Bank of Marin Bancorp
Form 10-Q
August 07, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION<br>Washington, D.C. 20549<br>FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

## OR

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

For the transition period from $\qquad$ to $\qquad$
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)

504 Redwood Blvd., Suite 100, Novato, CA
94947
(Address of principal executive office)
(Zip Code)

20-8859754
(IRS Employer Identification No.)

Registrant's telephone number, including area code: (415) 763-4520
Not Applicable
(Former name or former address, if changes since last report)
Indicate by check mark whether the registrant (1) has filed all reports to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

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

Indicate by check mark if the registrant is a shell company, in Rule $12 \mathrm{~b}(2)$ of the Exchange Act.
Yes o No x
As of July 31, 2008 there were $5,136,917$ shares of common stock outstanding.

## BANK OF MARIN BANCORP

## Explanatory Note

Bank of Marin Bancorp is the successor registrant to Bank of Marin pursuant to an 8-K filed with the SEC on June 29, 2007.

On July 1, 2007 (the "Effective Date"), a bank holding company reorganization was completed whereby Bank of Marin Bancorp became the parent holding company for Bank of Marin. On the Effective Date, each outstanding share of Bank of Marin common stock was converted into one share of Bank of Marin Bancorp common stock and Bank of Marin became a wholly-owned subsidiary of the holding company. Bancorp assumed the ticker symbol BMRC, which was formerly used by Bank of Marin. Prior to the Effective Date, Bank of Marin filed reports and proxy statements with the Federal Deposit Insurance Corporation ("FDIC") pursuant to Sections 12 of the Securities Exchange Act of 1934 (the "'34 Act").

The financial statements and discussion thereof contained in this report for periods subsequent to the reorganization relate to consolidated Bank of Marin Bancorp. Periods prior to the reorganization relate to Bank of Marin only. The information is comparable as the sole subsidiary of Bank of Marin Bancorp is the Bank of Marin.

This report refers to previous filings made by Bank of Marin with the FDIC pursuant to the ' 34 Act. Copies of these filing are available by requesting them in writing or by phone from:

Corporate Secretary
Bank of Marin
504 Redwood Blvd., Suite 100
Novato, CA 94947
415-763-4523
Copies of such filings are also available on Bancorp's website at www.bankofmarin.com. This website address is for information only and is not intended to be an active link, or to incorporate any website information into this document.

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## BANK OF MARIN BANCORP

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# BANK OF MARIN BANCORP <br> CONSOLIDATED STATEMENT OF CONDITION at June 30, 2008 and December 31, 2007 

| (in thousands, except share amounts - 2008 unaudited) | June 30, 2008 |  | $\begin{gathered} \text { December 31, } \\ 2007 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: |
| Assets |  |  |  |  |
| Cash and due from banks | \$ | 30,355 | \$ | 28,765 |
| Fed funds sold |  | 800 |  | 47,500 |
| Cash and cash equivalents |  | 31,155 |  | 76,265 |
| Investment securities |  |  |  |  |
| Held to maturity, at amortized cost |  | 19,476 |  | 13,182 |
| Available for sale (at fair market value, amortized cost $\$ 73,577$ at 6/30/08 and $\$ 87,450$ at $12 / 31 / 07$ ) |  | 72,999 |  | 86,989 |
| Total investment securities |  | 92,475 |  | 100,171 |
| Loans, net of allowance for losses of \$8,555 at 6/30/08 and \$7,575 at 12/31/07 |  | 790,955 |  | 717.303 |
| Bank premises and equipment, net |  | 8,635 |  | 7,821 |
| Interest receivable and other assets |  | 29,319 |  | 32,341 |
|  |  |  |  |  |
| Total assets | \$ | 952,539 | \$ | 933,901 |
|  |  |  |  |  |
| Liabilities and Stockholders' Equity |  |  |  |  |
|  |  |  |  |  |
| Liabilities |  |  |  |  |
| Deposits |  |  |  |  |
| Non-interest bearing | \$ | 219,684 | \$ | 220,272 |
| Interest bearing |  |  |  |  |
| Transaction accounts |  | 76,839 |  | 110,174 |
| Savings and money market |  | 422,834 |  | 421,255 |
| Time |  | 81,863 |  | 82,941 |
| Total deposits |  | 801,220 |  | 834,642 |
|  |  |  |  |  |
| Federal funds purchased and Federal Home Loan Bank borrowings |  | 46,800 |  | --- |
| Subordinated debenture |  | 5,000 |  | 5,000 |
| Interest payable and other liabilities |  | 6,972 |  | 6,485 |
|  |  |  |  |  |
| Total liabilities |  | 859,992 |  | 846,127 |
| Stockholders' Equity |  |  |  |  |
| Common stock, no par value |  |  |  |  |
| Authorized - 15,000,000 shares |  |  |  |  |
| Issued and outstanding - 5,140,351 shares at 6/30/08 and 5,122,971 at 12/31/07 |  | 50,679 |  | 51,059 |
| Retained earnings |  | 42,203 |  | 36,983 |
| Accumulated other comprehensive loss, net |  | (335) |  | (268) |


| Total stockholders' equity | 92,547 | 87,774 |  |  |
| :--- | ---: | ---: | ---: | ---: |
| Total liabilities and stockholders' equity | $\$$ | 952,539 | $\$$ | 933,901 |
| The accompanying notes are an integral part of these consolidated financial statements. |  |  |  |  |

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## BANK OF MARIN BANCORP

## CONSOLIDATED STATEMENT OF OPERATIONS

for the six months ended June 30, 2008 and June 30, 2007
(in thousands, except per share amounts - unaudited)
June 30, 2008 June 30, 2007
Interest income

| Interest and fees on loans held in portfolio | $\$$ | 26,712 | $\$$ |
| :--- | ---: | ---: | ---: |
| Interest on auto loans held for sale | --- | 25,723 |  |
| Interest on investment securities | --- | 8 |  |
| U.S. Treasury securities | 1,749 | 1,651 |  |
| Securities of U.S. Government agencies | 344 | 229 |  |
| Obligations of state and political subdivisions (tax exempt) | 167 | 221 |  |
| Corporate debt securities and other | 113 | 417 |  |
| Interest on Federal funds sold | 29,085 | 30,311 |  |

Interest expense

| Interest on interest bearing transaction accounts | 184 | 151 |
| :--- | ---: | ---: |
| Interest on savings and money market deposits | 3,774 | 7,170 |
| Interest on time deposits | 1,405 | 1,751 |
| Interest on borrowed funds | 523 | 764 |
| Total interest expense | 5,886 | 9,836 |
| Net interest income | 23,199 | 20,475 |
| Provision for loan losses | 1,125 | 140 |
| Net interest income after provision for loan losses | 22,074 | 20,335 |

Non-interest income
Service charges on deposit accounts $\quad 836 \quad 569$
Wealth Management Services 573
Net gain on indirect auto portfolio --- 710

| Net gain on redemption of shares in Visa, Inc. | 457 |  |
| :--- | ---: | ---: |
| Other income | 1,042 | 1,049 |

Total non-interest income $\quad 2,901$

| Non-interest expense |  |  |
| :--- | ---: | ---: |
| Salaries and related benefits | 8,193 | 8,126 |
| Occupancy and equipment | 1,561 | 1,439 |
| Depreciation and amortization | 645 | 611 |
| Data processing | 875 | 843 |
| Professional services | 825 | 702 |
| Other expense | 2,042 | 1,998 |
| Total non-interest expense | 14,141 | 13,719 |
| Income before provision for income taxes | 10,914 | 9,517 |
| Provision for income taxes | 4,252 | 3,640 |
| Net income | $\$$ | 6,662 |


| Net income per common share: | $\$$ | 1.30 | $\$$ |
| :--- | :---: | :---: | :---: |
| Basic | $\$$ | 1.27 | $\$$ |
| Diluted |  |  | 1.13 |
| Weighted average shares used to compute net income per common share: |  | 5,137 |  |
| Basic |  | 5,232 | 5,209 |
| Diluted | $\$$ | 0.28 | $\$$ |
| Dividends declared per common share |  | 0.25 |  |

The accompanying notes are an integral part of these consolidated financial statements.
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## BANK OF MARIN BANCORP

## CONSOLIDATED STATEMENT OF OPERATIONS

for the three months ended June 30, 2008, March 31, 2008 and June 30, 2007

| (in thousands, except per share amounts - unaudited | June 30, 2008 |  | $\begin{gathered} \text { March 31, } \\ 2008 \end{gathered}$ |  | June 30, 2007 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Interest income |  |  |  |  |  |  |
| Interest and fees on loans held in portfolio | \$ | 13,400 | \$ | 13,312 | \$ | 13,027 |
| Interest on auto loans held for sale |  | --- |  | --- |  | 954 |
| Interest on investment securities |  |  |  |  |  |  |
| Securities of U.S. Government agencies |  | 882 |  | 867 |  | 809 |
| Obligations of state and political subdivisions (tax exempt) |  | 183 |  | 161 |  | 111 |
| Corporate debt securities and other |  | 78 |  | 89 |  | 123 |
| Interest on Federal funds sold |  | 1 |  | 112 |  | 415 |
| Total interest income |  | 14,544 |  | 14,541 |  | 15,439 |
|  |  |  |  |  |  |  |
| Interest expense |  |  |  |  |  |  |
| Interest on interest bearing transaction accounts |  | 96 |  | 88 |  | 74 |
| Interest on savings and money market deposits |  | 1,583 |  | 2,191 |  | 3,778 |
| Interest on time deposits |  | 654 |  | 751 |  | 882 |
| Interest on borrowed funds |  | 302 |  | 221 |  | 227 |
| Total interest expense |  | 2,635 |  | 3,251 |  | 4,961 |
|  |  |  |  |  |  |  |
| Net interest income |  | 11,909 |  | 11,290 |  | 10,478 |
| Provision for loan losses |  | 510 |  | 615 |  | 75 |
| Net interest income after provision for loan losses |  | 11,399 |  | 10,675 |  | 10,403 |
|  |  |  |  |  |  |  |
| Non-interest income |  |  |  |  |  |  |
| Service charges on deposit accounts |  | 430 |  | 406 |  | 321 |
| Wealth Management Services |  | 310 |  | 336 |  | 298 |
| Net gain on indirect auto portfolio |  | --- |  | --- |  | 190 |
| Net gain on redemption of shares in Visa, Inc. |  | --- |  | 457 |  | --- |
| Other income |  | 539 |  | 503 |  | 584 |
| Total non-interest income |  | 1,279 |  | 1,702 |  | 1,393 |
|  |  |  |  |  |  |  |
| Non-interest expense |  |  |  |  |  |  |
| Salaries and related benefits |  | 4,035 |  | 4,158 |  | 4,163 |
| Occupancy and equipment |  | 793 |  | 768 |  | 729 |
| Depreciation and amortization |  | 327 |  | 318 |  | 310 |
| Data processing |  | 430 |  | 445 |  | 425 |
| Professional services |  | 419 |  | 406 |  | 384 |
| Other expense |  | 1,136 |  | 906 |  | 1,019 |
| Total non-interest expense |  | 7,140 |  | 7,001 |  | 7,030 |
| Income before provision for income taxes |  | 5,538 |  | 5,376 |  | 4,766 |
|  |  |  |  |  |  |  |
| Provision for income taxes |  | 2,152 |  | 2,100 |  | 1,863 |
| Net income | \$ | 3,386 | \$ | 3,276 | \$ | 2,903 |

