrease) |
| Service charges on deposit accounts     | \$ 1,389           | \$ 1,355           | \$ 34               | 2.5 %               |                     |                     |
| Wealth Management and Trust Services    | 1,389              | 1,127              | 262                 | 23.2 %              |                     |                     |
| Other non-interest income               |                    |                    |                     |                     |                     |                     |
| Earnings on Bank-owned life insurance   | 556                | 516                | 40                  | 7.8 %               |                     |                     |
| Customer banking fees and other charges | 82                 | 92                 | (10 )               | (10.9 %)            |                     |                     |
| Debit card interchange fees             | 612                | 353                | 259                 | 73.4 %              |                     |                     |
| Pre-tax bargain purchase gain           | 147                | -                  | 147                 | NM                  |                     |                     |
| Other income                            | 570                | 718                | (148 )              | (20.6 %)            |                     |                     |
| Total other non-interest income         | 1,967              | 1,679              | 288                 | 17.2 %              |                     |                     |
| Total non-interest income               | \$ 4,745           | \$ 4,161           | \$ 584              | 14.0 %              |                     |                     |

Service charges on deposit accounts remain relatively unchanged when compared to the prior quarter. Service charges on deposit accounts increased slightly when compared to the same quarter a year ago, primarily due to fewer waivers of analysis charges. Service charges on deposit accounts remain relatively unchanged when compared to the first nine

months in 2011 and the first nine months a year ago.

The increase in Wealth Management and Trust Services (“WMTS”) income, when compared to last quarter and the same quarter a year ago is due to higher estate settlement fees and higher rates charged on corporate trust-related services. In addition, volatility in the equity and bond markets impacts the market value of trust assets and the related investment fees. As of September 30, 2011, June 30, 2011 and September 30, 2010, assets under management totaled approximately \$243.3 million, \$264.9 million and \$251.0 million, respectively. Equity market volatility in the third quarter of 2011 impacted the value of the assets under management, which was mitigated by new assets acquired under management in 2011. The increase in WMTS income in the first nine months of 2011 compared to the first nine months in the prior year is due to higher estate settlement fees and higher rates charged on corporate trust-related services, as well as higher average assets acquired under management.

Bank-owned life insurance (“BOLI”) income remains the same when compared to the prior quarter. The increase in BOLI income when compared to the same quarter a year ago is primarily due to additional income earned on \$2.5 million in new policies purchased in late March 2011. The increase in BOLI income when compared to the first nine months in 2011 to the first nine months in a year ago is primarily due to the purchase of additional policies mentioned above.

The increases in debit card interchange fees in the third quarter and first nine months of 2011 when compared to the same periods a year ago are primarily attributable to a steady increase in volume of debit card usage. In June 2011, the Federal Reserve finalized a new regulation to restrict interchange fees charged for debit card transactions by banks with more than \$10 billion in assets. Although we are exempt under the new rule, market pricing of the interchange fees may drive these revenues down. The effect on market pricing, if any, may take time to realize. Therefore, we cannot quantify the ultimate impact of this rule on such interchange fees. The decreases in other income in the three-month and nine-month periods ended September 30, 2011 when compared to the previous quarter and the first nine months a year ago are due to decrease in merchant card interchange fees.

#### Non-interest Expense

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

| (dollars in thousands; unaudited) | Three months ended |               |                    | September 30, 2011 compared to June 30, 2011 |                             | September 30, 2011 compared to September 30, 2010 |                             |
|-----------------------------------|--------------------|---------------|--------------------|--|-----------------------------|---|-----------------------------|
|                                   | September 30, 2011 | June 30, 2011 | September 30, 2010 | Amount Increase (Decrease)                   | Percent Increase (Decrease) | Amount Increase (Decrease)                        | Percent Increase (Decrease) |
| Salaries and related benefits     | \$ 5,320           | \$ 5,220      | \$ 4,665           | \$ 100                                       | 1.9%                        | \$ 655  | 14.0%                       |
| Occupancy and equipment           | 1,021              | 1,093         | 880                | (72)   | (6.6%)                      | 141   | 16.0%                       |
| Depreciation & amortization       | 329                | 314           | 335                | 15   | 4.8%                        | (6)   | (1.8%)                      |
| FDIC insurance                    | 189                | 214           | 388                | (25)   | (11.7%)                     | (199)   | (51.3%)                     |
| Data processing costs             | 642                | 909           | 491                | (267)  | (29.4%)                     | 151   | 30.8%                       |
| Professional services             | 465                | 740           | 550                | (275)  | (37.2%)                     | (85)  | (15.5%)                     |
| Other non-interest expense        |                    |               |                    |  |                             |   |                             |
| Advertising                       | 161                | 100           | 132                | 61   | 61.0%                       | 29  | 22.0%                       |
| Director expense                  | 126                | 117           | 117                | 9  | 7.7%                        | 9   | 7.7%                        |
| Other expense                     | 1,168              | 1,291         | 949                | (123)  | (9.5%)                      | 219   | 23.1%                       |
| Total other non-interest expense  | 1,455              | 1,508         | 1,198              | (53)   | (3.5%)                      | 257   | 21.5%                       |
| Total non-interest expense        | \$ 9,421           | \$ 9,998      | \$ 8,507           | \$ (577)                                     | (5.8%)                      | \$ 914  | 10.7%                       |

