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Bank of Marin Bancorp  
Form 10-Q  
May 08, 2015

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2015

OR

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

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

Commission File Number 001-33572

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

California  
(State or other jurisdiction of incorporation)

20-8859754  
(IRS Employer Identification No.)

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

94947  
(Zip Code)

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

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

Yes  No

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

Yes  No

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

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

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

Yes  No

As of April 30, 2015, there were 5,973,424 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 March 31, 2015 and December 31, 2014

(in thousands, except share data; 2015 unaudited)

	March 31, 2015	December 31, 2014
Assets		
Cash and due from banks	\$ 103,164	\$ 41,367
Investment securities		
Held-to-maturity, at amortized cost	107,476	116,437
Available-for-sale, at fair value (amortized cost \$201,568 and \$199,045 at March 31, 2015 and December 31, 2014, respectively)	204,680	200,848
Total investment securities	312,156	317,285
Loans, net of allowance for loan losses of \$15,156 and \$15,099 at March 31, 2015 and December 31, 2014, respectively	1,331,328	1,348,252
Bank premises and equipment, net	9,852	9,859
Goodwill	6,436	6,436
Core deposit intangible	3,577	3,732
Interest receivable and other assets	59,636	60,199
Total assets	\$ 1,826,149	\$ 1,787,130
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest-bearing	\$ 716,719	\$ 670,890
Interest-bearing		
Transaction accounts	95,439	93,758
Savings accounts	133,792	133,714
Money market accounts	478,145	503,543
CDARS® time accounts	11,493	—
Other time accounts	149,532	149,714
Total deposits	1,585,120	1,551,619
Federal Home Loan Bank ("FHLB") borrowings	15,000	15,000
Subordinated debentures	5,238	5,185
Interest payable and other liabilities	16,285	15,300
Total liabilities	1,621,643	1,587,104
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 - 5,967,614 and 5,939,482 at March 31, 2015 and December 31, 2014, respectively	83,011	82,436
Retained earnings	119,652	116,502
Accumulated other comprehensive income, net	1,843	1,088
Total stockholders' equity	204,506	200,026
Total liabilities and stockholders' equity	\$ 1,826,149	\$ 1,787,130

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

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BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, except per share amounts; unaudited)	Three months ended	
	March 31, 2015	March 31, 2014
Interest income		
Interest and fees on loans	\$15,379	\$16,319
Interest on investment securities		
Securities of U.S. government agencies	1,035	1,232
Obligations of state and political subdivisions	540	634
Corporate debt securities and other	205	268
Interest on Federal funds sold and due from banks	21	51
Total interest income	17,180	18,504
Interest expense		
Interest on interest-bearing transaction accounts	30	23
Interest on savings accounts	12	11
Interest on money market accounts	127	158
Interest on CDARS® time accounts	11	—
Interest on other time accounts	220	235
Interest on FHLB and overnight borrowings	78	78
Interest on subordinated debentures	104	105
Total interest expense	582	610
Net interest income	16,598	17,894
Provision for loan losses	—	150
Net interest income after provision for loan losses	16,598	17,744
Non-interest income		
Service charges on deposit accounts	525	556
Wealth Management and Trust Services	638	564
Debit card interchange fees	347	300
Merchant interchange fees	130	198
Earnings on bank-owned life insurance	203	213
Gains (losses) on investment securities, net	8	(8
Other income	338	393
Total non-interest income	2,189	2,216
Non-interest expense		
Salaries and related benefits	6,790	6,930
Occupancy and equipment	1,342	1,334
Depreciation and amortization	421	416
Federal Deposit Insurance Corporation insurance	236	250
Data processing	786	1,360
Professional services	564	628
Reversal of losses on off-balance sheet commitments	(201	) —
Other expense	1,910	1,925
Total non-interest expense	11,848	12,843
Income before provision for income taxes	6,939	7,117
Provision for income taxes	2,482	2,584
Net income	\$4,457	\$4,533
Net income per common share:		
Basic	\$0.75	\$0.77

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Diluted	\$0.74	\$0.76
Weighted average shares used to compute net income per common share:		
Basic	5,921	5,870
Diluted	6,048	5,980
Dividends declared per common share	\$0.22	\$0.19
Comprehensive income:		
Net income	\$4,457	\$4,533
Other comprehensive income		
Change in net unrealized gain on available-for-sale securities	1,317	1,415
Reclassification adjustment for (gain) loss on available-for-sale securities included in net income	(8	) 15
Net change in unrealized gain on available-for-sale securities, before tax	1,309	1,430
Deferred tax expense	554	519
Other comprehensive income, net of tax	755	911
Comprehensive income	\$5,212	\$5,444

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

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BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
for the year ended December 31, 2014 and the three months ended March 31, 2015

(in thousands; 2015 unaudited)	Common Stock		Retained Earnings	Accumulated Other Comprehensive Income, Net of Taxes	Total
	Shares	Amount			
Balance at December 31, 2013	5,877,524	\$80,095	\$101,464	\$(672 )	\$180,887
Net income	—	—	19,771	—	19,771
Other comprehensive income	—	—	—	1,760	1,760
Stock options exercised	49,415	1,452	—	—	1,452
Excess tax benefit - stock-based compensation	—	172	—	—	172
Stock issued under employee stock purchase plan	521	23	—	—	23
Restricted stock granted	8,523	—	—	—	—
Restricted stock forfeited / cancelled	(2,067 )	—	—	—	—
Stock-based compensation - stock options	—	200	—	—	200
Stock-based compensation - restricted stock	—	246	—	—	246
Cash dividends paid on common stock	—	—	(4,733 )	—	(4,733 )
Stock purchased by directors under director stock plan	260	12	—	—	12
Stock issued in payment of director fees	5,306	236	—	—	236
Balance at December 31, 2014	5,939,482	\$82,436	\$116,502	\$1,088	\$200,026
Net income	—	—	4,457	—	4,457
Other comprehensive income	—	—	—	755	755
Stock options exercised	9,371	312	—	—	312
Excess tax benefit - stock-based compensation	—	28	—	—	28
Stock issued under employee stock purchase plan	96	5	—	—	5
Restricted stock granted	15,970	—	—	—	—
Stock-based compensation - stock options	—	36	—	—	36
Stock-based compensation - restricted stock	—	56	—	—	56
Cash dividends paid on common stock	—	—	(1,307 )	—	(1,307 )
Stock issued in payment of director fees	2,695	138	—	—	138
Balance at March 31, 2015	5,967,614	\$83,011	\$119,652	\$1,843	\$204,506

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



BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CASH FLOWS

for the three months ended March 31, 2015 and 2014

(in thousands; unaudited)

	March 31, 2015	March 31, 2014
Cash Flows from Operating Activities:		
Net income	\$4,457	\$4,533
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	—	150
(Reversal of) provision for losses on off-balance sheet commitments	(201)	—
Compensation expense--common stock for director fees	74	58
Stock-based compensation expense	92	99
Excess tax benefits from exercised stock options	(16)	(37)
Amortization of core deposit intangible	155	193
Amortization of investment security premiums, net of accretion of discounts	570	660
Accretion of discount on acquired loans	(490)	(1,510)
Accretion of discount on subordinated debentures	53	54
Net amortization of deferred loan origination costs/fees	(164)	(81)
Write-down of other real estate owned	40	—
(Gain) loss on sale of investment securities	(8)	8
Depreciation and amortization	421	416
Earnings on bank owned life insurance policies	(203)	(213)
Net change in operating assets and liabilities:		
Interest receivable	456	111
Interest payable	(5)	(33)
Deferred rent and other rent-related expenses	(11)	76
Other assets	674	(479)
Other liabilities	(8)	(1,865)
Total adjustments	1,429	(2,393)
Net cash provided by operating activities	5,886	2,140
Cash Flows from Investing Activities:		
Purchase of held-to-maturity securities	(2,375)	—
Purchase of available-for-sale securities	(11,493)	(9,872)
Proceeds from sale of available-for-sale securities	1,559	2,023
Proceeds from sale of held-to-maturity securities	—	725
Proceeds from paydowns/maturity of held-to-maturity securities	11,043	3,678
Proceeds from paydowns/maturity of available-for-sale securities	7,133	8,429
Loans originated and principal collected, net	18,149	(7,750)
Purchase of premises and equipment	(414)	(342)
Cash paid for low income housing tax credit investment	(218)	(69)
Net cash provided by (used in) investing activities	23,384	(3,178)
Cash Flows from Financing Activities:		
Net increase (decrease) in deposits	33,501	(10,762)
Proceeds from stock options exercised	312	670
Proceeds from stock issued under employee and director stock purchase plans <sup>5</sup>	—	7
Cash dividends paid on common stock	(1,307)	(1,120)
Excess tax benefits from exercised stock options	16	37
Net cash provided by (used in) financing activities	32,527	(11,168)
Net increase (decrease) in cash and cash equivalents	61,797	(12,206)

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Cash and cash equivalents at beginning of period	41,367	103,773
Cash and cash equivalents at end of period	\$103,164	\$91,567
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$534	\$594
Cash paid for income taxes	\$30	\$—
Supplemental disclosure of non-cash investing and financing activities:		
Change in unrealized gain on available-for-sale securities	\$1,309	\$1,430
Securities transferred from available-for-sale to held-to-maturity	\$—	\$14,297
Subscription in low income housing tax credit investment	\$1,023	\$1,000
Stock issued in payment of director fees	\$138	\$103

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

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Note 1: Basis of Presentation

The consolidated financial statements include the accounts of Bank of Marin Bancorp ("Bancorp"), a bank holding company, and its wholly-owned bank subsidiary, Bank of Marin (the "Bank"), a California state-chartered commercial bank. References to "we," "our," "us" mean the holding company and the Bank that are consolidated for financial reporting purposes. The accompanying unaudited consolidated interim financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to those rules and regulations. Although we believe that the disclosures made are adequate to make the information not misleading, we suggest that these interim financial statements be read in conjunction with the financial statements and the notes thereto included in our 2014 Annual Report on Form 10-K. In the opinion of Management, the unaudited consolidated financial statements reflect all adjustments which are necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in stockholders' equity, and cash flows for the periods presented. All material intercompany transactions have been eliminated. The results of these interim periods may not be indicative of the results for the full year or for any other period. We have evaluated subsequent events through the date of filing with the SEC and have determined that there are no subsequent events that require additional recognition or disclosure.