Net income per common share:

| Basic | \$ | 0.66 | \$ | 0.64 | \$ | 0.56 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Diluted | \$ | 0.65 | \$ | 0.63 | \$ | 0.54 |
| Weighted average shares used to compute net income per common share: |  |  |  |  |  |  |
| Basic |  | 5,139 |  | 5,136 |  | 5,187 |
| Diluted |  | 5,226 |  | 5,238 |  | 5,329 |
| Dividends declared per common share | \$ | 0.14 | \$ | 0.14 | \$ | 0.13 |

The accompanying notes are an integral part of these consolidated financial statements.
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## BANK OF MARIN BANCORP

## CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

for the year ending December 31, 2007 and the six months ended June 30, 2008

| (dollar amounts in thousands <br> - 2008 unaudited) | Common StockShares Amount |  |  | Retained Earnings |  | Accumulated <br> Other <br> Comprehensive <br> (Loss)/Gain, <br> Net of <br> Taxes |  | Total |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| $\begin{aligned} & \text { Balance at December 31, } \\ & 2006 \end{aligned}$ | 5,366,416 | \$ | 61,355 | \$ | 28,760 | \$ | (590) | \$ | 89,525 |
| Cumulative-effect adjustment of adoption of SFAS No. 159 | --- |  | --- |  | $(1,452)$ |  | --- |  | $(1,452)$ |
| Comprehensive income: |  |  |  |  |  |  |  |  |  |
| Net income | --- |  | --- |  | 12,324 |  | --- |  | 12,324 |
| Other comprehensive income |  |  |  |  |  |  |  |  |  |
| Net change in unrealized loss on available for sale securities (net of tax liability of \$234) | --- |  | --- |  | --- |  | 322 |  | 322 |
| Comprehensive income | --- |  | --- |  | 12,324 |  | 322 |  | 12,646 |
| Stock options exercised | 112,496 |  | 1,620 |  | --- |  | --- |  | 1,620 |
| Excess tax benefit -stock-based compensation | --- |  | 729 |  | --- |  | --- |  | 729 |
| Stock repurchased, including commission costs | $(365,823)$ |  | $(13,483)$ |  | --- |  | --- |  | $(13,483)$ |
| Stock issued under employee stock purchase plan | 292 |  | 8 |  | --- |  | --- |  | 8 |
| Stock-based compensation stock options | --- |  | 502 |  |  |  |  |  | 502 |
| Cash dividends paid | --- |  | --- |  | $(2,649)$ |  | --- |  | $(2,649)$ |
| Stock issued in payment of director fees | 9,590 |  | 328 |  | --- |  | --- |  | 328 |
| Balance at December 31, 2007 | 5,122,971 | \$ | 51,059 | \$ | 36,983 | \$ | (268) | \$ | 87,774 |
| Comprehensive income: |  |  |  |  |  |  |  |  |  |
| Net income | --- |  | --- |  | 6,662 |  | --- |  | 6,662 |
| Other comprehensive income |  |  |  |  |  |  |  |  |  |
| Net change in unrealized loss on available for sale securities (net of tax benefit of \$49) | --- |  | --- |  | --- |  | (67) |  | (67) |
| Comprehensive income | --- |  | --- |  | 6,662 |  | (67) |  | 6,595 |
| Stock options exercised | 64,688 |  | 901 |  | --- |  | --- |  | 901 |
| Excess tax benefit -stock-based compensation | --- |  | 59 |  | --- |  | --- |  | 59 |


| Stock repurchased, including commission costs | $(58,609)$ |  | $(1,701)$ |  | --- |  | --- |  | $(1,701)$ |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Stock issued under employee stock purchase plan | 636 |  | 16 |  | --- |  | --- |  | 16 |
| Stock-based compensation stock options | --- |  | 222 |  | --- |  | --- |  | 222 |
| Restricted stock granted | 6,700 |  | --- |  | --- |  | --- |  | --- |
| Stock-based compensation restricted stock | --- |  | 6 |  | --- |  | --- |  | 6 |
| Cash dividends paid | --- |  | --- |  | $(1,442)$ |  | --- |  | $(1,442)$ |
| Stock issued in payment of director fees | 3,965 |  | 117 |  | --- |  | --- |  | 117 |
| Balance at June 30, 2008 | 5,140,351 | \$ | 50,679 | \$ | 42,203 | \$ | (335) | \$ | 92,547 |

The accompanying notes are an integral part of these consolidated financial statements.
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## BANK OF MARIN BANCORP

## CONSOLIDATED STATEMENT OF CASH FLOWS

for six months ended June 30, 2008 and 2007
(in thousands, unaudited)
Cash Flows from Operating Activities:

| Net income | $\$$ | 6,662 |
| :--- | ---: | ---: |
| Adjustments to reconcile net income to net cash provided by |  | 5,877 |
| operating activities: | 1,125 | 140 |
| Provision for loan losses | 140 | 141 |
| Compensation payable in common stock | 228 | 255 |
| Stock-based compensation expense | $(59)$ | $(621)$ |
| Excess tax benefits from exercised stock options | 135 | 93 |
| Amortization and accretion of investment security premiums, | 2 | --- |
| net | 645 | 611 |
| Loss on sale of investment securities | --- | $(710)$ |
| Depreciation and amortization | $(457)$ | ---- |
| Net gain on indirect auto portfolio | 14 | --1 |
| Net gain on redemption of shares in Visa, Inc. | 199 | 537 |
| Loss on disposal of premises and equipment | 3 | 52 |
| Net change in operating assets and liabilities: | 79 | 59 |
| Interest receivable | 2,872 | 1,286 |
| Interest payable | 472 | 9,460 |
| Deferred rent and other rent-related expenses | 5,398 | 11,303 |
| Other assets | 12,060 | 17,180 |
| Other liabilities |  |  |
| Total adjustments |  |  |
| Net cash provided by operating activities |  |  |

Cash Flows from Investing Activities:
Purchase of securities held-to-maturity $(8,135)$ $(2,056)$
Purchase of securities available-for-sale $(40,607)$ $(19,454)$
Proceeds from sale of securities 21,489
Proceeds from paydowns/maturity of:

| Securities held-to-maturity | 765 | 1,000 |
| :--- | ---: | ---: |
| Securities available-for-sale | 34,388 | 7,592 |
| Proceeds from sale of indirect auto loans | -- | 76,681 |
| Loans originated and principal collected, net | $(74,808)$ | $(13,726)$ |
| Additions to premises and equipment | $(1,473)$ | $(381)$ |
| Net cash (used in) provided by investing activities | $(68,381)$ | 49,656 |

Cash Flows from Financing Activities:
Net (decrease) increase in deposits $\quad(33,422)$ 39,780
Proceeds from stock options exercised $\quad 901$ 1,559

Net increase (decrease) in Federal funds purchased and

## Federal

Home Loan Bank borrowings
46,800
$(29,400)$

| Common stock repurchased | $(1,701)$ | $(11,055)$ |
| :--- | ---: | ---: |
| Dividends paid in cash | $(1,442)$ | $(1,305)$ |
| Stock issued under employee stock purchase plan | 16 | 621 |
| Excess tax benefits from exercised stock options | 59 | 200 |
| Net cash provided by financing activities | 11,211 | 67,036 |
| Net (decrease) increase in cash and cash equivalents | $(45,110)$ | 38,783 |
| Cash and cash equivalents at beginning of period | 76,265 | 105,819 |

Non-Cash Transactions: The six months ended June 30, 2007 reflected a cumulative-effect adjustment of the adoption of SFAS No. 159, which included non-cash decreases to net loans of $\$ 2.5$ million and retained earnings of $\$ 1.5$ million, and a non-cash increase to other assets of $\$ 1.0$ million.

The accompanying notes are an integral part of these consolidated financial statements.
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## BANK OF MARIN BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Introductory Explanation

On July 1, 2007 (the "Effective Date"), a bank holding company reorganization was completed whereby Bank of Marin Bancorp (Bancorp) became the parent holding company for Bank of Marin ( the "Bank"), its sole and wholly- owned subsidiary. On the Effective Date, in a tax-free exchange, each outstanding share of the Bank was converted into one share of Bancorp and the Bank became a wholly-owned subsidiary of the holding company. The information contained in the financial statements and accompanying footnotes for periods subsequent to the reorganization relate to consolidated Bank of Marin Bancorp. Periods prior to the reorganization relate to Bank of Marin only. The information is comparable for all periods as the sole subsidiary of Bancorp is the Bank.

## Note 1: Basis of Presentation

The consolidated financial statements include the accounts of Bancorp and its wholly-owned bank subsidiary. All material intercompany transactions have been eliminated. In the opinion of Management, the unaudited interim consolidated financial statements contain all adjustments necessary to present fairly the financial position, results of operations, changes in stockholders' equity and cash flows. All adjustments are of a normal, recurring nature.