| (dollars in thousands; unaudited) | Nine months ended  |                    | Amount              | Percent             |
|-----------------------------------|--------------------|--------------------|---------------------|---------------------|
|                                   | September 30, 2011 | September 30, 2010 | Increase (Decrease) | Increase (Decrease) |
| Salaries and related benefits     | \$ 15,469          | \$ 13,832          | \$ 1,637            | 11.8%               |
| Occupancy and equipment           | 3,021              | 2,692              | 329                 | 12.2%               |

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|   |                  |                  |                 |              |
|---|------------------|------------------|-----------------|--------------|
| Depreciation and amortization           | 951              | 1,033            | (82)            | (7.9%)       |
| FDIC insurance                          | 790              | 1,125            | (335)           | (29.8%)      |
| Data processing costs                   | 2,133            | 1,422            | 711             | 50.0%        |
| Professional services                   | 1,938            | 1,436            | 502             | 35.0%        |
| <b>Other non-interest expense</b>       |                  |                  |                 |              |
| Advertising                             | 347              | 316              | 31              | 9.8%         |
| Director expense                        | 361              | 356              | 5               | 1.4%         |
| Other expense                           | 3,539            | 3,108            | 431             | 13.9%        |
| <b>Total other non-interest expense</b> | <b>4,247</b>     | <b>3,780</b>     | <b>467</b>      | <b>12.4%</b> |
| <b>Total non-interest expense</b>       | <b>\$ 28,549</b> | <b>\$ 25,320</b> | <b>\$ 3,229</b> | <b>12.8%</b> |

The increases in salaries and benefit expenses in the three-month and nine-month periods ended September 30, 2011 when compared to the equivalent periods in the prior year reflected higher personnel costs associated with franchise expansion. When comparing the third quarter of 2011 to the second quarter of 2011, the increase in salaries and benefits is mainly due to higher incentive bonus, 401(k) and Employee Stock Ownership Plan contribution accruals, partially offset by fewer full-time equivalent employees (“FTE”). FTE totaled 227, 236 and 203 at September 30, 2011, June 30, 2011 and September 30, 2010, respectively.

The decrease in occupancy and equipment expenses compared to the previous quarter is mainly due to the lease re-negotiation of two branches at lower rates in the third quarter, as well as the closure of the St. Helena branch in the second quarter of 2011. The increase in occupancy and equipment compared to the same quarter last year is primarily due to higher rent expenses associated with our franchise expansion in Napa and Sonoma counties. The increase in occupancy and equipment expenses in the first nine months of 2011 compared to the first nine months a year ago relates to the branch expansion partially offset by leases re-negotiated at lower rates.

The decrease in depreciation and amortization expenses compared to the same quarter last year is mainly due to accelerated amortization of leasehold improvements in the third quarter of 2010 on our Corte Madera branch, which was relocated in July 2010. Depreciation and amortization expenses increased slightly compared to the prior quarter, mainly due to the addition of the Santa Rosa branch. The decrease in depreciation and amortization expenses in the first nine months of 2011 compared to the first nine months of 2010, is attributable to certain assets, including leasehold improvements on our old Corte Madera branch, which were fully-depreciated, as discussed above.