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

The following table shows: 1) weighted average basic shares, 2) potentially dilutive common shares related to stock options, unvested restricted stock awards 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 awards. Diluted EPS are calculated using the weighted average diluted shares. The number of potentially dilutive common shares included in quarterly diluted EPS is computed using the average market prices during the three months included in the reporting period under the treasury stock method. The number of potentially dilutive common shares included in year-to-date diluted EPS is a year-to-date weighted average of potentially dilutive common shares included in each quarterly diluted EPS computation. We have two forms of outstanding stock: common stock and unvested restricted stock awards. Holders of unvested restricted stock awards receive non-forfeitable dividends at the same rate as common shareholders and they both share equally in undistributed earnings. Therefore, under the two-class method, the difference in EPS is not significant for these participating securities.

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(in thousands, except per share data; unaudited)	Three months ended	
	March 31, 2015	March 31, 2014
Weighted average basic shares outstanding	5,921	5,870
Add: Potentially dilutive common shares related to stock options	47	43
Potentially dilutive common shares related to unvested restricted stock	6	6
Potentially dilutive common shares related to the warrant	74	61
Weighted average diluted shares outstanding	6,048	5,980
Net income	\$4,457	\$4,533
Basic EPS	\$0.75	\$0.77
Diluted EPS	\$0.74	\$0.76
Weighted average anti-dilutive shares not included in the calculation of diluted EPS	24	44

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Note 2: Recently Issued Accounting Standards

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

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The ASU is a converged standard involving FASB and International Financial Reporting Standards that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The guidance in this ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. For public entities, the ASU is effective on a retrospective basis for annual reporting periods, and interim periods within those annual periods, beginning after December 15, 2016. Since this ASU does not apply to financial instruments and we do not have a significant source of non-interest income subject to this ASU, we do not expect it to have a significant impact on our financial condition or results of operations.

In June 2014, the FASB issued ASU No. 2014-12, Compensation - Stock Compensation (Topic 718) Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. This ASU provides guidance for entities that grant their employees share-based payment awards where a performance target that affects vesting could be achieved after the requisite service period. That is the case when an employee is eligible to retire or otherwise terminate employment before the end of the period in which a performance target could be achieved and still be eligible to vest in the award if and when the performance target is achieved. This ASU stipulates that compensation expense should be recognized in the period where the performance target becomes probable of being achieved as opposed to the date that the award was granted. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. As of March 31, 2015 we have not granted share-based payment awards where a performance target that affects vesting could be achieved after the requisite service period. We do not expect this ASU to have a material impact on our financial condition or results of operations.

Note 3: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

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

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

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

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

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

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

(in thousands) 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 March 31, 2015 (unaudited):				
Securities available-for-sale:				
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies	\$ 152,142	\$—	\$ 149,472	\$ 2,670
Debentures of government-sponsored agencies	\$ 26,174	\$—	\$ 26,174	\$—
Privately-issued collateralized mortgage obligations	\$ 5,493	\$—	\$ 5,493	\$—
Obligations of state and political subdivisions	\$ 15,850	\$—	\$ 15,850	\$—
Corporate bonds	\$ 5,021	\$—	5,021	\$—
Derivative financial assets (interest rate contracts)	\$—	\$—	\$—	\$—
Derivative financial liabilities (interest rate contracts)	\$ 2,481	\$—	\$ 2,481	\$—
At December 31, 2014:				
Securities available-for-sale:				
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies	\$ 158,119	\$—	\$ 155,421	\$ 2,698
Debentures of government-sponsored agencies	\$ 14,557	\$—	\$ 14,557	\$—
Privately-issued collateralized mortgage obligations	\$ 7,294	\$—	\$ 7,294	\$—
Obligations of state and political subdivisions	\$ 15,880	\$—	\$ 15,771	\$—
Corporate bonds	\$ 4,998	\$—	\$ 5,437	\$—
Derivative financial assets (interest rate contracts)	\$ 61	\$—	\$ 61	\$—
Derivative financial liabilities (interest rate contracts)	\$ 1,996	\$—	\$ 1,996	\$—

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 March 31, 2015 and December 31, 2014, there are no securities that are considered Level 1 securities. As of March 31, 2015, we have one available-for-sale security that is considered a Level 3 security. The security is a U.S. government agency obligation collateralized by a small pool of business equipment loans guaranteed by the Small Business Administration program. This security is not actively traded and is owned only by a few investors. The significant unobservable data that is reflected in the fair value measurement include dealer quotes, projected prepayment speeds/average life and credit information, among other things. It was transferred to a Level 3 security during the second quarter of 2014. The increase in unrealized gain during the first quarter of 2015 is \$10 thousand.

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.

On a recurring basis, derivative financial instruments are recorded at fair value, which is based on the income approach using observable Level 2 market inputs, reflecting market expectations of future interest rates as of the measurement



date. Standard valuation techniques are used to calculate the present value of the future expected cash flows assuming an orderly transaction. Valuation adjustments may be made to reflect both our own credit risk and the counterparties' credit quality in determining the fair value of the derivatives. Level 2 inputs for the valuations are limited to observable market prices for London Interbank Offered Rate ("LIBOR") cash rates and Overnight Index Swap ("OIS") rates (for the very short term), quoted prices for LIBOR futures contracts, observable market prices for LIBOR and OIS swap rates, and one-month and three-month LIBOR basis spreads at commonly quoted intervals. Mid-market pricing of the inputs is used as a practical expedient in the fair value measurements. We project spot rates at reset days specified by each swap to determine future cash flows, then discount to present value using either LIBOR or OIS curves depending on the collateral posted as of the measurement date. When the value of any collateral placed with counterparties is less than the interest rate derivative liability, an additional discount is applied to reflect our potential credit risk to counterparties. We have used the spread between the Standard & Poor's BBB rated U.S. Bank Composite rate and LIBOR for the closest maturity term corresponding to the duration of the swaps to derive the credit-risk-related component of the discount rate of future cash flows from the collateral shortfall.

Certain financial assets may be measured at fair value on a non-recurring basis. These assets are subject to fair value adjustments that result from the application of the lower of cost or fair value accounting or write-downs of individual assets, such as impaired loans and other real estate owned ("OREO").

The following table presents the carrying value of financial instruments that were measured at fair value on a non-recurring basis and that were still held in the consolidated statements of condition at each respective period end, by level within the fair value hierarchy as of March 31, 2015 and December 31, 2014.

(in thousands) Description of Financial Instruments	Carrying Value <sup>1</sup>	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) <sup>1</sup>
At March 31, 2015 (unaudited):				
Impaired loans carried at fair value:				
Installment and other consumer	13	—	—	13
Total	\$13	\$—	\$—	\$13
At December 31, 2014:				
Impaired loans carried at fair value:				
Installment and other consumer	77	—	—	77
Total	\$77	\$—	\$—	\$77

<sup>1</sup> Represents collateral-dependent loan principal balances that had been generally written down to the values of the underlying collateral, net of specific valuation allowances of \$10 thousand and \$26 thousand at March 31, 2015 and December 31, 2014, respectively. The carrying value of loans fully charged-off, which includes unsecured lines of credit, overdrafts and all other loans, is zero.

When a loan is identified as impaired, it is reported at the lower of cost or fair value, measured based on the loan's observable market price (Level 1) or the current net realizable value of the underlying collateral securing the loan, if the loan is collateral dependent (Level 3). Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as type, leasing status and physical condition. When

appraisals are received, Management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by Management on a case-by-case basis and are generally unobservable valuation inputs as they are specific to the underlying collateral. There have been no significant changes in the valuation techniques during the quarter ended March 31, 2015.

OREO represents collateral acquired through foreclosure and is initially recorded at fair value as established by a current appraisal, adjusted for disposition costs. Subsequently, OREO is measured at lower of cost or fair value. OREO values are reviewed on an ongoing basis and any subsequent decline in fair value is recorded as a foreclosed asset expense in the current period. The value of OREO is determined based on independent appraisals, similar to the process used for impaired loans, discussed above, and is generally classified as Level 3. We had \$421 thousand and \$461 thousand of OREO as of March 31, 2015 and December 31, 2014, respectively, all of which was acquired from Bank of Alameda as part of the Acquisition. There was a \$40 thousand decline in the estimated fair value of the OREO during the first three months ended March 31, 2015.

#### Disclosures about Fair Value of Financial Instruments

The table below is a summary of fair value estimates for financial instruments as of March 31, 2015 and December 31, 2014, 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; 2015 unaudited)	March 31, 2015			December 31, 2014		
	Carrying Amounts	Fair Value	Fair Value Hierarchy	Carrying Amounts	Fair Value	Fair Value Hierarchy
Financial assets						
Cash and cash equivalents	\$103,164	\$103,164	Level 1	\$41,367	\$41,367	Level 1
Investment securities held-to-maturity	107,476	109,785	Level 2	116,437	118,643	Level 2
Loans, net	1,331,328	1,341,118	Level 3	1,348,252	1,361,244	Level 3
Interest receivable	5,453	5,453	Level 2	5,909	5,909	Level 2
Financial liabilities						
Deposits	1,585,120	1,585,907	Level 2	1,551,619	1,552,446	Level 2
Federal Home Loan Bank borrowings	15,000	15,514	Level 2	15,000	15,484	Level 2
Subordinated debentures	5,238	5,274	Level 3	5,185	5,290	Level 3
Interest payable	208	208	Level 2	213	213	Level 2

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

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

**Held-to-maturity Securities** - Held-to-maturity securities, which generally consist of mortgage-backed securities, obligations of state and political subdivisions and corporate bonds, are recorded at their amortized cost. Their fair value for disclosure purposes is determined using methodologies similar to those described above for available-for-sale securities using Level 2 inputs. If Level 2 inputs are not available, we may utilize pricing models that incorporate unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities (Level 3). As of March 31, 2015 and December 31, 2014, we did not hold any held-to-maturity securities whose fair value was measured using significant unobservable inputs.

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Loans - The fair value of loans with variable interest rates approximates 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 creditworthiness and similar remaining maturities. The allowance for loan losses (“ALLL”) is considered to be a reasonable estimate of the portion of loan discount attributable to credit risks.

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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 deposits without stated maturity, such as transaction accounts, savings accounts and money market accounts, is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting the future cash flows using current rates offered for deposits of similar remaining maturities.