Certain information and footnote disclosures presented in the annual financial statements are not included in the interim consolidated financial statements. Accordingly, the accompanying unaudited interim consolidated financial statements should be read in conjunction with Bancorp's 2007 Annual Report, which is incorporated by reference in Bancorp's 2007 Annual Report on Form 10-K. The results of operations for the six months ended June 30, 2008 are not necessarily indicative of the operating results for the full year.

The following table shows weighted average basic shares, common stock equivalents related to stock options and nonvested restricted stock, and weighted average diluted shares used in calculating earnings per share. Basic earnings per share are based upon the weighted average number of common shares outstanding (including vested restricted stock) during each period. Diluted earnings per share incorporates the dilutive effect of common stock equivalents outstanding, including stock options and nonvested restricted stock, on an average basis during each period.

| (in thousands) | Three months ended |  |  | Six months ended |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | June 30, 2008 | $\begin{gathered} \text { March 31, } \\ 2008 \end{gathered}$ | June 30, 2007 | June 30, 2008 | June 30, 2007 |
| Weighted average basic shares outstanding | 5,139 | 5,136 | 5,187 | 5,137 | 5,209 |
| Add: Common stock equivalents related to stock options and nonvested restricted stock | 87 | 102 | 142 | 95 | 167 |
| Weighted average diluted shares outstanding | 5,226 | 5,238 | 5,329 | 5,232 | 5,376 |
| Anti-dilutive shares not included in the calculation of diluted earnings per share | 236 | 211 | 67 | 227 | 0 |
| Net income | \$ 3,386 | 3,276 | \$ 2,903 | 6,662 | \$ 5,877 |


| Earnings per share (basic) | $\$$ | 0.66 | $\$$ | 0.64 | $\$$ | 0.56 | $\$$ | 1.30 | $\$$ | 1.13 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Earnings per share (diluted) | $\$$ | 0.65 | $\$$ | 0.63 | $\$$ | 0.54 | $\$$ | 1.27 | $\$$ | 1.09 |

Note 2: Recently Issued Accounting Standards
On June 16, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) on Emerging Issues Task Force (EITF) 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities" which states that when calculating basic earnings per share pursuant to the two-class method, all awards that contain rights to nonforfeitable dividends should be considered participating securities. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Dividends or dividend equivalents actually paid on share-based payment awards not expected to vest should be excluded from the earnings allocation to avoid counting the dividends as both compensation cost and distributed earnings. Undistributed earnings should be allocated to all outstanding share-based payment awards, including those that are not expected to vest. FSP EITF 03-6-1 will be effective for Bancorp beginning January 1, 2009. All prior-period earnings per share data presented will be adjusted retrospectively to conform to the provisions of FSP EITF 03-6-1. Early adoption is not permitted. Bancorp's presentation, but not the amount, of earnings per share will be affected upon adoption of FSP EITF 03-6-1 due to Bancorp's issuance of nonvested restricted common shares on May 1, 2008. See Note 6 below for further discussion.

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## BANK OF MARIN BANCORP

In May 2008, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States. SFAS No. 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board (PCAOB) amendments to AU Section 411, The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles." Bancorp expects that SFAS No. 162 will have no impact on its financial condition or results of operations.

On March 19, 2008, the FASB issued SFAS. No. 161, "Disclosures about Derivative Instruments and Hedging Activities-an Amendment of FASB Statement 133." SFAS No. 161 enhances required disclosures regarding derivatives and hedging activities, including improved disclosures regarding how: (a) an entity uses derivative instruments, (b) derivative instruments and related hedged items are accounted for under SFAS Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities", and (c) derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. As SFAS No. 161 is disclosure-related only, it is expected that SFAS No. 161 will have no impact on Bancorp's financial condition or results of operations.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations". SFAS No. 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS No. 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations Bancorp engages in will be recorded and disclosed following existing generally accepted accounting principles until January 1, 2009. Bancorp expects SFAS No. 141R would have an impact on its consolidated financial statements when effective if it acquires another company, but the nature and magnitude of the specific effects will depend upon the nature, terms and size of the acquisitions Bancorp consummates after the effective date.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements," which provides guidance for accounting and reporting of noncontrolling (minority) interests in consolidated financial statements. The statement is effective for fiscal years and interim periods within fiscal years beginning on or after December 15, 2008. Bancorp does not hold minority interests in subsidiaries, therefore it is expected that SFAS No. 160 will have no impact on its financial condition or results of operations.

In June 2007, the FASB EITF reached a consensus on EITF Issue No. 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards." The EITF requires that the tax benefit related to dividends paid on restricted stock, which are expected to vest, be recorded as an increase to additional paid-in-capital. The EITF was effective for all tax benefits on dividends declared by Bancorp after January 1, 2008. At adoption, there was no impact on Bancorp's financial position or results of operations.

Note 3: Fair Value Measurement
The Bank performs fair-market valuations on certain assets and liabilities as a result of the application of accounting guidelines that were in effect prior to the adoption of SFAS No. 157, "Fair Value Measurements." The following table summarizes the Bank's financial instruments that were measured at fair value on a recurring basis at June 30, 2008.

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|  | Quoted |  |  |  |
| :--- | :---: | :---: | :---: | :---: |
|  | Prices in |  |  |  |
|  |  | Active | Significant |  |
| (Dollars in thousands) |  | Markets for | Other | Significant |
| Description of Financial Instruments |  | Identical | Observable | Unobservable |
| Sune 30, | Assets | Inputs | Inputs |  |
|  | 2008 | (Level 1) | (Level 2) | (Level 3) |


| Securities available for sale | \$ | 72,999 | \$ | --- | \$ | 72,999 | \$ | --- |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Derivative financial assets | 53 |  |  |  | 53 |  |  | -- |
| Total Assets | \$ | 73,052 | \$ | --- | \$ | 73,052 | \$ | --- |
| Derivative financial liabilities | \$ | 671 | \$ |  | \$ | 671 | \$ | --- |

When available, quoted market prices (Level 1) are used to determine fair value of securities available for sale. If quoted market prices are not available, management obtains 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 prices, dealer-quoted prices, interest rates, benchmark yield curves, prepayment speeds, and credit spreads (Level 2). Level 1 securities include those traded on an active exchange, including U.S. Treasury securities. Level 2 securities include U.S. agencies' securities, mortgage-backed securities and corporate collateralized mortgage obligations. Changes in fair market value are recorded in other comprehensive income.

The fair value of derivative financial instruments 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 the Bank's own credit risk and the counterparty's credit quality in determining the fair value of the derivatives. Level 2 inputs for the valuations are limited to observable market prices for LIBOR cash rates (for the very short term), quoted prices for LIBOR futures contracts (two years and less) and observable market prices for LIBOR swap rates (at commonly quoted intervals from two years to beyond the derivative's maturity). Mid-market pricing of the inputs is used as a practical expedient in the fair value measurements. Key inputs for interest rate valuations are used to project spot rates at resets specified by each swap, as well as to discount those future cash flows to present value at measurement date. The interest rate derivative liability position was further discounted to reflect the potential credit risk to counterparties. The Bank has used the spread over LIBOR on the fifteen-year fixed-rate credit advance from the Federal Home Loan Bank (FHLB) in San Francisco to calculate this credit-risk related discount of future cash flows. Changes in fair market value are recorded in other non-interest income for fair value hedges using short-cut hedge accounting treatment and are recorded in interest income for fair value hedges not qualifying for short-cut hedge accounting treatment.

The interest rate swaps are carried on the balance sheet at their fair value in other assets (when the fair value is positive) or in other liabilities (when the fair value is negative) and offset in other non-interest income.

Note 4: Allowance for Loan Losses and Non-accrual Loans
The allowance for loan losses is maintained at levels considered adequate by management to provide for probable loan losses inherent in the portfolio. The allowance is based on management's assessment of various factors affecting the
loan portfolio, including problem loans, economic conditions and loan loss experience, and an overall evaluation of the quality of the underlying collateral.

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Activity in the allowance for loan losses follows:

| (in thousands - unaudited) | Three months ended |  |  |  |  |  | Six months ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | June 30, 2008 |  | $\begin{gathered} \text { March 31, } \\ 2008 \end{gathered}$ |  | June 30, 2007 |  | June 30, 2008 |  | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |  |
| Beginning balance | \$ | 8,199 | \$ | 7,575 | \$ | 7,042 | \$ | 7,575 | \$ | 8,023 |
| Cumulative-effect adjustment of adoption of SFAS No. 159 |  | --- |  | --- |  | --- |  | --- |  | $(1,048)$ |
| Provision for loan loss charged to expense |  | 510 |  | 615 |  | 75 |  | 1,125 |  | 140 |
| Loans charged off |  | (156) |  | (2) |  | (77) |  | (158) |  | (78) |
| Loan loss recoveries |  | ) |  | 11 |  | 13 |  | 13 |  | 16 |
| Ending balance | \$ | 8,555 | \$ | 8,199 | \$ | 7,053 | \$ | 8,555 | \$ | 7,053 |
| Total loans held in portfolio at end of period, before deducting allowance for loan losses | \$ | 799,510 | \$ | 769,530 | \$ | 653,924 | \$ | 799,510 | \$ | 653,924 |
| Ratio of allowance for loan losses to loans held in portfolio |  | 1.07\% |  | 1.07\% |  | 1.08\% |  | 1.07\% |  | 1.08\% |
| Non-accrual loans at period end | \$ | 236 | \$ | 244 | \$ | 5 | \$ | 236 | \$ | 5 |

At June 30, 2008, the Bank had two non-accrual loans totaling \$236 thousand. At March 31, 2008, the Bank had one non-accrual loan totaling \$244 thousand. At June 30, 2007, the Bank had one non-accrual loan amounting to $\$ 5$ thousand.

The gross interest income that would have been recorded had non-accrual loans been current totaled $\$ 6$ thousand in the quarter ended June 30, 2008 compared to $\$ 5$ thousand in the quarter ended June 30, 2007. The amount of foregone interest income on nonaccrual loans was $\$ 12$ thousand for each of the six-month periods ended June 30, 2008 and 2007.

