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

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from __________________ to __________________

Commission File Number 001-33572

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

California (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)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o

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

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

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

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

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CONDITION
at June 30, 2013 and December 31, 2012

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

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

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

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

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

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

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

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
for the six months ended June 30, 2013 and 2012

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Introductory Explanation

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

Note 1: Basis of Presentation

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

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

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

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

Weighted average anti-dilutive shares not included in the calculation of diluted EPS	60	45	69	54	44

Note 2: Recently Issued Accounting Standards

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

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

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

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

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

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

Note 3: Acquisition

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

Note 4: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

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

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

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

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

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

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

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

On a recurring basis, derivative financial instruments are recorded at fair value, which is based on the income approach using observable Level 2 market inputs, reflecting market expectations of future interest rates as of the measurement date. Standard valuation techniques are used to calculate the present value of the future expected cash flows assuming an orderly transaction. Valuation adjustments may be made to reflect both our own credit risk and the counterparties' credit quality in determining the fair value of the derivatives. Level 2 inputs for the valuations are limited to observable market prices for LIBOR cash rates (for the very short term), quoted prices for LIBOR futures contracts, observable market prices for LIBOR swap rates, and one-month and three-month LIBOR basis spreads at commonly quoted intervals. Mid-market pricing of the inputs is used as a practical expedient in the fair value measurements. Key inputs for interest rate valuations are used to project spot rates at resets specified by each swap, as well as to discount those future cash flows to present value at the measurement date. When the value of any collateral placed with counterparties is less than the interest rate derivative liability, the interest rate liability position is further discounted to reflect our potential credit risk to counterparties. We have used the spread between the Standard & Poors BBB rated U.S. Bank

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

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

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

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

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

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

Disclosures about Fair Value of Financial Instruments

The table below is a summary of fair value estimates for financial instruments as of June 30, 2013 and December 31, 2012, excluding financial instruments recorded at fair value on a recurring basis (summarized in the first table in this note). The carrying amounts in the following table are recorded in the consolidated statements of condition under the indicated captions. We have excluded non-financial assets and non-financial liabilities defined by the Codification (ASC 820-10-15-1A), such as Bank premises and equipment, deferred taxes and other liabilities. In addition, we have not disclosed the fair value of financial instruments specifically excluded from disclosure requirements of the Financial Instruments Topic of the Codification (ASC 825-10-50-8), such as Bank-owned life insurance policies.

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

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

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

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

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

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

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

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

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

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

Note 5: Investment Securities

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

	June 30, 2013				December 31, 2012			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
(in thousands; 2013 unaudited)	Cost	Value	Gains	(Losses)	Cost	Value	Gains	(Losses)
Held-to-maturity								
Obligations of state and political subdivisions	$89,517	$90,709	$1,881	$(689)	$96,922	$99,350	$2,855	$(427)
Corporate bonds	42,322	42,573	377	(126)	42,530	42,881	458	(107)
Total held-to-maturity	131,839	133,282	2,258	(815)	139,452	142,231	3,313	(534)
Available-for-sale								
Securities of U. S. government agencies:								
MBS pass-through securities issued by FNMA and FHLMC	48,452	48,732	792	(512)	52,042	53,713	1,711	(40)
CMOs issued by FNMA	2,326	2,402	76	—	4,447	4,550	105	(2)
CMOs issued by FHLMC	10,223	10,365	156	(14)	13,527	13,778	251	—
CMOs issued by GNMA	30,345	31,078	746	(13)	38,871	39,756	886	(1)
Debentures of government-sponsored agencies	19,398	19,223	150	(325)	20,462	20,589	228	(101)
Privately issued CMOs	17,245	17,762	552	(35)	21,071	21,576	595	(90)
Total available-for-sale	127,989	129,562	2,472	(899)	150,420	153,962	3,776	(234)
Total investment securities	$259,828	$262,844	$4,730	$(1,714)	$289,872	$296,193	$7,089	$(768)

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

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

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

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

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

Other-Than-Temporarily Impaired Debt Securities

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

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

June 30, 2013	< 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	$40,908	$(689)	—	—	$40,908	$(689)
Corporate bonds	12,585	(117)	1,990	(9)	14,575	(126)
Total held-to-maturity	53,493	(806)	1,990	(9)	55,483	(815)
Available-for-sale						
MBS pass-through securities issued by FNMA and FHLMC	31,145	(512)	—	—	31,145	(512)
CMOs issued by FHLMC	2,792	(14)	—	—	2,792	(14)
CMOs issued by GNMA	4,403	(13)	—	—	4,403	(13)
Debentures of government-sponsored agencies	14,675	(325)	—	—	14,675	(325)
Privately issued CMOs	1,868	(34)	176	(1)	2,044	(35)
Total available-for-sale	54,883	(898)	176	(1)	55,059	(899)
Total temporarily impaired securities	$108,376	$(1,704)	$2,166	$(10)	$110,542	$(1,714)