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

Subordinated Debentures - As part of the Acquisition, we assumed two subordinated debentures from NorCal. See Note 6 for further information. The fair values of the subordinated debentures were estimated by discounting the future cash flows (interest payment at a rate of three-month LIBOR plus 3.05% and 1.40%, respectively) to their present values using current market rates at which similar debt securities would be issued with similar credit ratings as ours and similar remaining maturities. Each interest payment was discounted at the spot rate for the corresponding term, determined based on the yields and terms of comparable trust preferred securities, plus a liquidity premium. In July 2010, the Dodd-Frank Act was signed into law and limits the ability of certain bank holding companies to treat trust preferred security debt issuances as Tier 1 capital. This law effectively closed the trust-preferred securities markets for new issuance and led to the absence of observable or comparable transactions in the market place. Due to the use of unobservable inputs of trust preferred securities, we consider the fair value to be a Level 3 measurement.

Commitments - Loan commitments and standby letters of credit generate ongoing fees, which are recognized over the term of the commitment period. We record an allowance reserve for these off-balance sheet commitments which is based on an estimate of probabilities of these commitments being drawn upon according to our historical utilization experience on different types of commitments and expected loss severity. We have set aside an allowance for losses in the amount of \$811 thousand and \$1.0 million as of March 31, 2015 and December 31, 2014, respectively.

#### Note 4: 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:

	March 31, 2015				December 31, 2014			
	Amortized Cost	Fair Value	Gross Gains	Unrealized (Losses)	Amortized Cost	Fair Value	Gross Gains	Unrealized (Losses)
(in thousands; 2015 unaudited)								
Held-to-maturity								
Obligations of state and political subdivisions	\$60,529	\$62,257	\$1,741	\$(13)	\$63,425	\$65,121	\$1,736	\$(40)
Corporate bonds	32,175	32,345	173	(3)	40,257	40,448	216	(25)
MBS pass-through securities issued by FHLMC and FNMA	14,772	15,183	411	—	12,755	13,074	319	—

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Total held-to-maturity	107,476	109,785	2,325	(16	)	116,437	118,643	2,271	(65	)
Available-for-sale										
Securities of U.S. government agencies:										
MBS pass-through securities										
issued by FHLMC and FNMA	90,215	92,057	1,842	—		92,963	94,214	1,262	(11	)
CMOs issued by FNMA	13,896	14,055	197	(38	)	14,771	14,790	77	(58	)
CMOs issued by FHLMC	29,482	29,799	339	(22	)	31,238	31,260	109	(87	)
CMOs issued by GNMA	15,933	16,231	308	(10	)	17,573	17,855	298	(16	)
Debentures of government-sponsored agencies	26,154	26,174	119	(99	)	14,694	14,557	95	(232	)
Privately issued CMOs	5,353	5,493	142	(2	)	7,137	7,294	172	(15	)
Obligations of state and political subdivisions	15,596	15,850	256	(2	)	15,733	15,880	155	(8	)
Corporate bonds	4,939	5,021	82	—		4,936	4,998	66	(4	)
Total available-for-sale	201,568	204,680	3,285	(173	)	199,045	200,848	2,234	(431	)
Total investment securities	\$309,044	\$314,465	\$5,610	\$(189	)	\$315,482	\$319,491	\$4,505	\$(496	)

The amortized cost and fair value of investment debt securities by contractual maturity at March 31, 2015 are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

(in thousands; 2015 unaudited)	March 31, 2015				December 31, 2014			
	Held-to-Maturity		Available-for-Sale		Held-to-Maturity		Available-for-Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	\$36,925	\$37,015	\$5,769	\$5,816	\$39,778	\$39,913	\$2,378	\$2,388
After one year but within five years	44,701	45,804	50,411	50,686	50,983	51,953	43,866	43,919
After five years through ten years	12,216	12,871	9,312	9,471	11,679	12,426	9,644	9,749
After ten years	13,634	14,095	136,076	138,707	13,997	14,351	143,157	144,792
Total	\$107,476	\$109,785	\$201,568	\$204,680	\$116,437	\$118,643	\$199,045	\$200,848

We sold two available-for-sale securities in 2015 with total proceeds of \$1.6 million and realized a gross gain of \$8 thousand.

We sold one available-for-sale and three held-to-maturity securities in the first quarter of 2014 with total proceeds of \$2.0 million and \$725 thousand, respectively, and incurred a loss of \$15 thousand and a gross gain of \$7 thousand, respectively. The sales of the held-to-maturity securities were due to evidence of significant deterioration in issuer creditworthiness since purchase.

Investment securities carried at \$69.2 million and \$74.7 million at March 31, 2015 and December 31, 2014, respectively, were pledged to the State of California: \$68.4 million and \$73.8 million to secure public deposits in compliance with the Local Agency Security Program at March 31, 2015 and December 31, 2014, respectively, and \$852 thousand and \$856 thousand to provide collateral for trust deposits at March 31, 2015 and December 31, 2014, 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 March 31, 2015 and December 31, 2014.

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

We have evaluated the credit of our investment securities and their issuer and/or insurers. Based on our evaluation, Management has determined that no investment security in our investment portfolio is other-than-temporarily impaired as of March 31, 2015. We do not have the intent, and it is more likely than not that we will not have to sell securities temporarily impaired at March 31, 2015 before recovery of the cost basis.

Twelve and twenty-eight investment securities were in unrealized loss positions at March 31, 2015 and December 31, 2014, respectively. Those securities are summarized and classified according to the duration of the loss period in the table below:

March 31, 2015  (in thousands; unaudited)	< 12 continuous months		> 12 continuous months		Total securities in a loss position	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
<b>Held-to-maturity</b>						
Obligations of state & political subdivisions	\$2,556	\$(3 )	361	(10 )	\$2,917	\$(13 )
Corporate bonds	1,997	(3 )	—	—	1,997	(3 )
<b>Total held-to-maturity</b>	<b>4,553</b>	<b>(6 )</b>	<b>361</b>	<b>(10 )</b>	<b>4,914</b>	<b>(16 )</b>
<b>Available-for-sale</b>						
CMOs issued by FNMA	—	—	3,918	(38 )	3,918	(38 )
CMOs issued by FHLMC	—	—	2,232	(22 )	2,232	(22 )
CMOs issued by GNMA	3,074	(10 )	—	—	3,074	(10 )
Debentures of government-sponsored agencies	—	—	9,901	(99 )	9,901	(99 )
Privately issued CMOs	458	(2 )	—	—	458	(2 )
Obligations of state & political subdivisions	—	—	588	(2 )	588	(2 )
<b>Total available-for-sale</b>	<b>3,532</b>	<b>(12 )</b>	<b>16,639</b>	<b>(161 )</b>	<b>20,171</b>	<b>(173 )</b>
<b>Total temporarily impaired securities</b>	<b>\$8,085</b>	<b>\$(18 )</b>	<b>\$17,000</b>	<b>\$(171 )</b>	<b>\$25,085</b>	<b>\$(189 )</b>

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December 31, 2014 (dollars in thousands)	< 12 continuous months		> 12 continuous months		Total securities in a loss position	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity						
Obligations of state & political subdivisions	\$ 5,830	\$(27)	\$ 359	\$(13)	\$ 6,189	\$(40)
Corporate bonds	3,009	(1)	3,533	(24)	6,542	(25)
Total held-to-maturity	8,839	(28)	3,892	(37)	12,731	(65)
Available-for-sale						
MBS pass-through securities issued by FNMA and FHLMC	1,960	(11)	—	—	1,960	(11)
CMOs issued by FNMA	—	—	4,115	(58)	4,115	(58)
CMOs issued by FHLMC	17,157	(44)	2,291	(43)	19,448	(87)
CMOs issued by GNMA	3,262	(16)	—	—	3,262	(16)
Debentures of government-sponsored agencies	494	(1)	9,769	(231)	10,263	(232)
Privately issued CMOs	817	(15)	—	—	817	(15)
Obligations of state & political subdivisions	2,695	(3)	1,112	(5)	3,807	(8)
Corporate bonds	1,002	(1)	990	(3)	1,992	(4)
Total available-for-sale	27,387	(91)	18,277	(340)	45,664	(431)
Total temporarily impaired securities	\$ 36,226	\$(119)	\$ 22,169	\$(377)	\$ 58,395	\$(496)

As of March 31, 2015, there were six investment positions that had been in a continuous loss position for more than twelve months. These securities consisted of a government-sponsored agency debenture, obligations of U.S. state and political subdivisions, and CMOs. We have evaluated each of the bonds and believe that the decline in fair value is primarily driven by factors other than credit. It is probable that we will be able to collect all amounts due according to the contractual terms and no other-than-temporary impairment exists on these securities. The CMOs issued by FNMA and FHLMC are supported by the U.S. Federal Government to protect us from credit losses. Additionally, the obligations of state and political subdivisions were deemed creditworthy based on our review of the issuers' recent financial information and their insurers, if any. Based upon our assessment of the credit fundamentals and the credit enhancements, we concluded that these securities were not other-than-temporarily impaired at March 31, 2015.

Six investment securities in our portfolio were in a temporary loss position for less than twelve months as of March 31, 2015. They consisted of a U.S. Agency CMO, obligations of U.S. state and political subdivisions, a corporate bond and privately issued CMOs. We determine that the strengths of GNMA through the U.S. Federal Government guarantee is sufficient to protect us from credit losses. Other temporarily impaired securities are deemed creditworthy after internal analysis. Additionally, all are rated as investment grade by at least one major rating agency. As a result of this impairment analysis, we concluded that these securities were not other-than-temporarily impaired at March 31, 2015.

#### Non-Marketable Securities

As a member of the FHLB, we are required to maintain a minimum investment in the FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can increase in the event we increase our total asset size or borrowings with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at its \$100 per share par value. We held \$8.2 million of FHLB stock recorded at cost in other assets on



the consolidated statements of condition at both March 31, 2015 and December 31, 2014. The carrying amounts of these investments are reasonable estimates of fair value because the securities are restricted to member banks and they do not have a readily determinable market value. Management does not believe that the FHLB stock is other-than-temporarily-impaired, as we expect to be able to redeem this stock at cost. On April 29, 2015, the FHLB distributed a cash dividend for the first quarter of 2015 at an annualized dividend rate of 7.67%.

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. On January 28, 2015, Visa's Board of Directors approved a 4-for-1 split of Visa's Class A common stock. As Class B holders, the conversion rate was adjusted to 1.6483 when converting this Class B common stock to Class A common stock, the value would be \$1.8 million at both March 31, 2015 and December 31, 2014. The conversion rate is subject to further reduction upon the final settlement of the covered litigation against Visa Inc. and its member banks. See Note 8 herein.