Effective January 1, 2007, the Bank elected the early-adoption provisions of SFAS No. 159, which permits entities to choose to measure eligible financial instruments at fair value at specified election dates. Upon adoption, the Bank selected the fair value option for the indirect auto loan portfolio, which was subsequently sold on June 5, 2007. In conjunction with the adoption of SFAS No. 159, the allowance for loan losses was reduced by $\$ 1.0$ million in the first quarter of 2007, which is reflected in the table above.

## Note 5: Borrowings

As of June 30, 2008 the Bank has a line of credit with the FHLB totaling $\$ 160.5$ million. At June 30, 2008, $\$ 31.8$ million was borrowed overnight under the line of credit. The interest rate for overnight borrowings is determined daily.

On February 5, 2008, the Bank entered into a ten-year borrowing agreement under the same FHLB line of credit for $\$ 15.0$ million at a fixed rate of $2.07 \%$. Interest-only payments are required every three months until maturity. Although the entire principal is due on February 5, 2018, the FHLB has the unconditional right to accelerate the due date on February 5, 2009 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. The Bank must comply with an accelerated due date, but is not required to accept replacement funding.

At June 30, 2008, $\$ 113.7$ million was remaining as available for borrowing from the FHLB under a formula based on eligible collateral. The FHLB borrowing and the FHLB line of credit are secured by a portfolio of loans under a blanket lien. On June 30, 2008, the pledged loans totaled $\$ 316.8$ million.

Additional borrowing capacity includes lines of credit with correspondent banks totaling $\$ 65.0$ million and a line of credit with the Federal Reserve Bank totaling $\$ 3.2$ million to borrow overnight. There were no borrowings under these credit facilities on June 30, 2008.

Note 6: Stockholders' Equity
Effective January 1, 2007, the Bank elected early adoption of SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." Upon adoption, the Bank selected the fair value option for its indirect auto loan portfolio, which was subsequently sold on June 5, 2007. Upon the adoption of SFAS No. 159 for its indirect auto loan portfolio, the Bank recorded a cumulative-effect adjustment as a charge to retained earnings totaling $\$ 1.5$ million effective January 1, 2007.

On July 1, 2007, the Effective Date, the bank holding company reorganization was completed and the Bank repurchased a total of 24,399 common shares of the Bank for $\$ 876$ thousand from six stockholders who dissented to the exchange of these shares for Bancorp common stock. Also, on the Effective Date, after the repurchase, each remaining outstanding share of the Bank was converted into one share of Bank of Marin Bancorp and the Bank became a wholly-owned subsidiary of the holding company.

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Under a $\$ 15$ million, twelve-month share repurchase program approved in October 2006 by the California Department of Financial Institutions (DFI) and the Federal Deposit Insurance Corporation (FDIC), the Bank repurchased 115,625 shares in the fourth quarter of 2006 at an average price of $\$ 34.26$ per share, plus commissions, for a total cost of $\$ 4.0$ million and 289,692 shares in the first quarter of 2007 at an average price of $\$ 38.10$ per share, plus commissions, for a total cost of $\$ 11.0$ million, at which time the program was completed.

In November 2007, Bancorp's Board of Directors approved an additional plan to repurchase up to $\$ 5$ million of common shares of Bancorp. No regulatory approval was required for this repurchase plan as Bancorp was exempted under the provisions of Regulation Y of the Federal Reserve Board. In the fourth quarter of 2007, Bancorp repurchased a total of 51,732 shares at an average price of $\$ 29.96$ per share, plus commissions, for a total cost of $\$ 1.5$ million. During the first six months of 2008, Bancorp repurchased 58,609 shares at an average price of $\$ 28.96$, plus commissions, for a total cost of $\$ 1.7$ million.

The Bank executed the repurchase transactions pursuant to the Securities and Exchange Commission's Rule 10b-18. All shares repurchased under both programs were made in open market transactions and were part of publicly announced repurchase programs.

A summary of cash dividends paid to stockholders, which are recorded as a reduction of retained earnings, is presented below.

| (in thousands except per share data unaudited) | Three months ended |  |  |  |  |  | Six months ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ |  | $\begin{gathered} \text { March } 31, \\ 2008 \end{gathered}$ |  | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |  | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ |  | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |  |
| Cash dividends | \$ | 722 | \$ | 720 | \$ | 680 | \$ | 1,442 | \$ | 1,305 |
| Cash dividends per share | \$ | 0.14 | \$ | 0.14 | \$ | 0.13 | \$ | 0.28 | \$ | 0.25 |

Under SFAS No. 123R, "Share-Based Payment," which was implemented in January 2006, the fair value of stock options on the grant date is recorded as a stock-based compensation expense in the income statement over the requisite service period with a corresponding increase in common stock. In addition, the Bank records excess tax benefits on the exercise of non-qualified stock options and on the disqualifying disposition of incentive stock options as an addition to common stock with a corresponding decrease in current taxes payable.

Stock-based compensation also includes compensation expense related to the issuance of nonvested restricted common shares pursuant to the 2007 Equity Plan. On May 1, 2008 employees were granted 6,700 restricted common shares of Bancorp, which vest twenty percent on each anniversary of the grant for five years. The grant-date fair value of the restricted common shares, which is equal to its intrinsic value, is recorded as compensation expense over the requisite service period with a corresponding increase in common stock. Any excess tax benefit on the vesting of these shares will be also recorded as increase in common stock and a corresponding decrease in current taxes payable. The holders of the nonvested restricted common shares are entitled to dividends on the same per-share ratio as the holders of common stock. Dividends paid on the portion of share-based awards not expected to vest are also included in stock-based compensation expense. Tax benefits on dividends paid on the portion of share-based awards expected to vest are recorded as increase to common stock with a corresponding decrease in current taxes payable.

Stock-based compensation and excess tax benefits on exercised options are shown below.
Three months ended
Six months ended

| (in thousands - unaudited) | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ |  | $\begin{gathered} \text { March } 31, \\ 2008 \end{gathered}$ |  | $\begin{gathered} \text { June 30, } \\ 2007 \end{gathered}$ |  | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ |  | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Stock-based compensation | \$ | 108 | \$ | 120 | \$ | 133 | \$ | 228 | \$ | 255 |
| (Deficient) Excess tax benefits on exercised options | \$ | (22) | \$ | 81 | \$ | 126 | \$ | 59 | \$ | 724 |

## Note 7: Financial Instruments with Off-Balance Sheet Risk

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

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The Bank is exposed to credit loss in the contract amount of the commitment in the event of nonperformance by the borrower. The Bank uses the same credit policies in making commitments as it does for on-balance-sheet instruments and evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Bank 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 contract amount of loan commitments not reflected on the statement of condition was $\$ 241.9$ million at June 30, 2008 at rates ranging from $3.93 \%$ to $10.00 \%$. This amount included $\$ 139.1$ million under commercial lines of credit (these commitments are contingent upon customers maintaining specific credit standards), $\$ 63.1$ million under revolving home equity lines and $\$ 33.4$ million under undisbursed construction loans. The Bank has set aside an allowance for losses in the amount of $\$ 484$ thousand for these commitments, which is recorded in "interest payable and other liabilities."

Note 8: Derivative Financial Instruments and Hedging Activities
The Bank has entered into interest-rate swaps, primarily as an asset/liability management strategy, in order to hedge the change in the fair value of both long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans due to changes in interest rates. Such hedges allow the Bank to offer long-term fixed rate loans to customers without assuming the interest rate risk of a long-term asset by swapping the Bank's fixed-rate interest stream for a floating-rate interest stream tied to the one-month LIBOR index. Such modification of the interest characteristics of the loan protects the Bank against an adverse effect on earnings and the net interest margin due to fluctuating interest rates.

The interest rate swaps are carried on the balance sheet at their fair value in other assets (when the fair value is positive) or in other liabilities (when the fair value is negative). The changes in fair value of swap using the shortcut accounting treatment is recorded in other non-interest income, while changes in fair value of the swap using non-short cut accounting is recorded in interest income .. The unrealized gain or loss in market value of the hedged fixed-rate loan is recorded as adjustment to the hedged loan and offset in other non-interest income (for shortcut accounting treatment) or interest income (for non-short cut accounting treatment).

During the third quarter of 2007, the Bank's forward swap was designated to offset the change in fair value of a loan originated during the period. The fair value of the related yield maintenance agreement totaling $\$ 69$ thousand at the date of designation, recorded in other assets, is being amortized to interest income using the effective yield method over the life of the loan.

The two interest rate swaps held by the Bank are scheduled to mature in June of 2020 and June of 2022. Information on the Bank's derivatives follows:

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| (in thousands) | Fair Value Swap (Shortcut Accounting Treatment) |  | Fair Value Swap (Non-shortcut Accounting Treatment) |  | Yield <br> Maintenance Agreement |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| At June 30, 2008: |  |  |  |  |  |  |
| Notional or contractual amount | \$ | 7,024 | \$ | 7,968 | \$ | --- |
| Credit risk amount (1) |  | --- |  | --- |  |  |
| Estimated net fair value |  | (79) |  | (592) |  | 53 |
|  |  |  |  |  |  |  |
| At December 31, 2007: |  |  |  |  |  |  |
| Notional or contractual amount | \$ | 7,201 | \$ | 8,134 | \$ | --- |
| Credit risk amount (1) |  | --- |  | --- |  | --- |
| Estimated net fair value |  | (44) |  | (603) |  | 62 |



Credit risk represents the amount of unrealized gain included in derivative assets which is subject to counterparty credit risk. It reflects the effect of master netting agreements and includes credit risk on virtual derivatives.
2 Tax equivalent yield equals $8.44 \%, 8.45 \%$, and $8.26 \%$ for three months ended June 30, 2008, March 31, 2008, and June 30, 2007, respectively; $8.44 \%$ and $8.26 \%$ for the six months ended June 30, 2008 and 2007, respectively.

