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

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

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

For the transition period from ___________________ to ___________________

Commission File Number 001-33572

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

California	20-8859754
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
504 Redwood Blvd., Suite 100, Novato, CA	94947
(Address of principal executive office)	(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o

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

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

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

As of October 31, 2011 there were 5,331,368 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

(in thousands, except share data; 2011 unaudited)	September 30, 2011	December 31, 2010
Assets		
Cash and due from banks	$ 130,675	$ 65,724
Short-term investments	2,111	19,508
Cash and cash equivalents	132,786	85,232
Investment securities		
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
Loans, net of allowance for loan losses of $13,224 and $12,392 at September 30, 2011 and December 31, 2010, respectively	979,419	929,008
Bank premises and equipment, net	9,624	8,419
Interest receivable and other assets	42,333	38,838
Total assets	$ 1,362,717	$ 1,208,150
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
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
Total liabilities	1,229,716	1,086,230
Stockholders' Equity		
Preferred stock, no par value, Authorized - 5,000,000 shares; none issued	---	---

Common stock, no par value, Authorized - 15,000,000 shares Issued and outstanding - 5,331,368 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
Total stockholders' equity		133,001		121,920
Total liabilities and stockholders' equity	$	1,362,717	$	1,208,150

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 September 30, 2011	June 30, 2011	September 30, 2010	Nine months ended September 30, 2011	September 30, 2010
Interest income					
Interest and fees on loans	$ 15,567	$ 16,862	$ 14,296	$ 48,329	$ 42,146
Interest on investment securities					
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
Total interest income	17,225	18,137	15,601	52,448	45,993
Interest expense					
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
Total interest expense	2,005	1,134	1,636	4,347	5,143
Net interest income	15,220	17,003	13,965	48,101	40,850
Provision for loan losses	500	3,000	1,400	4,550	4,300
Net interest income after provision for loan losses	14,720	14,003	12,565	43,551	36,550
Non-interest income					
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
Total non-interest income	1,565	1,581	1,307	4,745	4,161
Non-interest expense					
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

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 unaudited)	Preferred Stock	Common Stock Shares	Amount	Retained Earnings	Accumulated Other Comprehensive Income, 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 on available for sale securities (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 - stock-based compensation	---	---	132	---	---	132
Stock issued under employee stock purchase plan	---	563	17	---	---	17
Restricted stock granted	---	6,150	---	---	---	---
Restricted stock forfeited / cancelled	---	(2,320)	---	---	---	---
Stock-based compensation - stock options	---	---	241	---	---	241
Stock-based compensation - restricted stock	---	---	109	---	---	109
Cash dividends paid on common stock	---	---	---	(3,205)	---	(3,205)
Stock issued in payment of 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 on available for sale securities (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 - stock-based compensation	---	---	117	---	---	117
Stock issued under employee stock purchase plan	---	832	27	---	---	27
Restricted stock granted	---	5,675	---	---	---	---
Restricted stock forfeited	---	(315)	---	---	---	---
	---	---	186	---	---	186

Stock-based compensation - stock options						
Stock-based compensation - restricted stock	---	---	106	---	---	106
Cash dividends paid on common stock	---	---	---	(2,550)	---	(2,550)
Stock issued in payment of 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.

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, 2010
Cash Flows from Operating Activities:		
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
Cash Flows from Investing Activities:		
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)
Cash Flows from Financing Activities:		
Net increase in deposits	66,705	79,217
Proceeds from stock options exercised	651	244
Repayment of Federal Home Loan Bank borrowings	(33,500)	---

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.

	Three months ended			Nine months ended	
(in thousands, except per share data; unaudited)	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

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

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.

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 (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 (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

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:

Acquisiton-related Expenses (in thousands)	Three months ended September 30, 2011	Three months ended June 30, 2011	Nine months ended September 30, 2011
Professional services	$ -	$ 153	$ 457
Data processing	47	378	455
Other1	(37)	111	88
Total	$ 10	$ 642	$ 1,000

1Third-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.

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

(in thousands) Description of Financial Instruments	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Balance at September 30, 2011 (unaudited):				
Securities available for sale:				
Mortgage-backed securities and collaterized 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 collaterized 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.

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

	September 30, 2011		December 31, 2010	
(in thousands; 2011 amounts unaudited)	Carrying Amounts	Fair Value	Carrying Amounts	Fair 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

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

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)

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.

	September 30, 2011			
	Held to Maturity		Available for Sale	
(in thousands; unaudited)	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	$ 3,028	$ 3,029	$ ---	$ ---
After one but within five years	7,666	7,950	23,442	23,637
After five years 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.

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	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
(In thousands; unaudited)	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	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
(In thousands)	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 1	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						