December 31, 2012	< 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	$33,196	$(427)	$—	$—	$33,196	$(427)
Corporate bonds	15,649	(107)	—	—	15,649	(107)
Total held-to-maturity	48,845	(534)	—	—	48,845	(534)
Available-for-sale						
MBS pass-through securities issued by FNMA and FHLMC	3,569	(40)	—	—	3,569	(40)
CMOs issued by FNMA	3,185	(2)	—	—	3,185	(2)
CMOs issued by GNMA	1,550	(1)	—	—	1,550	(1)
Debentures of government-sponsored agencies	9,899	(101)	—	—	9,899	(101)
Privately issued CMOs	4,214	(89)	203	(1)	4,417	(90)
Total available-for-sale	22,417	(233)	203	(1)	22,620	(234)
Total temporarily impaired securities	$71,262	$(767)	$203	$(1)	$71,465	$(768)

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

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

Securities Carried at Cost

As a member of the FHLB, we are required to maintain a minimum investment in the FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can also increase in the event we need to increase our borrowing capacity with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at its $100 per share par value. We held $6.5 million and $6.0 million of FHLB stock recorded at cost in other assets on the consolidated statements of condition at June 30, 2013, and December 31, 2012. On July 29, 2013, the FHLB declared a cash dividend for the second quarter of 2013 at an annualized dividend rate of 5.14%. Management does not believe that the FHLB stock is other-than-temporarily-impaired, as we expect to be able to redeem this stock at cost.

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

Note 6: Loans and Allowance for Loan Losses

Credit Quality of Loans

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Generally, commercial borrowers with lines of credit are required to submit financial information with reporting intervals ranging from monthly to annually depending on credit size, risk and complexity.
- Investor commercial real estate borrowers with loans greater than $750 thousand are required to submit rent rolls or property income statements at least annually.
- Construction loans are monitored monthly, and assessed on an ongoing basis.
- Home equity and other consumer loans are assessed based on delinquency.
- Loans graded “Watch” or more severe, regardless of loan type, are assessed no less than quarterly.

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

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

Troubled Debt Restructuring

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

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

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

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

[1] Includes $10.0 million and $10.8 million of TDR loans that were accruing interest as of June 30, 2013 and December 31, 2012, respectively.

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

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

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

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

Modifications during the six months ended June 30, 2013 primarily involved maturity or payment extensions, while modifications in the six months ended June 30, 2012 primarily involved payment extensions and forbearances. There were no payment defaults during the first half of 2013, where the default occurred within the first twelve months after modification into a TDR. There were three commercial loans, two commercial real estate loans, and one construction loan modified as troubled debt restructurings within the previous twelve months with recorded investments of $887 thousand that subsequently defaulted and were charged-off in the six months ended June 30, 2012. We are reporting these defaulted TDRs based on a payment default definition of more than ninety days past due.

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

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

(dollars in thousands; 2013 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
June 30, 2013								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 2,449	$ 1,403	$ 3,082	$ 2,115	$890	$2,341	$65	$12,345
With a specific allowance recorded	4,241	1,132	2,941	6,647	277	230	1,774	17,242
Total recorded investment in impaired loans	$ 6,690	$ 2,535	$ 6,023	$ 8,762	$1,167	$2,571	$1,839	$29,587
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	$ 2,449	$ 3,060	$ 5,074	$ 2,302	$1,417	$2,341	$106	$16,749
With a specific allowance recorded	4,504	2,178	2,941	9,343	403	230	1,774	21,373
Total unpaid principal balance of impaired loans	$ 6,953	$ 5,238	8,015	$ 11,645	$1,820	$2,571	$1,880	$38,122
Specific allowance	$ 928	$ 58	$ 141	$ 1,353	$74	$25	$491	$3,070
Average recorded investment in impaired loans during the quarter ended June 30, 2013	7,327	2,534	6,041	8,820	1,158	2,590	1,879	30,349
Interest income recognized on impaired loans during the quarter ended June 30, 2013	107	53	—	185	12	22	18	397
Average recorded investment in impaired loans during the quarter ended March 31, 2013	9,491	2,522	6,105	4,116	1,132	3,066	1,920	28,352
Interest income recognized on	134	54	—	27	8	23	16	262