Note 9: Transactions with Visa Inc.
As a member bank of Visa Inc., the Bank holds 16,939 shares of Visa Inc. Class B common stock at a zero cost basis. In connection with Visa Inc.'s initial public offering (IPO) on March 19, 2008, the Bank recognized a $\$ 457$ thousand gain on the mandatory redemption of 10,677 shares of Class B common stock representing the difference between the cash proceeds received and the zero carrying basis of the stock redeemed. The remaining shares owned by the Bank cannot be converted into Class A (voting) shares until the later of the third anniversary of the IPO or the final resolution of the covered litigation described below.

The Bank recorded a liability of $\$ 242$ thousand in the fourth quarter of 2007 to cover its potential indemnification obligations to Visa, Inc. The obligations arose in connection with the Bank's proportionate share of certain litigation indemnifications provided to Visa U.S.A. by its member banks prior to Visa U.S.A.'s merger into Visa Inc. In March of 2008, the Bank reversed this liability because, subsequent to Visa Inc.'s IPO, Visa, Inc. established an escrow account from which it plans to pay any potential settlements.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In the following pages, Management discusses its analysis of the financial condition and results of operations for the second quarter of 2008 compared to the second quarter of 2007 and to the prior quarter (first quarter of 2008). This discussion should be read in conjunction with the related financial statements and with the audited financial statements and accompanying notes included in the Bank of Marin Bancorp's 2007 Annual Report. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

## Holding Company

On May 8, 2007, Bank of Marin stockholders approved the formation of a bank holding company. On July 1, 2007, the holding company, Bank of Marin Bancorp, acquired Bank of Marin as its wholly owned subsidiary. The holding company is expected to provide flexibility in meeting the financing needs of the Bank and in responding to evolving changes in the banking and financial services industries.

The financial statements and discussion thereof contained in this report for periods subsequent to the reorganization relate to consolidated Bank of Marin Bancorp. Periods prior to the reorganization relate to Bank of Marin only. The information is comparable as the sole subsidiary of Bank of Marin Bancorp is the Bank of Marin.

## 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.

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

Forward-looking statements are based on management's current expectations regarding economic, legislative, and regulatory issues that may impact Bancorp's earnings in future periods. A number of factors - many of which are beyond management's control - could cause future results to vary materially from current management expectations. Such factors include, but are not limited to, general economic conditions, changes in interest rates, deposit flows, real estate values and competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation; and other economic, competitive, governmental, regulatory and technological factors affecting Bancorp's operations, pricing, products and services. These and other important factors are detailed in the Risk Factors section of Bancorp's 2007 Form 10-K as filed with the SEC, copies of which are available from Bancorp at no charge, and in the Risk Factors noted in Part II, Item 1A of this report . Forward-looking statements speak only as of the date they are made. Bancorp does 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.

## Critical Accounting Policies

Critical accounting policies are those that are both most important to the portrayal of Bancorp's 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.
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Management has determined the following four accounting policies to be critical: Allowance for Loan Losses, Share-Based Payment, Accounting for Income Taxes and Fair Value Option for Financial Assets and Liabilities.

## Allowance for Loan Losses

Allowance for loan losses is based upon estimates of loan losses and is maintained at a level considered adequate to provide for probable losses inherent in the outstanding loan portfolio. The allowance is increased by provisions charged to expense and reduced by net charge-offs. In periodic evaluations of the adequacy of the allowance balance, management considers the Bank's past loan loss experience by type of credit, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, current economic conditions and other factors. The Bank formally assesses the adequacy of the allowance for loan losses on a quarterly basis. These assessments include the periodic re-grading of loans based on changes in their individual credit characteristics including delinquency, seasoning, recent financial performance of the borrower, economic factors, changes in the interest rate environment, and other factors as warranted. Loans are initially graded when originated. They are reviewed as they are renewed, when there is a new loan to the same borrower and/or when identified facts demonstrate heightened risk of default. Review of larger problem loans occurs at least quarterly.

The Bank's method for assessing the appropriateness of the allowance includes specific allowances for identified problem loans, an allowance factor for pools of credits, and allowances for changing environmental factors (e.g., portfolio trends, concentration of credit, growth, economic factors). Allowances for identified problem loans are based on specific analysis of individual credits. Loss estimation factors for loan pools are based on analysis of local economic factors applicable to each loan pool. Allowances for changing environmental factors are management's best estimate of the probable impact these changes have had on the loan portfolio as a whole.

Share-Based Payment
On January 1, 2006, the Bank adopted the provisions of SFAS No.123R, "Share-Based Payment," which requires that all share-based payments, including stock options and nonvested restricted common shares, be recognized as an expense in the income statement based on the grant-date fair value of the award with a corresponding increase to common stock.

The Bank determines fair value of stock options at grant date using the Black-Scholes pricing model that takes into account the stock price at the grant date, the exercise price, the expected dividend yield, stock price volatility and the risk-free interest rate over the expected life of the option. The Black-Scholes model requires the input of highly subjective assumptions including the expected life of the stock-based award and stock price volatility. The estimates used in the model involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, the Bank's recorded stock-based compensation expense could have been materially different from that reflected in these financial statements. The fair value of nonvested restricted common shares generally equals the stock price at grant date. In addition, the Bank is required to estimate the expected forfeiture rate and only recognize expense for those share-based awards expected to vest. If the Bank's actual forfeiture rate is materially different from the estimate, the share-based compensation expense could be materially different. For additional discussion of SFAS No.123R, see Note 5 of the Notes to Financial Statements.

Accounting for Income Taxes
Income taxes reported in the financial statements are computed based on an asset and liability approach in accordance with FASB Statement No. 109, "Accounting for Income Taxes."(FASB No. 109). Bancorp recognizes the amount of
taxes payable or refundable for the current year, and deferred tax assets and liabilities for the expected future tax consequences that have been recognized in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Bancorp records net deferred tax assets to the extent it is more likely than not that they will be realized. In evaluating Bancorp's 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.

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Effective January 1, 2007, Bancorp adopted the provisions of FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109," which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB No. 109. FIN 48 establishes a "more-likely-than-not" recognition threshold that must be met before a tax benefit can be recognized in the financial statements. For tax positions that meet the more-likely-than-not threshold, an enterprise may recognize only the largest amount of tax benefit that is greater than fifty percent likely of being realized upon ultimate settlement with the taxing authority. Management believed that there were no tax positions that did not meet the more-likely-than-not recognition threshold; therefore, there were no adjustments to retained earnings as a consequence of adopting FIN No. 48 and no subsequent adjustments to the provision for income taxes related to FIN 48. To the extent tax authorities disagree with these tax positions, the Bank's and Bancorp's effective tax rates could be materially affected in the period of settlement with the taxing authorities.

## Fair Value Option for Financial Assets and Financial Liabilities and Fair Value Measurements

Effective January 1, 2007, the Bank elected early adoption of FASB Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" and FASB Statement No. 157, "Fair Value Measurements" and elected the fair value option for its indirect auto loan portfolio, which was subsequently sold. The changes in fair value of the portfolio after the initial adoption at each balance sheet date were recorded through earnings prior to the sale on June 5, 2007. The Bank determined fair value at January 1, 2007 and March 31, 2007 based on certain criteria including weighted average interest rate, remaining term and FICO credit score. The expected cash flows were discounted using Treasury rates and a spread above the Treasury rate was applied based on recent sales of similar assets. The assumptions represented management's best estimates, but these estimates involved inherent uncertainties and the application of management's judgment. As a result, if other assumptions had been used, the Bank's recorded unrealized gain in the first quarter of 2007 could have been materially different from that reflected in these financial statements.

As a result of the Bank's fair value measurement election for the auto loan portfolio, the Bank recorded a cumulative-effect adjustment of $\$ 1.5$ million, net of tax, as a reduction of retained earnings as of January 1, 2007. In addition, $\$ 190$ thousand and $\$ 520$ thousand of pre-tax net gains were recorded in the Bank's second and first quarter 2007 earnings, respectively ( 2 cents and 6 cents per diluted share, respectively, on an after-tax basis), representing the change in fair value of such instruments during those periods after giving effect to the cumulative-effect adjustment.

The Bank has established and documented a process for determining fair value. For detailed information on the Bank's use of fair valuation of financial instruments and our related valuation methodologies, see Note 3 to the consolidated financial statements in this Form 10-Q.

## Executive Summary

In the first half of 2008, the Bank experienced loan growth of $\$ 75$ million, an increase of over $10.3 \%$, without compromising its high standards of underwriting. During the same period, deposits, exclusive of the $\$ 53$ million short-term deposit placed with the Bank over the 2007 year-end, increased $\$ 19.5$ million, or $2.5 \%$. Overnight borrowing and Federal Home Loan Bank (FHLB) borrowings increased $\$ 46.8$ million to fund the loan growth. In the current economic environment, the Bank has experienced intense competition for deposits. This is primarily due to a combination of businesses and consumers having less funds to deposit and higher deposit rates offered by competitors in order to maintain their funding base. During this time, the Bank has maintained a rational approach to retaining relationship deposits without seeking deposits that are solely rate sensitive.

Through its Asset/Liability Management Committee (ALCO), Management continually monitors the balance of loans, deposits and purchased or sold funds to ensure measured growth under sound banking practices. The Bank's compliance with regulatory requirements including capital adequacy and liquidity are monitored on an ongoing basis and loan or deposit rates may be adjusted to achieve management's objectives.

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## BANK OF MARIN BANCORP

Management anticipates that cash and cash equivalents on hand, deposits and borrowing capacity will provide adequate liquidity for its operating, investing and financing needs and its regulatory liquidity requirements for the foreseeable future.

A combination of lower deposit and borrowing rates and a shift in interest-earning assets from Federal funds sold to higher-yielding loans contributed to a net income increase of over thirteen percent in the six months ended June 30, 2008 compared to the six months ended June 30, 2007. At June 30, 2007, Federal funds sold included reinvestment of the proceeds from the sale of the Bank's $\$ 77$ million indirect auto loan portfolio in the second quarter of 2007.