We invest in low income housing tax credit funds as a limited partner, which totaled \$2.8 million and \$1.8 million recorded in other assets as of March 31, 2015 and December 31, 2014, respectively. In the first three months of 2015, we recognized \$72 thousand of low income housing tax credits and other tax benefits, net of \$56 thousand of amortization expense of low income housing tax credit investment, as a component of income tax benefit. As of March 31, 2015, our unfunded commitments for these low income housing tax credit funds totaled \$2.2 million. We did not recognize any impairment losses on these low income housing tax credit investments during the first three months of 2015, or the year ended December 31, 2014.

Note 5: Loans and Allowance for Loan Losses

Credit Quality of Loans

Outstanding loans by class and payment aging as of March 31, 2015 and December 31, 2014 are as follows:

Loan Aging Analysis by Class as of March 31, 2015 and December 31, 2014

(dollars in thousands; 2015 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential <sup>1</sup>	Installment and other consumer	Total	
March 31, 2015									
30-59 days past due	\$ 13	\$ —	\$ —	\$ —	\$ 295	\$ 161	\$ 184	\$ 653	
60-89 days past due	296	—	—	—	—	—	—	296	
Greater than 90 days past due (non-accrual) <sup>2</sup>	373	1,403	2,354	5,107	166	—	79	9,482	
Total past due	682	1,403	2,354	5,107	461	161	263	10,431	
Current	195,760	233,934	651,494	51,943	112,816	73,214	16,892	1,336,053	
Total loans <sup>3</sup>	\$ 196,442	\$ 235,337	\$ 653,848	\$ 57,050	\$ 113,277	\$ 73,375	\$ 17,155	\$ 1,346,484	
Non-accrual loans to total loans	0.2	% 0.6	% 0.4	% 9.0	% 0.1	% —	% 0.5	% 0.7	%
December 31, 2014									
30-59 days past due	\$ 183	\$ —	\$ —	\$ —	\$ 646	\$ —	\$ 180	\$ 1,009	
	—	—	—	—	—	—	—	—	

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60-89 days past due									
Greater than 90 days past due (non-accrual) <sup>2</sup>	—	1,403	2,429	5,134	280	—	104	9,350	
Total past due	183	1,403	2,429	5,134	926	—	284	10,359	
Current	210,040	229,202	671,070	43,279	109,862	73,035	16,504	1,352,992	
Total loans <sup>3</sup>	\$210,223	\$230,605	\$673,499	\$48,413	\$110,788	\$73,035	\$16,788	\$1,363,351	
Non-accrual loans to total loans	—	% 0.6	% 0.4	% 10.6	% 0.3	% —	% 0.6	% 0.7	%

<sup>1</sup> Our residential loan portfolio does not include sub-prime loans, nor is it our practice to underwrite loans commonly referred to as "Alt-A mortgages", the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or higher loan-to-value ratios.

<sup>2</sup> Amounts include \$1.4 million of Purchased Credit Impaired ("PCI") loans that have stopped accreting interest at both March 31, 2015 and December 31, 2014. Amounts exclude accreting PCI loans of \$3.7 million and \$3.8 million at March 31, 2015 and December 31, 2014, respectively, as we have a reasonable expectation about future cash flows to be collected and we continue to recognize accretable yield on these loans in interest income. There were no accruing loans past due more than ninety days at March 31, 2015 or December 31, 2014.

<sup>3</sup> Amounts include net deferred loan costs of \$651 thousand and \$487 thousand at March 31, 2015 and December 31, 2014, respectively. Amounts are also net of unaccreted purchase discounts on non-PCI loans of \$4.2 million and \$4.4 million at March 31, 2015 and December 31, 2014, respectively.

Our commercial loans are generally made to established small and mid-sized businesses to provide financing for their working capital needs, equipment purchases, acquisitions, or refinancings. Management examines historical, current, and projected cash flows to determine the ability of the borrower to repay obligations as agreed. Commercial loans are made based primarily on the identified cash flows of the borrower and secondarily on the underlying collateral or

guarantor support. The cash flows of borrowers, however, may not occur as expected, and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed, such as accounts receivable or inventory, and include a personal guarantee. Some short-term loans may be made on an unsecured basis. We target stable local businesses with guarantors that have proven to be more resilient in periods of economic stress. Typically, the guarantors provide an additional source of repayment for most of our credit extensions.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans discussed above. We underwrite these loans to be repaid from cash flow and to be supported by real property collateral. Repayment of commercial real estate loans is largely dependent on the successful operation of the property securing the loan, or of the business conducted on the property securing the loan. Underwriting standards for commercial real estate loans include, but are not limited to, conservative debt coverage and loan-to-value ratios. Furthermore, substantially all of our loans are guaranteed by the owners of the properties. Commercial real estate loans may be adversely affected by conditions in the real estate markets or in the general economy. In the event of a vacancy, strong guarantors have historically carried the loans until a replacement tenant could be found. The owner's substantial equity investment provides a strong economic incentive to continue to support the commercial real estate projects. As such, we have generally experienced a relatively low level of loss and delinquencies in this portfolio.

Construction loans are generally made to developers and builders to finance construction, renovation and occasionally land acquisitions. These loans are underwritten after evaluation of the borrower's financial strength, reputation, prior track record, and independent appraisals. The construction industry can be impacted by significant events, including: the inherent volatility of real estate markets and vulnerability to delays due to weather, change orders, inability to obtain construction permits, labor or material shortages, and price changes. 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 installment and other consumer loans. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. Diversification, 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 conservative loan-to-value ratio, the number of such loans a borrower can have at one time, and documentation requirements. Our residential loan portfolio includes TIC units in San Francisco. These loans tend to have more equity in their properties than conventional residential mortgages, which mitigates risk. Installment and other consumer loans include mostly floating home loans and mobile 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 Federal Deposit Insurance Corporation ("FDIC"). Our internally assigned grades are as follows:

Pass – Loans to borrowers of acceptable or better credit quality. Borrowers in this category demonstrate fundamentally sound financial 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. Negative external industry factors are generally not present. The loan may be secured, unsecured or supported by non-real estate collateral for which the value is more difficult to determine and/or marketability is more uncertain. This category also includes "Watch" loans, where the primary source of repayment has been delayed. "Watch" is intended to be a transitional grade, with either an upgrade or downgrade within a reasonable period.

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

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

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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 nonaccrual 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 are generally required to submit rent rolls or property income statements at least annually.

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

Home equity and other consumer loans are reviewed based on delinquency.

Loans graded "Watch" or more severe, regardless of loan type, are reviewed no less than quarterly.

The following table represents an analysis of loans by internally assigned grades, including the PCI loans, at March 31, 2015 and December 31, 2014:

(in thousands; 2015 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Purchased credit-impaired	Total
<b>Credit Risk Profile by Internally Assigned Grade:</b>									
<b>March 31, 2015</b>									
Pass	\$ 181,842	\$ 211,551	\$ 640,656	\$ 50,305	\$ 111,227	\$ 71,768	\$ 16,816	\$ 2,202	\$ 1,286,367
Special Mention	9,424	10,281	3,853	1,078	321	—	—	1,031	25,988
Substandard	4,974	10,876	7,175	5,657	1,662	1,607	339	1,839	34,129
Total loans	\$ 196,240	\$ 232,708	\$ 651,684	\$ 57,040	\$ 113,210	\$ 73,375	\$ 17,155	\$ 5,072	\$ 1,346,484
<b>December 31, 2014</b>									
Pass	\$ 197,659	\$ 205,820	\$ 651,548	\$ 41,710	\$ 107,933	\$ 70,987	\$ 16,101	\$ 2,210	\$ 1,293,968
Special Mention	6,776	10,406	13,304	1,008	322	—	190	1,140	33,146
Substandard	5,464	11,763	6,473	5,684	2,466	2,048	497	1,842	36,237
Total loans	\$ 209,899	\$ 227,989	\$ 671,325	\$ 48,402	\$ 110,721	\$ 73,035	\$ 16,788	\$ 5,192	\$ 1,363,351

#### Troubled Debt Restructuring

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

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

A loan may no longer be reported as a TDR if it is subsequently refinanced or restructured at market terms through the normal underwriting process, the borrower is no longer considered to be in financial difficulty and performance on the loan is reasonably assured. The removal of TDR status must be approved by the same management level that approved the upgrading of the loan classification. During the first quarter of 2015, a loan with a recorded investment

of \$108 thousand was removed from TDR designation. There were no loans removed from TDR designation during 2014.

The table below summarizes outstanding TDR loans by loan class as of March 31, 2015 and December 31, 2014. The summary includes both TDRs that are on non-accrual status and those that continue to accrue interest.

(in thousands; 2015 unaudited)	As of	
Recorded investment in Troubled Debt Restructurings <sup>1</sup>	March 31, 2015	December 31, 2014
Commercial and industrial	\$3,477	\$3,584
Commercial real estate, owner-occupied	8,427	8,459
Commercial real estate, investor	522	524
Construction	5,657	5,684
Home equity	561	694
Other residential	2,037	2,045
Installment and other consumer	1,636	1,713
Total	\$22,317	\$22,703

<sup>1</sup> Includes \$15.6 million and \$15.9 million of TDR loans that were accruing interest as of March 31, 2015 and December 31, 2014, respectively. Includes \$1.6 million and \$1.8 million of acquired loans at March 31, 2015 and December 31, 2014, respectively.

The table below presents the following information for loans modified in a TDR during the quarter ended March 31, 2014: 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 and fully charged-off TDR loans. There were no loans modified in a TDR during 2015.

(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 March 31, 2014:				
Commercial and industrial	3	\$ 1,420	\$ 1,405	\$1,405
Home equity	1	150	150	150
Installment and other consumer	3	170	168	169
Total	7	\$ 1,740	\$ 1,723	\$1,724

Modifications during the three months ended March 31, 2014 primarily involved maturity extensions and interest rate concessions. During the first three months of 2015 and 2014, there were no defaults on loans that had been modified in a TDR within the prior twelve-month period. We report defaulted TDRs based on a payment default definition of more than ninety days past due.