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

the six months ended
June 30, 2012

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

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

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

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
For the three months ended June 30, 2013									
Allowance for loan losses:									
Beginning balance	$4,032	$1,348	$4,020	$650	$1,216	$431	$1,366	$371	$13,4
Provision (reversal)	(189)	(26)	345	1,084	63	(30)	28	(175)	1,100
Charge-offs	(386)	—	—	(13)	(126)	—	(85)	—	(610
Recoveries	342	84	3	—	—	—	4	—	433
Ending balance	$3,799	$1,406	$4,368	$1,721	$1,153	$401	$1,313	$196	$14,3
For the three months ended March 31, 2013									
Allowance for loan losses:									
Beginning balance	$4,100	$1,313	$4,372	$611	$1,264	$551	$1,231	$219	$13,6
Provision (reversal)	(50)	35	(375)	42	(49)	(120)	135	152	(230
Charge-offs	(71)	—	—	(4)	(7)	—	(1)	—	(83
Recoveries	53	—	23	1	8	—	1	—	86
Ending balance	$4,032	$1,348	$4,020	$650	$1,216	$431	$1,366	$371	$13,4
For the six months ended June 30, 2013									
Allowance for loan losses:									
Beginning balance	$4,100	$1,313	$4,372	$611	$1,264	$551	$1,231	$219	$13,6
Provision (reversal)	(239)	9	(30)	1,126	14	(150)	163	(23)	870
Charge-offs	(457)	—	—	(17)	(133)	—	(86)	—	(693
Recoveries	395	84	26	1	8	—	5	—	519
Ending balance	$3,799	$1,406	$4,368	$1,721	$1,153	$401	$1,313	$196	$14,3
As of June 30, 2013:									
Ending ALLL related to loans collectively evaluated for impairment	$2,871	$1,348	$4,227	$368	$1,079	$376	$822	$196	$11,2
Ending ALLL related to loans individually evaluated for impairment	$745	$—	$141	$1,353	$74	$25	$491	$—	$2,82
Ending ALLL related to purchased credit-impaired loans	$183	$58	$—	$—	$—	$—	$—	$—	$241
Loans outstanding:									
Collectively evaluated for impairment	$163,753	$203,656	$528,544	$18,966	$89,129	$40,719	$16,435	$—	$1,06
Individually evaluated for impairment[1]	6,414	—	6,023	8,762	1,167	2,571	1,839	—	26,77

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

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

NM - Not Meaningful

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Allowance for Loan Losses and Recorded Investment in Loans

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

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

NM - Not Meaningful

Allowance for Loan Losses and Recorded Investment in Loans

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

For the six months ended June 30, 2012									
Allowance for loan losses:									
Beginning balance	$ 4,334	$ 1,305	$ 3,710	$ 1,505	$ 1,444	$ 940	$ 1,182	$ 219	$ 14,639
Provision (reversal)	32	19	134	(348)	234	(182)	143	68	100
Charge-offs	(850)	(181)	(178)	(172)	(110)	(196)	(5)	—	(1,692)
Recoveries	370	5	—	—	12	—	1	—	388
Ending balance	$ 3,886	$ 1,148	$ 3,666	$ 985	$ 1,580	$ 562	$ 1,321	$ 287	$ 13,435

Purchased Credit-Impaired Loans

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

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

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

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

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

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

[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 with an unpaid principal balance of $672.4 million and $567.8 million at June 30, 2013 and December 31, 2012, respectively. Our FHLB line of credit totaled $391.0 million and $321.3 million at June 30, 2013 and December 31, 2012, respectively. In addition, we pledge a certain residential loan portfolio, which totaled $26.5 million and $30.1

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

Note 7: Borrowings

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

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

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

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

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

Note 8: Stockholders' Equity

Preferred Stock

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

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

Dividends

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

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

Share-Based Payments

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

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

Note 9: Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

We make commitments to extend credit in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit in the form of loans or through standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being fully drawn upon, the total commitment amount does not necessarily represent future cash requirements.

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

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

Operating Leases

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

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

Litigation and Regulatory Matters

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

We are responsible for our proportionate share of certain litigation indemnifications provided to Visa U.S.A. by its member banks in connection with lawsuits related to anti-trust charges and interchange fees. On July 13, 2012, Visa U.S.A. signed a memorandum of understanding to enter into a settlement agreement to resolve the Class Plaintiffs' claims and an agreement in principle to resolve the Individual Plaintiffs' claims in the same multi-district interchange litigation. The settlement includes a cash payment through further reduction in conversion rate of Visa Class B shares by member banks and a ten basis point reduction in credit card interchange rates for eight months. A number of procedural steps remain before this settlement can become final and the full impact to member banks like us is still uncertain. However, we are not aware of significant future cash settlement payments required by us on the litigation and the ten basis point reduction in credit card interchange fees for us is not expected to be material. Also refer to Note 13 to the Consolidated Financial Statements of the Bancorp's 2012 Annual Report on Form 10-K.

Note 10: Derivative Financial Instruments and Hedging Activities

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

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

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

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

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

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

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

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

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

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

[1] See Note 4 for valuation methodology.

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

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

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

Offsetting of Financial Assets and Derivative Assets

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

[1] Amounts exclude accrued interest totaling $7 thousand and $1 thousand at June 30, 2013 and December 31, 2012, respectively.

Offsetting of Financial Liabilities and Derivative Liabilities

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

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

[2] Amounts exclude accrued interest totaling $62 thousand and $74 thousand at June 30, 2013 and December 31, 2012, respectively.

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

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

Forward-Looking Statements

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

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

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

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

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

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

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.

RESULTS OF OPERATIONS

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

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