Beginning in August 2007 and continuing through April 2008, the Federal Reserve lowered its target interest rate by 325 basis points, resulting in lower offered deposit rates by the Bank, improving the Bank's net interest margin along with the reinvestment of loan sale proceeds into higher-yielding relationship loans. Loan yields did not fall as dramatically since the yield on fixed-rate loans, which comprise about half of the loan portfolio, remained relatively unchanged. The largest factors likely to affect the Bank's net interest margin in the remainder of 2008 will be the volume of loan demand, and the level to which the Bank responds to competitive pricing on loans and deposits in its market, which will, in turn, be influenced by the Bank's liquidity level, as well as the repricing of variable rate loans.

In the first half of 2008, the Bank recorded a non-recurring pre-tax gain of $\$ 457$ thousand related to the mandatory redemption of shares in Visa, Inc. and the reversal of a $\$ 242$ thousand pre-tax charge for the potential obligation to Visa Inc. in connection with certain indemnifications provided to Visa Inc. by Visa member banks. In the first half of 2007, the Bank recorded a non-recurring pre-tax gain of $\$ 710$ thousand on the sale of the indirect auto portfolio.

As part of its conservative management practices, the Bank has not participated in subprime lending nor does it hold investment securities backed by subprime loans. The Bank does not hold common or preferred stock of either the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac), which have recently come under financial pressure.

Bancorp's most recent share repurchase program began in November 2007 under which repurchases up to $\$ 5$ million were approved by the Board of Directors. In the first half of 2008, 58,609 shares were repurchased under the program for $\$ 1.7$ million, including commissions. Approximately $\$ 1.8$ million is remaining under this repurchase plan as of June 30, 2008. Management uses share repurchase programs to utilize excess capital and to enhance earnings per share. Bancorp has maintained its strong capital position, with total risk-based capital of $11.8 \%$ at June 30, 2008.

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## BANK OF MARIN BANCORP

## RESULTS OF OPERATIONS

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

| (dollars in thousands except per share data) | As of and for the three months ended |  |  |  |  |  | As of and for the six months ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | June 30, 2008 |  | $\begin{gathered} \text { March 31, } \\ 2008 \end{gathered}$ |  | June 30, 2007 |  | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ |  | June 30, 2007 |  |
| For the period: |  |  |  |  |  |  |  |  |  |  |
| Net income | \$ | 3,386 | \$ | 3,276 | \$ | 2,903 | \$ | 6,662 | \$ | 5,877 |
| Net income per share |  |  |  |  |  |  |  |  |  |  |
| Basic |  | 0.66 |  | 0.64 |  | 0.56 |  | 1.30 |  | 1.13 |
| Diluted |  | 0.65 |  | 0.63 |  | 0.54 |  | 1.27 |  | 1.09 |
| Return on average equity |  | 14.73\% |  | 14.63\% |  | 13.90\% |  | 14.68\% |  | 14.13\% |
| Return on average assets |  | 1.48\% |  | 1.48\% |  | 1.32\% |  | 1.48\% |  | 1.36\% |
| Cash dividend payout ratio |  | 21.21\% |  | 21.88\% |  | 23.21\% |  | 21.54\% |  | 22.12\% |
| Efficiency ratio |  | 54.14\% |  | 53.89\% |  | 59.22\% |  | 54.01\% |  | 58.69\% |
| At period end: |  |  |  |  |  |  |  |  |  |  |
| Book value per share | \$ | 18.00 | \$ | 17.68 | \$ | 16.21 | \$ | 18.00 | \$ | 16.21 |
| Total assets | \$ | 952,539 | \$ | 919,839 | \$ | 890,377 |  | 952,539 | \$ | 890,377 |
| Total loans, gross | \$ | 799,510 | \$ | 769,530 | \$ | 653,924 |  | 799,5100 | \$ | 653,9240 |
| Total deposits | \$ | 801,220 | \$ | 760,162 | \$ | 776,477 | \$ | 801,220 | \$ | 776,477 |
| Loan-to-deposit ratio |  | 99.8\% |  | 101.2\% |  | 84.2\% |  | 99.8\% |  | 84.2\% |

## 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 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. The table below indicates net interest income, net interest margin, and net interest rate spread for each period presented. 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 higher than net interest rate spread because it reflects interest income earned on assets funded with non-interest-bearing sources of funds, which include demand deposits and stockholders' equity.

Interest rate changes can create fluctuations in the net interest margin due to an imbalance in the timing of repricing or maturity of assets or liabilities. Interest rate risk exposure is managed with the goal of minimizing the impact of interest rate volatility on the net interest margin.

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

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Distribution of Average Statements of Condition and Analysis of Net Interest Income



| (in thousands) | Six months ended June 30, 2008 |  |  | Six months ended June 30, 2007 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Average Balance | Interest <br> Income/ <br> Expense (1) | Yield/ <br> Rate (1) | Average Balance |  | erest ome/ nse (1) | Yield/ <br> Rate (1) |
| Federal funds sold | \$ 5,682 | 113 | 3.99\% | \$ 16,017 | \$ | 417 | 5.25\% |
| Investment securities |  |  |  |  |  |  |  |
| U.S. Treasury securities | --- | --- | --- | 638 |  | 8 | 2.42\% |
| U.S. Government agencies | 72,157 | 1,749 | 4.87\% | 68,894 |  | 1,651 | 4.83\% |
| Other | 6,675 | 167 | 5.07\% | 7,779 |  | 221 | 5.76\% |
| Municipal bonds | 18,237 | 485 | 5.35\% | 12,524 |  | 305 | 4.91\% |
| Loans and banker's acceptances (2) | 756,354 | 26,712 | 7.10\% | 717,025 |  | 27,785 | 7.81\% |
| Total interest-earning assets | 859,105 | 29,226 | 6.84\% | 822,877 |  | 30,387 | 7.45\% |
| Cash and due from banks | 21,790 |  |  | 26,121 |  |  |  |
| Bank premises and equipment, net | 8,121 |  |  | 8,340 |  |  |  |
| Interest receivable and other assets, net | 16,674 |  |  | 16,638 |  |  |  |
| Total assets | \$ 905,690 |  |  | \$ 873,976 |  |  |  |

Liabilities and
Stockholders'
Equity

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| Interest-bearing transaction accounts | \$ 78,169 | \$ | 184 | 0.47\% | \$ 75,895 | \$ | 151 | 0.40\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Savings and money market accounts | 404,259 |  | 3,774 | 1.88\% | 391,444 |  | 7,170 | 3.69\% |
| Time accounts | 82,421 |  | 1,405 | 3.43\% | 87,564 |  | 1,751 | 4.03\% |
| Purchased funds | 32,206 |  | 363 | 2.27\% | 23,269 |  | 564 | 4.89\% |
| Borrowed funds | 5,000 |  | 160 | 6.31\% | 5,000 |  | 200 | 8.00\% |
| Total interest-bearing liabilities | 602,055 |  | 5,886 | 1.97\% | 583,172 |  | 9,836 | 3.40\% |
| Demand accounts | 204,848 |  |  |  | 200,669 |  |  |  |
| Interest payable and other liabilities | 7,534 |  |  |  | 6,248 |  |  |  |
| Stockholders' equity | 91,253 |  |  |  | 83,887 |  |  |  |
| Total liabilities \& stockholders' equity | \$ 905,690 |  |  |  | \$ 873,976 |  |  |  |
| Net interest income |  | \$ | 23,340 |  |  | \$ | 20,551 |  |
| Net interest margin |  |  |  | 5.46\% |  |  |  | 5.04\% |
| Net interest rate spread |  |  |  | 4.87\% |  |  |  | 4.05\% |

(1) Yields and interest income are presented on a taxable-equivalent basis using the Federal statutory rate of 35 percent.
(2) Average balances on loans outstanding include non-performing loans, if any. The amortized portion of net loan origination fees (costs) is included in interest income on loans, representing an adjustment to the yield.

## Second Quarter 2008 Compared to Second Quarter 2007

The tax-equivalent net interest margin increased to $5.52 \%$ in the second quarter of 2008, up 45 basis points from the second quarter of 2007. Sharply lower rates on deposits, purchased funds and borrowed funds were only partially offset by lower loan yields. The drop of 100 basis points in the Federal funds target rate in the latter part of 2007 and 225 basis points in the first half of 2008 resulted in lower offered rates on deposits and lower borrowing rates, favorably impacting the net interest margin. In the second quarter of 2008 compared to the second quarter of 2007, the improvement in the margin was enhanced by a shift in the mix of interest-earning assets from Fed funds sold to loans and a higher mix of demand deposits, partially offset by an elevated concentration of higher-costing purchased funds.

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## BANK OF MARIN BANCORP

Total average interest-earning assets increased $\$ 41.8$ million, or $5.0 \%$, in the second quarter of 2008 compared to the second quarter of 2007. The increase primarily relates to loan growth of $\$ 65.3$ million and higher investment securities of $\$ 8.0$ million, partially offset by a decline of $\$ 31.5$ million in Federal funds sold. Federal funds sold declined as the proceeds from the sale of the indirect auto loan portfolio in the second quarter of 2007, which were initially invested in Federal funds sold, were reinvested in loans.

The yield on the loan portfolio, which comprised $88.9 \%$ and $85.5 \%$ of average interest-earning assets in the quarters ended June 30, 2008 and June 30, 2007, respectively, decreased 94 basis points in the second quarter of 2008 over the comparable period a year ago due to the repricing of variable-rate loans and new loans at lower market rates, as well as maturities and pay downs of loans with higher yields. The average yield on interest-earning assets decreased 73 basis points in the second quarter of 2008 compared to the second quarter in 2007. The decline in yield on loans was partially offset by increased yields on agency securities and municipal bonds.

In the quarter ended June 30, 2008, the yield on the portfolio of agency securities increased 27 basis points from the same quarter a year ago. Agency securities comprised $8.1 \%$ and $8.3 \%$ of average interest-earning assets in those periods, respectively. These securities generally have shorter lives than other securities in the portfolio and will mature or be called more quickly. The increase in yield on agency securities in the periods primarily relates to the maturity of lower-yielding securities. The yield on municipal bond securities, which comprised $2.2 \%$ or less of interest-earning assets in each of the two quarters presented, increased 50 basis points from the same quarter a year ago. The increase relates to the purchase of municipal bonds at higher market rates than those maturing. In 2008, higher rates on new municipal bonds resulted from reduced market demand due to growing concern over the stability of certain companies that insure municipal bonds. At the same time, investor demand moved toward safer treasury securities in volatile market conditions. These market conditions required some municipalities to offer higher rates to attract investors.