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

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

(in thousands; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
March 31, 2015								
Recorded investment in impaired loans:								
With no specific allowance recorded	\$ 1,318	\$ 5,545	\$ 2,875	\$ 5,107	\$263	\$ 1,024	\$295	\$16,427
With a specific allowance recorded	2,533	2,882	—	560	298	1,012	1,398	8,683
Total recorded investment in impaired loans	\$ 3,851	\$ 8,427	\$ 2,875	\$ 5,667	\$561	\$ 2,036	\$ 1,693	\$25,110
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	\$ 1,315	\$ 6,545	\$ 4,867	\$ 7,797	\$263	\$ 1,024	\$295	\$22,106
With a specific allowance recorded	2,604	2,882	—	745	298	1,012	1,398	8,939
Total unpaid principal balance of impaired loans	\$ 3,919	\$ 9,427	\$ 4,867	\$ 8,542	\$561	\$ 2,036	\$ 1,693	\$31,045
Specific allowance	\$ 652	\$ 32	\$ —	\$ 3	\$1	\$ 85	\$ 188	\$961
Average recorded investment in impaired loans during the quarter ended March 31, 2015								
Average recorded investment in impaired loans during the quarter ended March 31, 2015	\$ 3,718	\$ 8,443	\$ 2,915	\$ 5,681	\$627	\$ 2,041	\$ 1,743	\$25,168
Interest income recognized on impaired loans during the quarter ended March 31, 2015								
Interest income recognized on impaired loans during the quarter ended March 31, 2015	\$ 62	\$ 66	\$ 6	\$ 9	\$5	\$ 23	\$ 19	\$190
Average recorded investment in impaired loans during the quarter ended March 31, 2014								
Average recorded investment in impaired loans during the quarter ended March 31, 2014	\$ 5,945	\$ 5,484	\$ 3,283	\$ 6,524	\$577	\$ 2,054	\$ 1,884	\$25,751
Interest income recognized on impaired loans during the quarter ended March 31, 2014								
Interest income recognized on impaired loans during the quarter ended March 31, 2014	\$ 118	\$ 83	\$ 7	\$ 21	\$4	\$ 23	\$ 18	\$274

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(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
December 31, 2014								
Recorded investment in impaired loans:								
With no specific allowance recorded	\$ 1,141	\$ 5,577	\$ 2,954	\$ 5,134	\$ 393	\$ 1,026	\$ 239	\$ 16,464
With a specific allowance recorded	2,443	2,882	—	561	300	1,019	1,554	\$ 8,759
Total recorded investment in impaired loans	\$ 3,584	\$ 8,459	\$ 2,954	\$ 5,695	\$ 693	\$ 2,045	\$ 1,793	\$ 25,223
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	\$ 1,186	\$ 6,577	\$ 4,945	\$ 7,824	\$ 880	\$ 1,026	\$ 239	\$ 22,677
With a specific allowance recorded	2,524	2,882	—	749	300	1,019	1,554	9,028
Total recorded investment in impaired loans	\$ 3,710	\$ 9,459	\$ 4,945	\$ 8,573	\$ 1,180	\$ 2,045	\$ 1,793	\$ 31,705
Specific allowance	\$ 694	\$ 65	\$ —	\$ 3	\$ —	\$ 92	\$ 284	\$ 1,138
Average recorded investment in impaired loans during 2014	5,354	6,604	3,138	6,471	741	1,744	1,857	25,909
Interest income recognized on impaired loans during 2014	378	288	28	85	19	74	76	948

The gross interest income that would have been recorded, had non-accrual loans been current, totaled \$231 thousand and \$205 thousand in the quarters ended March 31, 2015, and March 31, 2014, 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.

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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 March 31, 2015 totaled approximately \$5.4 million. At March 31, 2015, there were \$1.2 million outstanding commitments to extend credit on impaired loans, including loans to borrowers whose terms have been modified in TDRs.

The following tables disclose 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 Rollforward for the Period

(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 March 31, 2015									
Allowance for loan losses:									
Beginning balance	\$ 2,837	\$ 1,924	\$ 6,672	\$ 839	\$ 859	\$ 433	\$ 566	\$ 969	\$ 15,099
Provision (reversal)	(275 )	170	(383 )	(61 )	63	(3 )	(99 )	588	—
Charge-offs	(2 )	—	—	—	—	—	(6 )	—	(8 )
Recoveries	60	—	3	—	1	—	1	—	65
Ending balance	\$ 2,620	\$ 2,094	\$ 6,292	\$ 778	\$ 923	\$ 430	\$ 462	\$ 1,557	\$ 15,156

For the three months ended March 31,  
2014

Allowance for loan losses:									
Beginning balance	\$ 3,056	\$ 2,012	\$ 6,196	\$ 633	\$ 875	\$ 317	\$ 629	\$ 506	\$ 14,224
Provision (reversal)	(255 )	(27 )	268	100	11	92	(142 )	103	150
Charge-offs	(61 )	—	—	(197 )	—	—	(3 )	—	(261 )
Recoveries	32	—	5	—	1	—	81	—	119
Ending balance	\$ 2,772	\$ 1,985	\$ 6,469	\$ 536	\$ 887	\$ 409	\$ 565	\$ 609	\$ 14,232

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
As of March 31, 2015:									
Ending ALLL related to loans collectively evaluated for impairment	\$ 1,968	\$ 2,062	\$ 6,292	\$ 775	\$ 922	\$ 345	\$ 274	\$ 1,557	\$ 14,232
	\$ 648	\$ 32	\$ —	\$ —	\$ 1	\$ 85	\$ 188	\$ —	\$ 922

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Ending ALLL related to loans individually evaluated for impairment									
Ending ALLL related to purchased credit-impaired loans	\$4	\$—	\$—	\$3	\$—	\$—	\$—	\$—	\$7
Loans outstanding:									
Collectively evaluated for impairment	\$192,557	\$225,684	\$648,809	\$51,383	\$112,649	\$71,339	\$15,462	\$—	\$1,160,474
Individually evaluated for impairment <sup>1</sup>	3,683	7,024	2,875	5,657	561	2,036	1,693	—	23,599
Purchased credit-impaired	202	2,629	2,164	10	67	—	—	—	5,000
Total	\$196,442	\$235,337	\$653,848	\$57,050	\$113,277	\$73,375	\$17,155	\$—	\$1,194,073
Ratio of allowance for loan losses to total loans	1.33	% 0.89	% 0.96	% 1.36	% 0.81	% 0.59	% 2.69	% NM	1.16
Allowance for loan losses to non-accrual loans	702	% 149	% 267	% 15	% 556	% NM	585	% NM	160

<sup>1</sup> Total excludes \$1.6 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

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, 2014:									
Ending ALLL related to loans collectively evaluated for impairment	\$2,143	\$1,859	\$6,672	\$836	\$859	\$341	\$282	\$969	\$13,951
Ending ALLL related to loans individually evaluated for impairment	\$690	\$65	\$—	\$—	\$—	\$92	\$284	\$—	\$1,131
Ending ALLL related to purchased credit-impaired loans	\$4	\$—	\$—	\$3	\$—	\$—	\$—	\$—	\$7
Loans outstanding:									
Collectively evaluated for impairment	\$206,603	\$220,933	\$668,371	\$42,718	\$110,028	\$70,990	\$14,995	\$—	\$1,333,648
Individually evaluated for impairment <sup>1</sup>	3,296	7,056	2,954	5,684	693	2,045	1,793	—	23,521
Purchased credit-impaired	324	2,616	2,174	11	67	—	—	—	5,192
Total	\$210,223	\$230,605	\$673,499	\$48,413	\$110,788	\$73,035	\$16,788	\$—	\$1,368,363
Ratio of allowance for loan losses to total loans	1.35	% 0.83	% 0.99	% 1.73	% 0.78	% 0.59	% 3.37	% NM	1.11
Allowance for loan losses to non-accrual loans	NM	137	% 275	% 16	% 307	% NM	544	% NM	161

<sup>1</sup> Total excludes \$1.7 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

Purchased Credit-Impaired Loans

We evaluated loans purchased in acquisitions in accordance with accounting guidance in ASC 310-30 related to loans acquired with deteriorated credit quality. Acquired loans are considered credit-impaired if there is evidence of deterioration of credit quality since origination and it is probable, at the acquisition date, that we will be unable to collect all contractually required payments receivable. Management has determined certain loans purchased in our two acquisitions 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.

The following table reflects the outstanding balance and related carrying value of PCI loans as of March 31, 2015 and December 31, 2014.

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PCI Loans (in thousands; 2015 unaudited)	March 31, 2015		December 31, 2014	
	Unpaid principal balance	Carrying value	Unpaid principal balance	Carrying value
Commercial and industrial	\$301	\$202	\$479	\$324
Commercial real estate	6,806	4,793	6,831	4,790
Construction	132	10	136	11
Home equity	230	67	232	67
Total purchased credit-impaired loans	\$7,469	\$5,072	\$7,678	\$5,192

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

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Accretable Yield (dollars in thousands, unaudited)	Three months ended	
	March 31, 2015	March 31, 2014
Balance at beginning of period	\$4,027	\$3,649
Removals <sup>1</sup>	(77	) —
Accretion	(119	) (180
Reclassifications from nonaccretable difference <sup>2</sup>	—	1,832
Balance at end of period	\$3,831	\$5,301

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

<sup>2</sup> Primarily relates to changes 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 \$863.6 million and \$868.1 million at March 31, 2015 and December 31, 2014, respectively. Our FHLB line of credit totaled \$446.7 million and \$450.6 million at March 31, 2015 and December 31, 2014, respectively. In addition, we pledge a certain residential loan portfolio, which totaled \$30.9 million and \$27.7 million at March 31, 2015 and December 31, 2014, respectively, to secure our borrowing capacity with the Federal Reserve Bank (“FRB”). Also see Note 6 below.

#### Note 6: Borrowings

**Federal Funds Purchased** – We had unsecured lines of credit totaling \$72.0 million with correspondent banks for overnight borrowings at March 31, 2015 and December 31, 2014. In general, interest rates on these lines approximate the federal funds target rate. At March 31, 2015 and December 31, 2014, we had no overnight borrowings outstanding under these credit facilities.

**Federal Home Loan Bank Borrowings** – As of March 31, 2015 and December 31, 2014, we had lines of credit with the FHLB totaling \$446.7 million and \$450.6 million, respectively, based on eligible collateral of certain loans. At March 31, 2015 and December 31, 2014, we had no FHLB overnight borrowings.

On February 5, 2008, we entered into a ten-year borrowing agreement under the same FHLB line of credit for \$15.0 million at a fixed rate of 2.07%, which remained outstanding at March 31, 2015. 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 May 5, 2015 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 March 31, 2015, \$431.5 million was remaining as available for borrowing from the FHLB, net of the term borrowing and letters of credit acquired from NorCal totaling \$241 thousand.