The decrease in FDIC insurance expenses compared to the same quarter a year ago primarily reflect the revision to the FDIC insurance assessment base. In February 2011, as required by the Dodd-Frank Act, the FDIC approved a rule that changes the FDIC insurance assessment base from adjusted domestic deposits to a bank's average consolidated total assets minus average tangible equity, defined as Tier 1 capital. While the new rule expanded the assessment base, it lowered assessment rates to between 2.5 and 9 basis points on the broader base for banks in the lowest risk category. The change was effective for the second quarter of 2011. Since we have a solid core deposit base and do not rely heavily on borrowings and brokered deposits, the benefit of the lower assessment rate significantly outweighed the effect of a wider assessment base. The decrease from the prior quarter reflected a lower FDIC assessment rate.

The decrease in FDIC insurance from the same quarter last year also reflects the expiration of the FDIC Transaction Account Guarantee Program ("TAGP") on December 31, 2010, which provided unlimited insurance coverage on non-interest-bearing transaction accounts. We paid a 15 basis point surcharge per \$100 covered balances in excess of \$250 thousand from January to December 2010. When comparing the first nine months of 2011 to the first nine months of 2010, the decrease in FDIC insurance is primarily due to the revision to the FDIC insurance assessment base and the expiration TAGP as mentioned above.

The decrease in data processing expenses from the prior quarter primarily reflects one-time system conversion and integration costs related to the Acquisition in the second quarter. The increase in data processing costs in the third quarter of 2011 when compared to the same period a year ago reflects a higher volume of data processing associated with franchise expansion. Data processing expenses in the first nine months of 2011 increased compared to the same period a year ago due to the reasons mentioned above.

The decrease in professional service expenses in the third quarter compared to the prior quarter is mainly due to expenses in the second quarter associated with the Acquisition and legal workout fees reimbursed by a loan borrower in the third quarter of 2011. The decrease from the same period a year ago is due to legal workout fee reimbursements in the third quarter of 2011. The increase in the first nine months of 2011 compared to the same period a year ago primarily reflects expenses incurred related to the Acquisition, including investment banking consulting, legal, accounting and valuation expenses. Additionally, we incurred more net legal fees related to loan workouts in the first nine months of 2011 than in the comparable period a year ago.

The fluctuations in advertising expenses from the prior quarter and from the same quarter a year ago are primarily due to the timing of our various bank advertising programs. The increase in advertising expenses in the first nine months of 2011 compared to the first nine months of 2010 is due to the timing of bank advertising programs as well as the additional expenses related to the franchise expansion.

Director fees in the three months ended September 30, 2011 remained relatively consistent compared to the same quarter last year and the prior quarter, and also remained constant in the first nine months of 2011 compared to the same period a year ago.

Other expenses decreased from the prior quarter as we wrote off certain facility and network fixed assets in the second quarter of 2011 that we purchased from the FDIC related to the Acquisition settlement. The increases in other expenses in the three-month and nine-month periods ended September 30, 2011 when compared to the equivalent periods in the prior year reflected higher expenses related to foreclosed assets, amortization on core deposit intangible assets associated with the Acquisition and higher miscellaneous expenses.

#### Provision for Income Taxes

We reported a provision for income taxes of \$2.6 million, \$2.1 million, and \$2.0 million for the quarters ended September 30, 2011, June 30, 2011, and September 30, 2010, respectively. The effective tax rates were 38.3%, 38.4%



and 37.4%, respectively, for those same periods. The provision for income taxes was \$7.6 million and \$5.7 million for the first nine months ended September 30, 2011 and 2010, respectively. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, adjusted for the effect of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities, Bank-owned life insurance policies and certain federal 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. We have not been subject to an alternative minimum tax during these periods.

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.

## FINANCIAL CONDITION

### Summary

During the first nine months of 2011, total assets increased \$154.6 million, or 12.8%, to \$1.4 billion. This increase in assets primarily reflects an increase in investment securities of \$51.9 million, an increase in net loans of \$50.4 million, and an increase in cash and cash equivalents of \$47.6 million. Total loans reached \$992.6 million at September 30, 2011, representing an increase of \$51.2 million, or 5.4%, over December 31, 2010. This growth reflected the loans purchased as part of the Acquisition, partially offset by the successful resolution through payoffs of several high credit risk loans, as well as the prepayment of certain large credits in a low interest rate environment. Further, we have experienced a modest level of loan originations this year, in line with reduced market demand and strong competition for quality loans. The following table presents the composition of our loans outstanding by class:

#### Loans Outstanding

(Dollars in thousands; September 30, 2011

| unaudited)                           | September 30, 2011 | December 31, 2010 |
|--------------------------------------|--------------------|-------------------|
| Commercial loans                     | \$ 172,389         | \$ 153,836        |
| Real estate                          |                    |                   |
| Commercial owner-occupied            | 160,558            | 142,590           |
| Commercial investor                  | 420,427            | 383,553           |
| Construction                         | 54,806             | 77,619            |
| Home equity                          | 97,323             | 86,932            |
| Other residential <sup>1</sup>       | 63,850             | 69,991            |
| Installment and other consumer loans | 23,290             | 26,879            |
| Total loans                          | 992,643            | 941,400           |
| Allowance for loan losses            | (13,224 )          | (12,392 )         |
| Total net loans                      | \$ 979,419         | \$ 929,008        |

<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.

As of September 30, 2011, impaired loans totaled \$18.6 million (including TDRs of \$9.9 million), compared to \$14.1 million (including TDRs of \$1.2 million) at December 31, 2010. Impaired loans included non-accrual loans totaling \$10.7 million at September 30, 2011, compared to \$12.9 million at December 31, 2010. Purchased credit impaired loans totaled \$6.5 million at September 30, 2011, including loans totaling \$5.4 million that have experienced credit deterioration post Acquisition (included in the impaired loan total mentioned above). Accruing loans past due 30-89 days increased from \$352 thousand at December 31, 2010, and \$763 thousand at June 30, 2011 to \$5.0 million at September 30, 2011. The increase is mainly attributable to a delinquent construction loan which was in the process of renewal.

Our investment securities portfolio increased \$51.9 million in the first nine months of 2011, primarily due to purchases of \$91.1 million of securities (primarily U.S. agency securities), partially offset by \$26.0 million of

pay-downs and maturities of available-for-sale securities. Investment securities in our portfolio that may be backed by mortgages having sub-prime or Alt-A features (certain corporate CMOs) represent 2.9% of our total investment portfolio.

At September 30, 2011, other assets included BOLI of \$21.4 million, compared to \$18.3 million at December 31, 2010. Other assets also include net deferred tax assets of \$5.4 million and \$6.6 million at September 30, 2011 and December 31, 2010, respectively. These deferred tax assets consist primarily of tax benefits expected to be realized in future periods related to temporary differences for the allowance for loan losses, depreciation, leases and deferred compensation. Management believes these assets to be realizable due to our consistent record of earnings and the expectation that earnings will continue at a level adequate to realize such benefits.

During the first nine months of 2011, total liabilities increased \$143.5 million to \$1.2 billion. The increase in total liabilities was primarily due to an increase in deposits of \$160.8 million, primarily reflecting the impact of the Acquisition, as well as growth in our core markets. The higher level of deposits reflects growth in most deposit categories, except for CDARS® time deposits, which decreased \$34.7 million. Demand deposits comprised 31.8% of total deposits at September 30, 2011, compared to 27.8% at December 31, 2010. In addition, Management has strategically allowed the \$9.0 million internet deposits assumed as part of the Acquisition to run off.

Stockholders' equity increased \$11.1 million to \$133.0 million during the first nine months of 2011. The increase in stockholders' equity primarily reflects the net income accumulated during the period, partially offset by cash dividends to shareholders.

#### Capital Adequacy

Bancorp and the Bank 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, Bancorp and the Bank must meet specific capital guidelines that involve quantitative measures of Bancorp's and the Bank's 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 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.

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The Bank's and Bancorp's capital adequacy ratios as of September 30, 2011 and December 31, 2010 are presented in the following table.

| Capital Ratios for Bancorp<br>(in thousands; September 30, 2011 unaudited)<br>As of September 30, 2011 | Actual Ratio |       |   | Ratio for Capital Adequacy Purposes |        |   |
|--|--------------|-------|---|-------------------------------------|--------|---|
|  | Amount       | Ratio |   | Amount                              | Ratio  |   |
| Total Capital (to risk-weighted assets)  | \$ 149,350   | 13.30 | % | \$ ≥ 89,801                         | ≥ 8.00 | % |
| Tier 1 Capital (to risk-weighted assets)   | \$ 130,597   | 11.63 | % | \$ ≥ 44,901                         | ≥ 4.00 | % |
| Tier 1 Capital (to average assets)   | \$ 130,597   | 9.60  | % | \$ ≥ 54,412                         | ≥ 4.00 | % |