The average balance of interest-bearing liabilities increased $\$ 23.3$ million, or $4.0 \%$, in the second quarter of 2008 compared to the same period a year ago. A $\$ 31.8$ million increase in purchased funds to fund loan growth was partially offset by a decrease of $\$ 5.1$ million in savings and money market accounts and $\$ 4.2$ million in time accounts. The decline in interest-bearing deposits compared to the second quarter in 2007 reflects general economic conditions affecting customers and increased competition including both bank and non-bank financial institutions.

The rate on interest-bearing liabilities decreased 165 basis points in the second quarter of 2008 over the same quarter a year ago. The overall cost of liabilities is affected by offered rates and the mix of deposits and other interest-bearing liabilities. In the second quarter of 2008, the rate on savings and money market accounts decreased 214 basis points compared to the same quarter a year ago and the rate on time deposits decreased 88 basis points in the same comparable period. The decreases reflected sharply declining market rates. The rate on purchased funds decreased 218 basis points in the second quarter of 2008 compared to the same quarter last year reflecting the decline in the Federal funds target rate. The rate on borrowed funds decreased 264 basis points due a decline in the LIBOR rate, to which the borrowing is indexed.

In the second quarter of 2008, the average balance of demand deposits, on which no interest is paid, increased to $27.3 \%$ of average deposits, up from $26.5 \%$ in the same quarter a year ago. Savings and money market accounts decreased to $51.9 \%$ of average balance of deposits in the second quarter of 2008, down from $52.3 \%$ in the second quarter of 2007, time deposits decreased to $10.7 \%$ of average balance of deposits from $11.2 \%$, and interest-bearing transaction accounts increased to $10.1 \%$ from $9.9 \%$ in the same period. The increase in the proportion of demand deposits contributed to the lower cost of funds.

Second Quarter of 2008 Compared to First Quarter of 2008
The tax equivalent net interest margin increased to $5.52 \%$ in the second quarter of 2008, up 11 basis points from the prior quarter. The rapid 200 basis point decline in the Federal funds target rate in the first quarter of 2008 eased to a 25 basis point decline in the second quarter.

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Total average interest-earning assets increased $\$ 29.3$ million, or $3.5 \%$, in the second quarter of 2008 compared to the prior quarter. The increase primarily relates to $\$ 40.9$ million loan growth, partially offset by a decline of $\$ 10.9$ million in Fed funds sold.

The yield on the loan portfolio, which comprised $88.9 \%$ and $87.1 \%$ of average interest-earning assets in the quarters ended June 30, 2008 and March 31, 2008, respectively, decreased 34 basis points in the quarter ended June 30, 2008 over the prior quarter. The average yield on total interest-earning assets decreased 23 basis points in the same comparable period. The decline in loan yields due to the re-pricing of variable-rate loans and new loans at lower market rates was partially offset by the favorable effect on yield due to a shift in the mix of interest-earning assets from Fed funds sold to loans and higher yields on agency securities and other investments.

The average balance of interest-bearing liabilities increased $\$ 15.3$ million, or $2.6 \%$, in the second quarter of 2008 compared to the prior quarter. An increase of $\$ 22.3$ million in purchased funds to fund loan growth was partially offset by a decrease of $\$ 7.3$ million in savings and money market accounts. The decline in savings and money market accounts reflects general economic conditions affecting customers and increased competition, including both bank and non-bank financial institutions. In the second quarter of 2008, interest-bearing transaction accounts and time accounts remained fairly consistent with the prior quarter.

The rate on interest-bearing liabilities decreased 46 basis points in the second quarter of 2008 compared to the prior quarter, reflecting generally declining market rates.

In the second quarter of 2008, demand deposits, on which no interest is paid, increased to $27.3 \%$ of average deposits, up from $25.9 \%$ in the prior quarter. Savings and money market accounts decreased to $51.9 \%$ of average deposits in the second quarter of 2008 , down from $53.2 \%$ in the first quarter of 2008, while the proportion of time deposits remained unchanged at $10.7 \%$ and interest-bearing transaction accounts declined slightly to $10.1 \%$ from $10.2 \%$. The increase in the proportion of demand deposits in addition to the rate reductions discussed above, contributed to the lower cost of funds.

Six Months 2008 Compared to Six Months 2007
The tax-equivalent net interest margin increased to $5.46 \%$ in the first six months of 2008, up 42 basis points from the first six months of 2007. Lower rates on deposits and purchased and borrowed funds were only partially offset by lower loan and securities yields.

Average interest-earning assets increased $\$ 36.2$ million, or $4.4 \%$, in the first half of 2008 compared to the first half of 2007. The increase primarily relates to loan growth of $\$ 39.3$ million, partially offset by a $\$ 10.3$ million decline in Federal funds sold. Federal funds sold declined as the proceeds from the sale of the indirect auto portfolio in the second quarter of 2007, which were initially invested in Federal funds, were reinvested in loans.

The yield on the loan portfolio, which comprised $88.0 \%$ and $87.1 \%$ of average earning assets in the six-months ended June 30, 2008 and June 30, 2007, respectively, decreased 71 basis points in the first half of 2008 compared to the first half of 2007 due to the repricing of variable rate loans and new loans at lower market rates, as well as maturities and pay downs of higher yielding loans.

In the six months ended June 30, 2008, the yield on the portfolio of agency securities remained fairly consistent with the yield a year ago, and agency securities comprised $8.4 \%$ of interest-earning assets in both periods. The yield on municipal bonds, which comprised approximately $2.1 \%$ of interest-earning assets in the six months ended June 30,

2008 and 2007, increased 44 basis points in the six months ended June 30, 2008 compared to the same period in 2007 due to higher rates offered by municipalities as discussed earlier.

The average balance of interest-bearing liabilities increased $\$ 18.9$ million, or $3.2 \%$, in the first half of 2008 compared to the first half of 2007. An increase in savings and money market accounts of $\$ 12.8$ million and purchased funds of $\$ 8.9$ million were partially offset by a decline of $\$ 5.1$ million in time deposits.

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The rate on interest-bearing liabilities decreased 143 basis points in the six months ended June 30, 2008 compared to the six months ended June 30, 2007, reflecting generally declining market rates. The rate on savings and money market accounts decreased 181 basis points in the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The rate on time deposits declined only 60 basis points in the same comparable period since time deposits have longer maturities and the rates on customer accounts change less frequently. The rate on purchased funds declined 262 basis points, primarily due to declines in the target Federal funds rate. The rate on borrowed funds declined 169 basis points due to a decline in LIBOR, to which the borrowing rate is indexed.

The mix of deposits was relatively unchanged in the six-month period ended June 30, 2008 compared to the same period a year ago.

## Provision for Loan Losses

The Bank formally assesses the adequacy of the allowance for loan losses on a quarterly basis. The Bank provides, as an expense, an amount to bring the allowance for loan losses to a level to provide adequate coverage for probable loan losses. The adequacy of the allowance for loan losses is evaluated based on several factors, including growth of the loan portfolio, analysis of probable losses in the portfolio and recent loss experience. Actual losses on loans are charged against the allowance, and the allowance is increased through the provision for loan losses charged to expense. For further discussion, see sections captioned "Critical Accounting Policies."

The Bank's provision for loan losses was $\$ 510$ thousand in the second quarter of 2008 compared to $\$ 75$ thousand in the second quarter of 2007, and $\$ 615$ thousand in the first quarter of 2008. During the first six months of 2008, the provision for loan losses totaled $\$ 1.1$ million compared to $\$ 140$ thousand in the first six months of 2007. The increases are mainly a result of the significant level of loan growth that the Bank experienced in 2007 and 2008. The allowance for loan losses as a percentage of loans totaled $1.07 \%$ at June 30, 2008, unchanged from March 31, 2008, and down one basis point from June 30, 2007. Net charge-offs in the second quarter of 2008 totaled $\$ 154$ thousand compared with $\$ 64$ thousand in the second quarter of 2007, and $\$ 9$ thousand net recoveries in the first quarter of 2008. Net charge-offs totaled $\$ 145$ thousand in the first six months of 2008 compared to $\$ 62$ thousand in the first six months of 2007.

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

| (dollars in thousands) | Three months ended |  |  | June 30, 2008 compared to March 31, 2008 |  | June 30, 2008 compared to June 30, 2007 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | June 30, 2008 | $\begin{gathered} \text { March } 31, \\ 2008 \end{gathered}$ | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ | Increase (Decrease) | Increase (Decrease) |  | crease crease) | Increase (Decrease) |
| Service charges on deposit accounts | \$ 430 | \$ 406 | \$ 321 | \$ 24 | 5.9\% | \$ | 109 | 34.0\% |
| Wealth Management Services | 310 | 336 | 298 | (26) | (7.7\%) |  | 12 | 4.0\% |
| Unrealized gain on indirect auto portfolio | --- | --- | 190 | --- | --- |  | (190) | NM |
| Net gain on redemption of shares in Visa, Inc | --- | 457 | --- | (457) | NM |  | --- | NM |
| Other non-interest income |  |  |  |  |  |  |  |  |
| Earnings on Bank-owned life insurance | 151 | 147 | 144 | 4 | 2.7\% |  | 7 | 4.9\% |
| Customer banking fees and other charges | 116 | 94 | 155 | 22 | 23.4\% |  | (39) | (25.2\%) |
| Other income | 272 | 262 | 285 | 10 | 3.8\% |  | (13) | (4.6\%) |
| Total other non-interest income | 539 | 503 | 584 | 36 | 7.2\% |  | (45) | (7.7\%) |
| Total non-interest income | \$ 1,279 | \$ 1,702 | \$ 1,393 | \$ (423) | (24.9\%) | \$ | (114) | (8.2\%) |