**Federal Reserve Line of Credit** – We have a line of credit with the FRB secured by certain residential loans. At March 31, 2015 and December 31, 2014, we had borrowing capacity under this line totaling \$30.9 million and \$27.7 million, respectively, and had no outstanding borrowings with the FRB.

As part of the Acquisition, we assumed two subordinated debentures due to NorCal Community Bancorp Trusts I and II (the "Trusts"), established for the sole purpose of issuing trust preferred securities on September 22, 2003 and December 29, 2005, respectively. The subordinated debentures were recorded at fair values totaling \$4.95 million at acquisition date with contractual values totaling \$8.2 million. The difference between the contractual balance and the fair value at acquisition date is accreted into interest expense over the lives of the debentures. Accretion on the subordinated debentures totaled \$53 thousand in the first three months of 2015 and \$54 thousand in the first three months of 2014. We have the option to defer payment of the interest on the subordinated debentures for a period of up to five years, as long as there is no default on the subordinated debentures. In the event of interest deferral, dividends to Bank of Marin Bancorp common stockholders are prohibited. The trust preferred securities were sold and issued in private transactions pursuant to an exemption from registration under the Securities Act of 1933, as amended. Bancorp has guaranteed, on a subordinated basis, distributions and other payments due on trust preferred securities



totaling \$8.0 million issued by the Trusts which have identical maturity, repricing and payment terms as the subordinated debentures.

The following is a summary of the contractual terms of the subordinated debentures due to the Trusts as of March 31, 2015:

(in thousands; unaudited)

Subordinated debentures due to NorCal Community Bancorp Trust I on October 7, 2033 with interest payable quarterly, based on 3-month LIBOR plus 3.05%, repricing quarterly (3.30% as of March 31, 2015), redeemable, in whole or in part, on any interest payment date	\$4,124
Subordinated debentures due to NorCal Community Bancorp Trust II on March 15, 2036 with interest payable quarterly, based on 3-month LIBOR plus 1.40%, repricing quarterly (1.67% as of March 31, 2015), redeemable, in whole or in part, on any interest payment date	4,124
Total	\$8,248

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## Note 7: Stockholders' Equity

## Warrant

Under the United States Department of the Treasury Capital Purchase Program (the "TCPP"), Bancorp issued to the U.S. Treasury a warrant to purchase 154,242 shares of common stock at a per share exercise price of \$27.23. The warrant was immediately exercisable and expires on December 5, 2018. 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 157,198 shares of common stock at \$26.72 per share as of March 31, 2015 in accordance with Section 13(c) of the Form of Warrant to Purchase Common Stock.

## Dividends

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

(in thousands, except per share data; unaudited)	Three months ended	
	March 31, 2015	March 31, 2014
Cash dividends to common stockholders	\$1,307	\$1,120
Cash dividends per common share	\$0.22	\$0.19

## 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 stock awards and performance-based stock awards pursuant to the 2007 Equity Plan. The grant-date fair value of the restricted stock awards and performance-based stock awards, which is equal to 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.

Starting in 2015, performance-based stock awards were issued to a selected group of employees. Stock award vesting is contingent upon the achievement of pre-established long-term performance goals set by the Compensation Committee of the Board of Directors. Performance is measured over a three-year period and cliff vested. These performance-based stock awards were granted at a maximum opportunity level, and based on the achievement of the pre-established goals, the actual payouts can range from 0% to 200% of the target award. For performance-based stock awards, an estimate is made of the number of shares expected to vest based on the probability that the performance criteria will be achieved to determine the amount of compensation expense to be recognized. The estimate is re-evaluated quarterly and total compensation expense is adjusted for any change in the current period.

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 awards as an addition to common stock with a corresponding decrease in current taxes payable.

The holders of unvested restricted stock awards and performance-based stock awards are entitled to dividends on the same per-share ratio as 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 8: 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 some 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 creditworthiness 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 \$343.7 million at March 31, 2015. This amount included \$177.2 million under commercial lines of credit (these commitments are contingent upon customers maintaining specific credit standards), \$118.3 million under revolving home equity lines, \$34.5 million under undisbursed construction loans, \$2.3 million under standby letters of credit, and a remaining \$11.4 million under personal and other lines of credit. We record an allowance for losses on these off-balance sheet commitments based on an estimate of probabilities of these commitments being drawn upon according to our historical utilization experience on different types of commitments and expected loss severity. We have set aside an allowance for losses in the amount of \$811 thousand and \$1.0 million for these commitments as of March 31, 2015 and December 31, 2014, respectively, which is recorded in interest payable and other liabilities on the consolidated statements of condition. A reduction in reserve requirements for off-balance sheet commitments due to the reduced effect of historical charge-offs resulted in the decline in the allowance for losses in the first quarter of 2015.

## Operating Leases

We rent certain premises and equipment under long-term, non-cancelable operating leases expiring at various dates through the year 2028. Most of the leases contain certain renewal options and escalation clauses. At March 31, 2015, the approximate minimum future commitments payable under non-cancelable contracts for leased premises are as follows:

(in thousands; unaudited)	2015	2016	2017	2018	2019	Thereafter	Total
Operating leases	\$2,822	\$3,788	\$3,781	\$3,810	\$3,553	\$6,786	\$24,540

## Litigation 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 contingent 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. ("Visa") by its member banks in connection with lawsuits related to anti-trust charges and interchange fees ("Covered Litigation"). Visa Inc. maintains an escrow account from which settlements of, or judgments in, the covered litigation

are paid. According to the latest SEC filing by VISA, Inc. dated April 30, 2015, at March 31, 2015, the balance of escrow account was \$1.2 billion. On January 14, 2015, following a Court-approved process to give class members who previously opted out of the damages portion of the class settlement an option to rejoin it, the class administrator submitted a report stating that it had received 1,179 requests by merchants to rejoin the cash settlement class, some of which may include multiple merchants. The conversion rate of Visa Class B common stock held by us to Class A common stock (as discussed in Note 4) may reduce if Visa makes more Covered Litigation settlement payments in the future and the full impact to member banks is still uncertain. However, we are not aware of significant future cash settlement payments required by us on the Covered Litigation.

Note 9: 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 payments to floating-rate interest payments, generally benchmarked to the one-month U.S. dollar LIBOR index, protects us against changes in the fair value of our loans 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. When the fixed-rate loans are originated, the forward swaps are designated to offset the change in fair value in the loans. 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 is 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 \$250 thousand, depending upon the counterparty). Collateral levels are monitored and adjusted on a regular basis for changes in interest rate swap values.

As of March 31, 2015, we have eight interest rate swap agreements, which are scheduled to mature in September 2018, June 2020, August 2020, 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 \$40 thousand and \$41 thousand as of March 31, 2015 and December 31, 2014, respectively. Information on our derivatives follows:

	Asset derivatives		Liability derivatives	
(in thousands; 2015 unaudited)	March 31, 2015	December 31, 2014	March 31, 2015	December 31, 2014
Fair value hedges:				
Interest rate contracts notional amount	\$—	\$4,589	\$30,992	\$26,899
Interest rate contracts fair value <sup>1</sup>	\$—	\$61	\$2,481	\$1,996
			Three months ended	
(in thousands; unaudited)			March 31, 2015	March 31, 2014
(Decrease) increase in value of designated interest rate swaps recognized in interest income			\$(546)	) \$736
Payment on interest rate swaps recorded in interest income			(235)	) (253)
Increase (decrease) in value of hedged loans recognized in interest income			571	) (531)
Decrease in value of yield maintenance agreement recognized against interest income			(14)	) (47)
Net loss on derivatives recognized against interest income <sup>2</sup>			\$(224)	) \$(95)

<sup>1</sup> See Note 3 for valuation methodology.

<sup>2</sup> Includes hedge ineffectiveness gain of \$11 thousand and gain of \$158 thousand for the quarters ended March 31, 2015 and March 31, 2014, 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; 2015 unaudited)			Gross Amounts Not Offset in the Statements of Condition			
	Gross Amounts of Recognized Assets <sup>1</sup>	Gross Amounts Offset in the Statements of Condition	Net Amounts of Assets Presented in the Statements of Condition <sup>1</sup>	Financial Instruments	Cash Collateral Received	Net Amount
As of March 31, 2015						
Derivatives by Counterparty						
Counterparty A	\$—	\$—	\$—	\$—	\$—	\$—
Counterparty B	—	—	—	—	—	—
Total	\$—	\$—	\$—	\$—	\$—	\$—
As of December 31, 2014						
Derivatives by Counterparty						
Counterparty A	\$61	\$—	\$61	\$(61)	)\$—	\$—
Counterparty B	—	—	—	—	—	—
Total	\$61	\$—	\$61	\$(61)	)\$—	\$—

<sup>1</sup> Amounts exclude accrued interest totaling zero and \$1 thousand at March 31, 2015 and December 31, 2014, respectively.

Offsetting of Financial Liabilities and Derivative Liabilities

(in thousands; 2015 unaudited)			Gross Amounts Not Offset in the Statements of Condition			
	Gross Amounts of Recognized Liabilities <sup>2</sup>	Gross Amounts Offset in the Statements of Condition	Net Amounts of Liabilities Presented in the Statements of Condition <sup>2</sup>	Financial Instruments	Cash Collateral Pledged	Net Amount
As of March 31, 2015						
Derivatives by Counterparty						
Counterparty A	\$2,107	\$—	\$2,107	\$—	\$(2,107)	)\$—
Counterparty B	374	—	374	—	(374)	)—
Total	\$2,481	\$—	\$2,481	\$—	\$(2,481)	)\$—



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As of December 31,  
2014

Derivatives by  
Counterparty

Counterparty A	\$ 1,616	\$—	\$ 1,616	\$(61	)\$(1,360	)\$195
Counterparty B	380	—	380	—	(380	)—
Total	\$ 1,996	\$—	\$ 1,996	\$(61	)\$(1,740	)\$195

<sup>2</sup> Amounts exclude accrued interest totaling \$40 thousand and \$39 thousand at March 31, 2015 and December 31, 2014, respectively.

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

Management's discussion of the financial condition and results of operations 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 2014 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 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 preceded by "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, the monetary policies of the FRB, 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 securities, integration of acquisitions and competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation; adverse weather conditions, including the drought in California; and other economic, competitive, governmental, regulatory and technological factors affecting our operations, pricing, products and services.