|  |            |       |   |             |        |   |
|--|------------|-------|---|-------------|--------|---|
| As of December 31, 2010                  |            |       |   |             |        |   |
| Total Capital (to risk-weighted assets)  | \$ 138,545 | 13.34 | % | \$ ≥ 83,068 | ≥ 8.00 | % |
| Tier 1 Capital (to risk-weighted assets) | \$ 120,375 | 11.59 | % | \$ ≥ 41,534 | ≥ 4.00 | % |
| Tier 1 Capital (to average assets)       | \$ 120,375 | 9.91  | % | \$ ≥ 48,566 | ≥ 4.00 | % |

| Capital Ratios for the<br>Bank<br>(in thousands;<br>September 30,<br>2011 unaudited)<br>As of September 30,<br>2011 | Actual Ratio |       |   | Ratio for Capital Adequacy Purposes |        | Ratio to be Well Capitalized under Prompt Corrective Action Provisions |              |         |   |
|---|--------------|-------|---|-------------------------------------|--------|--|--------------|---------|---|
|   | Amount       | Ratio |   | Amount                              | Ratio  | Amount   | Ratio        |         |   |
| Total Capital (to risk-weighted assets)   | \$ 145,477   | 12.96 | % | \$ ≥ 89,799                         | ≥ 8.00 | %  | \$ ≥ 112,249 | ≥ 10.00 | % |
| Tier 1 Capital (to risk-weighted assets)  | \$ 126,724   | 11.29 | % | \$ ≥ 44,900                         | ≥ 4.00 | %  | \$ ≥ 67,349  | ≥ 6.00  | % |
| Tier 1 Capital (to average assets)  | \$ 126,724   | 9.32  | % | \$ ≥ 54,407                         | ≥ 4.00 | %  | \$ ≥ 68,008  | ≥ 5.00  | % |

|  |            |       |   |             |        |   |              |         |   |
|--|------------|-------|---|-------------|--------|---|--------------|---------|---|
| As of December 31, 2010                  |            |       |   |             |        |   |              |         |   |
| Total Capital (to risk-weighted assets)  | \$ 131,817 | 12.70 | % | \$ ≥ 83,067 | ≥ 8.00 | % | \$ ≥ 103,834 | ≥ 10.00 | % |
| Tier 1 Capital (to risk-weighted assets) | \$ 113,647 | 10.95 | % | \$ ≥ 41,533 | ≥ 4.00 | % | \$ ≥ 62,300  | ≥ 6.00  | % |
| Tier 1 Capital (to average assets)       | \$ 113,647 | 9.36  | % | \$ ≥ 48,566 | ≥ 4.00 | % | \$ ≥ 60,708  | ≥ 5.00  | % |

### 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. Management does not anticipate significant reliance on Federal funds purchased and FHLB advances in the near future, as our core deposit inflow has provided adequate liquidity to fund our operations. If we were to rely on Federal funds purchased or FHLB advances in the future, we expect to have the ability to post 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 September 30, 2011 totaled \$132.8 million, an increase of \$47.6 million over December 31, 2010. The primary sources of funds during the first nine months of 2011 included \$66.7 million increase in net deposits, \$44.0 million of cash received from the Acquisition, \$44.1 million in pay-downs and maturities of investment securities, \$17.4 million net cash provided by operating activities, and \$11.7 million in loan principal collections (net of origination). The primary uses of funds were \$96.7 million in investment securities purchases, and \$33.5 million in repayment of FHLB borrowings.

At September 30, 2011, our cash and cash equivalents and unpledged available-for-sale securities with estimated maturities within one year totaled \$135.0 million. The remainder of the unpledged available for sale securities portfolio of \$144.4 million provides additional liquidity. Taken together, these liquid assets equaled 20.5% of our assets at September 30, 2011, compared to 15.1% at December 31, 2010. The increased liquidity at September 30, 2011 was primarily due to the overall growth in net deposits, as well as cash received from the Acquisition.