These and other important factors are detailed in the Risk Factors section of our 2014 Form 10-K as filed with the SEC, copies of which are available from us at no charge. Forward-looking statements apply 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		
	March 31, 2015	March 31, 2014	
For the period:			
Net income	\$4,457	\$4,533	
Net income per share			
Basic	\$0.75	\$0.77	
Diluted	\$0.74	\$0.76	
Return on average equity	8.92	% 9.97	%
Return on average assets	1.00	% 1.01	%
Common stock dividend payout ratio	29.33	% 24.66	%
Average shareholders' equity to average total assets	11.19	% 10.11	%
Efficiency ratio	63.07	% 63.86	%
Tax equivalent net interest margin	4.00	% 4.25	%
 (dollars in thousands, except per share data; unaudited)			
At period end:			
Book value per common share	\$34.27	\$31.51	
Total assets	\$1,826,149	\$1,797,852	
Total loans	\$1,346,484	\$1,277,990	
Total deposits	\$1,585,120	\$1,576,340	
Loan-to-deposit ratio	84.9	% 81.1	%
Total risk-based capital ratio - Bancorp	13.8	% 13.5	%
Common equity Tier 1 ratio - Bancorp	12.5	% -	
Tier 1 leverage ratio (to average assets) - Bancorp	11.1	% 9.9	%

## Executive Summary

Earnings in the first quarter of 2015 totaled \$4.5 million, compared to \$4.7 million in the fourth quarter of 2014 and \$4.5 million in the first quarter of 2014. Diluted earnings per share totaled \$0.74 in the first quarter of 2015, compared to \$0.78 in the prior quarter and \$0.76 in the same quarter last year.

Loans totaled \$1.35 billion at March 31, 2015, compared to \$1.36 billion at December 31, 2014. New loan volume of approximately \$30 million in the first quarter of 2015 was offset by payoffs of approximately \$40 million, and combined with utilization on lines of credit and amortization on existing loans produced a net decrease of \$16.9 million over December 31, 2014. Payoffs in the first quarter of 2015 included four large loans totaling \$23.1 million that were due to property sales. Advances on construction loans increased balances by \$8.6 million despite the sale of one large project. Credit quality remains strong with non-accrual loans representing 0.70% of total loans at March 31, 2015, compared to 0.69% at December 31, 2014. Non-accrual loans increased minimally from \$9.4 million at year-end to \$9.5 million at March 31, 2015. Accruing loans past due 30 to 89 days totaled \$949 thousand at March 31, 2015, compared to \$1.0 million at December 31, 2014.

There was no provision for loan losses recorded in the first quarter of 2015 or the prior quarter, compared to a provision for loan losses totaling \$150 thousand in the first quarter of 2014. The ratio of allowance for loan losses ("ALLL") to total loans increased from 1.11% at December 31, 2014 to 1.13% at March 31, 2015.

Deposits totaled \$1.6 billion at March 31, 2015 and grew \$33.5 million over December 31, 2014. Non-interest bearing deposits increased to 45.2% of total deposits at March 31, 2015, compared to 43.2% at December 31, 2014. Day-to-day deposit volatility in transaction accounts due to normal seasonal activity and new business ventures by several of our largest business customers resulted in a \$32.3 million decrease in average deposit balances for the quarter while period ending balances increased at March 31, 2015. CDARS time deposits increased \$11.5 million from December 31, 2014, as Management made a strategic decision to reinstate CDARS reciprocal deposits in the first quarter of 2015.

The total risk-based capital ratio for Bancorp was 13.8% at March 31, 2015, compared to 13.9% at December 31, 2014. The common equity tier one ratio, a new regulatory ratio under Basel III (Basel Committee on Bank Supervision guidelines for determining regulatory capital), was 12.5% at March 31, 2015. As reported in the Capital Adequacy section of this document, all four of our capital ratios are well above regulatory requirements for a well-capitalized institution under the new requirements that took effect January 1, 2015.

Net interest income totaled \$16.6 million in the first quarter of 2015, compared to \$17.1 million in the prior quarter and \$17.9 million in the same quarter a year ago. The decrease from the prior quarter reflects fewer days in the first quarter of 2015. The impact of a lower loan yield on the margin was largely offset by a higher allocation of average loans and lower average cash and investment balances. The decrease from the same quarter a year ago primarily relates to a lower level of income recognition on acquired loans as well as lower average balances on investments. The tax-equivalent net interest margin was 4.00%, 3.99% and 4.25%, respectively, for the first quarter of 2015, the prior quarter, and the first quarter of 2014. The decrease in net interest margin in the first quarter of 2015 compared to the same quarter a year ago is primarily due to a decrease in accretion on acquired loans.

Non-interest income totaled \$2.2 million in the first quarter of 2015, in the prior quarter and in the same quarter a year ago.

Non-interest expense totaled \$11.8 million in the first quarter of 2015, compared to \$11.6 million in the prior quarter and \$12.8 million in the same quarter a year ago. The increase in non-interest expense from the prior quarter was associated with a year-end reduction to accrued bonus expense and first quarter salaries for several positions that were

vacant in the fourth quarter. A reduction in reserve requirements for off-balance sheet commitments due to the reduced effect of historical charge-offs resulted in a reversal of some provision in the first quarter of 2015. The decrease in non-interest expense from the same quarter a year ago primarily relates to \$746 thousand in one-time acquisition-related expenses associated with data processing and personnel severance costs in the first quarter of 2014 and the reversal of provision for off-balance sheet commitments in 2015.

## Critical Accounting Policies and Estimates

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

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

### Allowance for Loan Losses

Allowance for Loan Losses is based upon estimates of loan losses and is maintained at a level considered adequate to provide for probable losses inherent in the loan portfolio. The allowance is increased by provisions for loan losses charged against earnings and reduced by charge-offs, net of recoveries.

In periodic evaluations of the adequacy of the allowance balance, Management considers current economic conditions, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, our past loan loss experience and other factors. The ALLL is based on estimates, and ultimate losses may vary from current estimates. Our Board of Directors' Asset/Liability Management Committee ("ALCO") reviews the adequacy of the ALLL at least quarterly. The allowance is adjusted based on that review if, in the judgment of the Board of Directors and Management, changes are warranted.

The overall allowance consists of 1) specific allowances for individually identified impaired loans ("ASC 310-10") and 2) general allowances for pools of loans ("ASC 450-20"), which incorporate changing qualitative and environmental factors (e.g., portfolio growth and trends, credit concentrations, economic and regulatory factors, etc.).

The first component, specific allowances, results from the analysis of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. Through Management's ongoing loan grading and credit monitoring process, individual loans are identified that have conditions indicating the borrower may be unable to pay all amounts due in accordance with the contractual terms. These loans are evaluated for impairment individually by Management. Management considers an originated loan to be impaired when it is probable we will be unable to collect all amounts due according to the contractual terms of the loan agreement. For allowances established on acquired loans, refer to Acquired Loans discussed below. When the fair value of the impaired loan is less than the recorded investment in the loan, the difference is recorded as an impairment through the establishment of a specific allowance. For loans determined to be impaired, the extent of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate at origination (for originated loans), based on the loan's observable market price, or based on the fair value of the collateral if the loan is collateral dependent or if foreclosure is imminent. Generally with problem credits that are collateral dependent, we obtain appraisals of the collateral at least annually. We may obtain appraisals more frequently if we believe the collateral value is subject to market volatility, if a specific event has occurred to the collateral, or if we believe foreclosure is imminent.

The second component is an estimate of the probable inherent losses in each loan pool with similar characteristics. This analysis encompasses the entire loan portfolio excluding acquired loans until the discount has been fully accreted. For allowances established on acquired loans, see below under Acquired Loans. Under our allowance model, loans are evaluated on a pool basis by loan segment which is further delineated by Federal regulatory reporting codes ("CALL codes"). Each segment is assigned an expected loss factor which is primarily based on a rolling twenty-quarter look-back at our historical losses for that particular segment, as well as a number of other factors.

The model determines loan loss reserves based on objective and subjective factors. Objective factors include an historical loss rate using the rolling twenty-quarter look-back, changes in the volume and nature of the loan portfolio, changes in credit quality metrics (past due loans, nonaccrual loans, net charge-offs and adversely-graded loans), and the existence of credit concentrations. Subjective factors include changes in the overall economic environment, legal and regulatory conditions, experience level of lending management and other relevant staff, uncertainties related to acquisitions, as well as the quality of our loan review process. The total amount allocated is determined by applying loss multipliers to outstanding loans by CALL code.

While we believe we use the best information available to determine the allowance for loan losses, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining

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the allowance. A decline in local and national economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect our financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance for loan losses based upon their judgment of information available to them at the time of their examination.

For further information regarding the allowance for loan losses, see Note 5 - Loans and Allowance for Loan Losses in the Consolidated Financial Statements of this Form 10-Q.

#### Acquired Loans

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

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

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

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

For acquired loans not considered credit impaired ("non-PCI") loans, we recognize the entire fair value discount accretion to interest income, based on the acquired loan's contractual cash flows using an effective interest rate method for term loans, and on a straight line basis for revolving lines, as the timing and amount of cash flows under revolving lines are not predictable. When a non-PCI loan is placed on nonaccrual status subsequent to acquisition, accretion stops until it is returned to accrual status. The level of accretion on non-PCI loans varies from period to period due to maturities and early payoffs of these loans during the reporting periods. Subsequent to acquisition, if the probable and estimable losses for non-PCI loans exceed the amount of the remaining unaccreted discount, the excess is established as an allowance for loan losses.

We acquired certain loans with evidence of credit quality deterioration subsequent to their origination and for which it was probable, at acquisition, that we would be unable to collect all contractually required payments ("PCI loans"). These loans were evaluated on an individual basis. Management applied significant subjective judgment in determining which loans were PCI loans. Evidence of credit quality deterioration as of the purchase date may include



data such as past due and nonaccrual status, risk grades and charge-off history. Revolving credit agreements (e.g., home equity lines of credit and revolving commercial loans) where the borrower had revolving rights at acquisition date were not considered PCI loans because the timing and amount of cash flows cannot be reasonably estimated.

According to the accounting guidance for PCI loans, the difference between the contractually required payments and the cash flows expected to be collected at acquisition, considering the impact of prepayments, is referred to as the nonaccretable difference and is not recorded. Furthermore, the difference between the expected cash flows and the fair value at acquisition date ("accretable difference") is accreted into interest income at a level yield of return over the remaining term of the loan, provided that the timing and amount of future cash flows is reasonably estimable.

All PCI loans that were classified as nonaccrual loans prior to the acquisition were no longer classified as nonaccrual if we believed that we would fully collect the new carrying value of these loans at acquisition. When there is doubt as to the timing and amount of future cash flows to be collected, PCI loans are classified as nonaccrual loans. It is important to note that judgment is required to classify PCI loans as accruing or nonaccrual, and is dependent on having a reasonable expectation about the timing and amount of cash flows expected to be collected. When the timing and/or amounts of expected cash flows on such loans are not reasonably estimable, no interest is accreted and the PCI loan is reported as a nonaccrual loan; otherwise, interest is accreted and the loans are reported as accruing loans.

If we have probable decreases in cash flows expected to be collected on PCI loans, specific allowances are established to account for credit deterioration subsequent to acquisition. The amount of cash flows expected to be collected and, accordingly, the adequacy of the allowance for loan losses are particularly sensitive to changes in loan credit quality. If we have probable and significant increases in cash flows expected to be collected on PCI loans, we first reverse any previously established specific allowance for loan loss and then increase interest income as a prospective yield adjustment over the remaining life of the loans. The impact of changes in variable interest rates is recognized prospectively as adjustments to interest income.

For PCI loans, the estimate of cash flows expected to be collected is updated each quarter and requires the continued use of key assumptions and estimates similar to the initial estimate of fair value. Given the current economic environment, we apply judgment to develop our estimate of cash flows given the impact of collateral value changes, loan workout plans, changing probability of default, loss severities and prepayments. Therefore, accretion on PCI loans fluctuates based on changes in cash flows expected to be collected.

For purposes of accounting for the PCI loans from past business combinations, we elected not to apply the pooling method but to account for these loans individually. Disposals of loans, which may include sales of loans to third parties, receipt of payments in full by the borrower, or foreclosure of the collateral, result in removal of the loan from the PCI loan portfolio at its carrying amount. If a PCI loan pays off earlier than expected, a gain is recorded as interest income when the payoff amount exceeds the recorded investment.

For further information regarding our acquired loans, see Note 5 - Loans and Allowance for Loan Losses in the Consolidated Financial Statements of this Form 10-Q.

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

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

For each security in an unrealized loss position ("impaired security"), we assess whether we intend to sell the security or if it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. If we intend to sell the security or it is more likely than not we will be required to sell the security before recovery of its amortized cost basis, the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date is recognized against earnings.

For impaired securities that are not intended for sale and will not be required to be sold prior to recovery of our amortized cost basis, we determine if the impairment has a credit loss component. For both held-to-maturity and available-for-sale securities, if the amount of cash flows expected to be collected are less than the amortized cost, an other-than-temporary impairment shall be considered to have occurred and the credit loss component is recognized against earnings as the difference between present value of the expected future cash flows and the amortized cost. In determining the present value of the expected cash flows, we discount the expected cash flows at the effective interest rate implicit in the security at the date of purchase. The remaining difference between the fair value and the amortized basis is deemed to be due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

For held-to-maturity securities, if there is no credit loss component, no impairment is recognized. The portion of other-than-temporary impairment recognized in other comprehensive income for credit impaired debt securities classified as held-to-maturity is accreted from other comprehensive income to the amortized cost of the debt security over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows.

For further information regarding other-than-temporary impairment of investment securities, see Note 4 - Investment Securities in the Consolidated Financial Statements of this Form 10-Q.

#### Accounting for Income Taxes

Income taxes reported in the consolidated financial statements are computed based on an asset and liability approach. We recognize the amount of taxes payable or refundable for the current year and we recognize deferred tax assets and liabilities related to expected future tax consequences that have been recognized in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. We record net deferred tax assets to the extent it is more likely than not that they will be realized. In evaluating our ability to recover the deferred tax assets, Management considers all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies and recent financial operations. In projecting future taxable income, Management develops assumptions including the amount of future state and federal pretax operating income, the reversal of temporary differences, and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates being used to manage the underlying business. Bancorp files consolidated federal and combined state income tax returns.

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

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

We present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss ("NOL") carryforward, or similar tax loss or tax credit carryforward, rather than as a liability, when (1) the uncertain tax position would reduce the NOL or other carryforward under the tax law of the applicable jurisdiction and (2) we intend to and are able to use the deferred tax asset for that purpose. Otherwise, the unrecognized tax benefit is presented as a liability instead of being netted with deferred tax assets.

#### Fair Value Measurements

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

When we develop our fair value measurement process, we maximize the use of observable inputs. Whenever there is no readily available market data, we use our best estimates and assumptions in determining fair value, but these

estimates involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these financial statements.

For further information regarding fair value measurements, see Note 3 - Fair Value of Assets and Liabilities in the Consolidated Financial Statements of this Form 10-Q.

## Net Interest Income

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

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

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

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Average Statements of Condition and Analysis of Net Interest Income

(dollars in thousands; unaudited)	Three months ended March 31, 2015			Three months ended March 31, 2014			
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	
<b>Assets</b>							
Interest-bearing due from banks <sup>1</sup>	\$38,295	\$21	0.22 %	\$85,750	\$51	0.24 %	
Investment securities <sup>2, 3</sup>	311,978	1,927	2.47 %	361,795	2,293	2.54 %	
Loans <sup>1, 3, 4</sup>	1,351,791	15,675	4.64 %	1,268,841	16,511	5.20 %	
Total interest-earning assets <sup>1</sup>	1,702,064	17,623	4.14 %	1,716,386	18,855	4.39 %	
Cash and non-interest-bearing due from banks	41,073			41,793			
Bank premises and equipment, net	9,839			9,088			
Interest receivable and other assets, net	58,132			55,829			
Total assets	\$1,811,108			\$1,823,096			
<b>Liabilities and Stockholders' Equity</b>							
Interest-bearing transaction accounts	\$92,376	\$30	0.13 %	\$127,098	\$23	0.07 %	
Savings accounts	133,877	12	0.04 %	121,278	11	0.04 %	
Money market accounts	486,830	127	0.11 %	518,930	158	0.12 %	
CDARS® time accounts	4,689	11	0.95 %	—	—	— %	
Other time accounts	149,429	220	0.60 %	160,978	235	0.59 %	
FHLB fixed-rate advance <sup>1</sup>	15,397	78	2.07 %	15,000	78	2.07 %	
Subordinated debenture <sup>1</sup>	5,207	104	7.99 %	4,988	105	8.58 %	
Total interest-bearing liabilities	887,805	582	0.27 %	948,272	610	0.26 %	
Demand accounts	705,024			674,689			
Interest payable and other liabilities	15,594			15,748			
Stockholders' equity	202,685			184,387			
Total liabilities & stockholders' equity	\$1,811,108			\$1,823,096			
Tax-equivalent net interest income/margin <sup>1</sup>		\$17,041	4.00 %		\$18,245	4.25 %	
Reported net interest income/margin <sup>1</sup>		\$16,598	3.90 %		\$17,894	4.17 %	
Tax-equivalent net interest rate spread			3.88 %			4.13 %	

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

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

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

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



The tax-equivalent net interest margin was 4.00% in the first quarter of 2014, compared to 4.25% in the same quarter a year ago. The decrease of twenty-five basis points was primarily due to the impact of the low interest rate environment on our loan and investment portfolios, lower loan fees and lower accretion on both PCI and non-PCI loans, partially offset by higher average loan balances. The net interest spread decreased twenty-five basis points over the same period for the same reasons.

The average yield on interest-earning assets decreased twenty-five basis points in the first quarter of 2015 compared to the first quarter of 2014 due to the reasons listed above. Average loans as a percentage of average interest-earning assets was 79.4% and 73.9% for the first quarter of 2015 and the first quarter of 2014, respectively. Total average interest-earning assets decreased \$14.3 million, or 0.8%, in the first quarter of 2015, compared to the first quarter of 2014.

Loans acquired through the acquisition of other banks are classified as PCI or non-PCI loans and are recorded at fair value at acquisition date. For acquired loans not considered credit impaired, the level of accretion varies due to maturities and early pay-offs. Accretion on PCI loans fluctuates based on changes in cash flows expected to be collected. Gains on pay-offs of PCI loans are recorded as interest income when the pay-off amount exceeds the recorded investment.

Accretion and gains on pay-offs of purchased loans recorded to interest income were as follows:

(dollars in thousands; unaudited)	Three months ended		March 31, 2014	
	March 31, 2015		March 31, 2014	
	Dollar	Basis point impact to	Dollar	Basis point impact to
	Amount	net interest margin	Amount	net interest margin
Accretion on PCI loans	\$119	3 bps	\$180	4 bps
Accretion on non-PCI loans	\$371	9 bps	\$1,330	31 bps
Gains on pay-offs of PCI loans	\$43	1 bps	\$—	0 bps

Market interest rates are, in part, based on the target federal funds interest rate (the interest rate banks charge each other for short-term borrowings) implemented by the Federal Reserve Open Market Committee ("FOMC"). The target interest rate has been at its historic low with a range of 0% to 0.25%, as the accommodative monetary policy measures taken by the FRB in recent years, including three rounds of quantitative easing, has led to a prolonged low interest rate environment. As a result, we have experienced downward pricing pressure on our interest-earning assets that negatively impacted our net interest margin and yields on our earning assets, and we expect little relief from this downward pricing pressure and fewer opportunities to reduce future funding costs in 2015.

#### Provision for Loan Losses

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

There was no provision for loan losses recorded in the first quarter of 2015, compared to a provision for loan losses totaling \$150 thousand in the same quarter a year ago. The allowance for loan losses totaled 1.13% of loans at March 31, 2015, compared to 1.11% at December 31, 2014. Non-accrual loans totaled \$9.5 million, or 0.70% of Bancorp's loan portfolio at March 31, 2015, compared to \$9.4 million, or 0.69% at December 31, 2014.

Impaired loan balances totaled \$25.1 million at March 31, 2015, compared to \$25.2 million at December 31, 2014, with specific valuation allowances of \$961 thousand and \$1.1 million, respectively. Classified loans, which have regulatory risk grades of "substandard" or "doubtful", decreased to \$34.1 million at March 31, 2015, from \$36.2 million at December 31, 2014.

Net recoveries in the first quarter of 2015 totaled \$57 thousand, compared to net charge-offs of \$142 thousand in the same quarter a year ago. The percentage of net charge-offs to average loans was 0.00% in the first quarter of 2015, compared to 0.01% in the first quarter of 2014.

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Non-interest Income

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

(dollars in thousands; unaudited)	Three months ended		Amount Increase (Decrease)	Percent Increase (Decrease)
	March 31, 2015	March 31, 2014		
Service charges on deposit accounts	\$525	\$556	\$(31)	(5.6)