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 9.8% equity to assets ratio, 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 \$77.0 million with correspondent banks. Further, we have pledged a certain residential loan portfolio that increased our borrowing capacity with the FRB, which totaled \$42.5 million at September 30, 2011. As of September 30, 2011, 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 \$246.9 million, of which \$211.9 million was available at September 30, 2011. 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 \$264.7 million at September 30, 2011 at rates ranging from 1.91% to 18.00%. This amount included \$148.4 million under commercial lines of credit (these commitments are contingent upon customers maintaining specific credit standards), \$77.0 million under revolving home equity lines, \$17.0 million under undisbursed construction loans, \$13.0 million under standby letters of credit, and a remaining \$9.3 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 \$148.6 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. As the Bank made a \$28 million distribution to Bancorp in March 2009 in connection with Bancorp's repurchase of preferred stock, distributions from the Bank to Bancorp will be subject to advance regulatory approval for three years beginning in 2010. The primary uses of funds for Bancorp are stockholder dividends and ordinary operating expenses. Management anticipates that the current cash level at Bancorp will be sufficient to meet its funding requirements through early 2012, at which time we will apply for regulatory approval for a dividend from the Bank to Bancorp.





ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

Our most significant form of market risk is interest rate risk. The risk is inherent in our deposit and lending 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. Interest rate risk exposure is managed with the goal of minimizing the impact of interest rate volatility on the net interest margin.

Activities in asset and liability management include, but are not limited to, lending, borrowing, accepting deposits and investing in securities. Interest rate risk is the primary market risk associated with asset and liability management. 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 11 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.

Since 2009, there has been no change to the Federal funds target rate, which has been kept at a historic low level of 0-0.25%. The Bank currently has low interest rate risk and is slightly asset sensitive in a rising rate environment. During the first nine months of 2011, the Bank’s asset sensitivity increased from the rise in liquidity and variable rate loans. That increase in asset sensitivity was partially offset by the increase in investment securities and interest bearing transaction, savings and money market deposit accounts. If market rates rise, we expect asset sensitivity to increase as loans with interest rates on floors begin to adjust. We have mitigated earnings sensitivity to a certain extent through the procurement of fixed-rate borrowings from the FHLB. Also refer to “Market Risk Management” in our 2010 Annual Report on Form 10-K.

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 2010 Form 10-K.

ITEM 1A Risk Factors

Purchased Loans from the Acquisition May Lose Value if the Estimated Fair Value is Inaccurate

Our determination regarding the fair value of assets purchased in the Acquisition, including loans, could be inaccurate, which could materially and adversely affect our business, financial condition, results of operations and future prospects. Management makes various assumptions and judgments about the collectability of the acquired loans, including the creditworthiness of borrowers and the value of the real estate and other assets serving as collateral for the repayment of secured loans. The timing and amount of future expected cash flows is hence subject to a great degree of uncertainty. Increases in the amount of future losses in response to different economic conditions or adverse developments in the acquired loan portfolio may result in increased credit loss provisions and could have a negative impact on our operating results.

Other than noted above, there have been no material changes from the risk factors previously disclosed in our 2010 Form 10-K. Refer to "Risk Factors" in our 2010 Form 10-K, pages 12 through 20.

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 September 30, 2011.

ITEM 3 Defaults Upon Senior Securities

None.

ITEM 4 [Removed and Reserved]

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   | Form          | Incorporated by Reference |                      |                   | Herewith |
|----------------|---|---------------|---------------------------|----------------------|-------------------|----------|
|                |   |               | 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 |          |
| 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<br>AM S-3 | 333-156782                | 4.4                  | April 29, 2009    |          |
| 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   | 8-K           | 001-33572                 | 10.1<br>10.2<br>10.3 | January 6, 2011   |          |

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|              |  |     |           |       |                  |
|--------------|--|-----|-----------|-------|------------------|
|              | Colombo, Chief Executive Officer, Christina Cook, Chief Financial Officer, Kevin Coonan, Chief Credit Officer, and Peter Pelham, Director of Retail Banking, dated January 1, 2011 |     |           | 10.4  |                  |
| 10.11        | 2007 Form of Change in Control Agreement   | 8-K | 001-33572 | 10.1  | October 31, 2007 |
| 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 |
| <u>31.01</u> | 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                             |     |           |       | Filed            |
| <u>31.02</u> | 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            |
| <u>32.01</u> | Certification pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002.   |     |           |       | Furnished        |
| 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)

November 7,  
2011  
Date

/s/ Russell A. Colombo

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

November 7,  
2011  
Date

/s/ Christina J. Cook

Christina J. Cook  
Executive Vice President &  
Chief Financial Officer  
(Principal Financial Officer)

November 7,  
2011  
Date

/s/ Cecilia Situ

Cecilia Situ  
First Vice President &  
Controller  
(Principal Accounting Officer)