NM-Not Meaningful

| (dollars in thousands) | Six months ended |  |  |  | Amount <br> Increase <br> (Decrease) |  | Percent <br> Increase <br> (Decrease) |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { June } 30, \\ 2008 \end{gathered}$ |  | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |  |  |  |  |
| Service charges on deposit accounts | \$ | 836 | \$ | 569 | \$ | 267 | 46.9\% |
| Wealth Management Services |  | 646 |  | 573 |  | 73 | 12.7\% |
| Unrealized gain on indirect auto portfolio |  | --- |  | 710 |  | (710) | NM |
| Net gain on redemption of shares in Visa, Inc |  | 457 |  | --- |  | 457 | NM |
| Other non-interest income |  |  |  |  |  |  |  |
| Earnings on Bank-owned life insurance |  | 297 |  | 283 |  | 14 | 4.9\% |
| Customer banking fees and other charges |  | 210 |  | 275 |  | (65) | (23.6\%) |
| Other income |  | 535 |  | 491 |  | 44 | 9.0\% |
| Total other non-interest income |  | 1,042 |  | 1,049 |  | (7) | (0.7\%) |

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Total non-interest income
$\begin{array}{llll}\$ & 2,981 & \$ 2,901 & \$\end{array}$
$80 \quad 2.8 \%$

NM - Not Meaningful
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Non-interest income for the second quarter of 2008 decreased $\$ 114$ thousand, or $8.2 \%$, as compared to the second quarter of 2007 and decreased $\$ 423$ thousand, or $24.9 \%$, compared to the prior quarter. The first quarter of 2008 included a net gain of $\$ 457$ thousand on the mandatory redemption of a portion of the Bank's shares of Visa, Inc, which became a public company through its initial public offering on March 19, 2008. The second quarter of 2007 included a $\$ 190$ thousand unrealized gain on the indirect auto portfolio. Excluding these gains, non-interest income in the second quarter of 2008 increased by $6.3 \%$ from the same quarter a year ago and increased by $2.7 \%$ when compared to the prior quarter.

Service charges on deposit accounts increased $\$ 109$ thousand, or $34.0 \%$, from the comparable quarter a year ago and increased $\$ 24$ thousand, or $5.9 \%$, from the preceding quarter. These increases are primarily attributable to an increase in fees from the Bank's business analysis accounts, primarily reflecting a reduced earnings income credit, and growth in number of customers and services provided, as well as an increase in the volume of fees on checks drawn against insufficient funds. Wealth Management Services (WMS) income increased $\$ 12$ thousand, or $4.0 \%$, from the second quarter of 2007, reflecting an increase in assets under management and market appreciation, and decreased \$26 thousand, or $7.7 \%$, from the prior quarter, due to market depreciation. Other non-interest income decreased $\$ 45$ thousand, or $7.7 \%$, from the second quarter of 2007 and increased $\$ 36$ thousand, or $7.2 \%$, from the prior quarter. The decrease from the same quarter a year ago is primarily due to a decrease in remote deposit capture fees (which are run through account analysis), reverse mortgage fees (this business was exited May 1, 2008) and mortgage fees. The increase compared to the prior quarter relates to an increase in miscellaneous income (due to interest the Bank received on amended tax returns) and higher fees (which included Visa, Visa debit and remote capture), partially offset by lower reverse mortgage fees, as the Bank exited that business on May 1, 2008.

Non-interest income totaled $\$ 3.0$ million for the first six months of 2008, an increase of $\$ 80$ thousand, or $2.8 \%$, from the first six months of 2007. The adoption of SFAS No. 159 and the subsequent sale of the indirect auto loan portfolio generated a net gain in the first six months of 2007 of $\$ 710$ thousand and, in the first six months of 2008, the sale of shares of Visa Inc. generated a net gain of $\$ 457$ thousand. Excluding these gains, non-interest income in the first six months of 2008 increased $15.2 \%$ from the comparable period a year ago. The net gain on sale of the auto portfolio is comprised of $\$ 520$ thousand recorded in the first quarter of 2007 representing the change in the fair value of the portfolio during the quarter, plus a net gain recorded in the second quarter representing the pre-tax gain on the sale totaling $\$ 489$ thousand based on actual proceeds, net of selling expenses of $\$ 299$ thousand, including commissions, legal fees and conversion costs. The $\$ 457$ thousand gain recorded in the first quarter of 2008 represents the mandatory redemption of a portion of the Bank's shares of Visa, Inc.

Service charges on deposit accounts in the first six months of 2008 increased $\$ 267$ thousand, or $46.9 \%$, compared to the first six months of 2007 and is primarily attributable to an increase effective April 1, 2007, in the fees the Bank charges for checks drawn against insufficient funds, combined with higher volume, as well as reduced earnings credits provided to certain customer accounts. WMS income totaled $\$ 646$ thousand during the first six months of 2008, an increase of $\$ 73$ thousand, or $12.7 \%$, compared to the same period in 2007 , primarily reflecting new assets under management. Other income for the first six months of 2008 totaled $\$ 1.0$ million and reflected lower remote deposit capture fees, substantially offset by higher miscellaneous income (due to interest the Bank received in the second-quarter of 2008 on amended tax returns) and BOLI income.

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

| (dollars in thousands) | Three months ended |  |  |  |  | $\begin{gathered} \text { June } 30,2008 \\ \text { compared } \\ \text { to March 31, } 2008 \end{gathered}$ |  |  | June 30, 2008 compared to June 30, 2007 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | June 30, 2008 | March 31,$2008$ |  | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |  | Increase (Decrease) |  | Increase (Decrease) | Amount Increase (Decrease) |  | Percent <br> Increase <br> (Decrease) |
| Salaries and related benefits | \$ 4,035 | \$ | 4,158 | \$ | 4,163 | \$ | (123) | (3.0\%) | \$ | (128) | (3.1\%) |
| Occupancy and equipment | 793 |  | 768 |  | 729 |  | 25 | 3.3\% |  | 64 | 8.8\% |
| Depreciation \& amortization | 327 |  | 318 |  | 310 |  | 9 | 2.8\% |  | 17 | 5.5\% |
| Data processing fees | 430 |  | 445 |  | 425 |  | (15) | (3.4\%) |  | 5 | 1.2\% |
| Professional services | 419 |  | 406 |  | 384 |  | 13 | 3.2\% |  | 35 | 9.1\% |
| Other non-interest expense |  |  |  |  |  |  |  |  |  |  |  |
| Advertising | 87 |  | 102 |  | 108 |  | (15) | (14.7\%) |  | (21) | (19.4\%) |
| Director expense | 117 |  | 113 |  | 114 |  | 4 | 3.5\% |  | 3 | 2.6\% |
| Other expense | 932 |  | 691 |  | 797 |  | 241 | 34.9\% |  | 135 | 16.9\% |
| Total other non-interest expense | 1,136 |  | 906 |  | 1,019 |  | 230 | 25.4\% |  | 117 | 11.5\% |
| Total non-interest expense | \$ 7,140 | \$ | 7,001 | \$ | 7,030 | \$ | 139 | 2.0\% | \$ | 110 | 1.6\% |


| (dollars in thousands) | Six months ended |  |  |  | Amount Increase (Decrease) |  | Percent Increase (Decrease) |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | June 30, 2008 |  | June 30, 2007 |  |  |  |  |
| Salaries and related benefits | \$ | 8,193 | \$ | 8,126 | \$ | 67 | 0.8\% |
| Occupancy and equipment |  | 1,561 |  | 1,439 |  | 122 | 8.5\% |
| Depreciation \& amortization |  | 645 |  | 611 |  | 34 | 5.6\% |
| Data processing fees |  | 875 |  | 843 |  | 32 | 3.8\% |
| Professional services |  | 825 |  | 702 |  | 123 | 17.5\% |
| Other non-interest expense |  |  |  |  |  |  |  |
| Advertising |  | 189 |  | 170 |  | 19 | 11.2\% |
| Director expense |  | 230 |  | 225 |  | 5 | 2.2\% |
| Other expense |  | 1,623 |  | 1,603 |  | 20 | 1.2\% |
| Total other non-interest expense |  | 2,042 |  | 1,998 |  | 44 | 2.2\% |
| Total non-interest expense | \$ | 14,141 | \$ | 13,719 | \$ | 422 | 3.1\% |

Non-interest expense for the second quarter of 2008 increased $\$ 110$ thousand, or $1.6 \%$, as compared to the second quarter of 2007, and increased by $\$ 139$ thousand, or $2.0 \%$, from the prior quarter. Excluding the $\$ 242$ thousand Visa litigation reversal discussed below, non interest expense for the second quarter of 2008 decreased by $\$ 103$ thousand, or $1.4 \%$ from the prior quarter.

Salaries and benefits for the second quarter of 2008 decreased $\$ 128$ thousand, or $3.1 \%$, when compared to the second quarter of 2007 and decreased by $\$ 123$ thousand, or $3.0 \%$, when compared to the prior quarter. The decrease from the second quarter of 2007 primarily represents lower full-time equivalent employees (FTE), which totaled 187, 184 and 194 in June 2008, March 2008 and June 2007, respectively, and lower stock-based compensation. The decrease from the prior quarter reflects lower $401 \mathrm{~K} / \mathrm{ESOP}$ contributions, payroll taxes, and the capitalization of deferred loan costs as defined in SFAS No. 91 "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." These decreases were partially offset by a higher bonus accrual.

Occupancy and equipment expenses increased $\$ 64$ thousand, or $8.8 \%$, from the second quarter of 2007 and increased $\$ 25$ thousand, or $3.3 \%$ from prior quarter. The increase from second quarter 2007 is primarily due to increases in premises rent, including a new branch facility and higher maintenance and repair costs. The increase from the prior quarter primarily reflects higher maintenance and repair costs and annual rent increases.

Depreciation and amortization expenses for the second quarter of 2008 increased $\$ 17$ thousand, or $5.5 \%$, from the second quarter of 2007 and increased $\$ 9$ thousand or $2.8 \%$ from the previous quarter. These increases are primarily due to the remodeling of the San Rafael branch in the second quarter of 2008.

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Data processing expense for the second quarter of 2008 remained relatively unchanged when compared to the second quarter of 2007 and decreased $\$ 15$ thousand, or $3.4 \%$, compared to the previous quarter. This decrease primarily reflects a one time de-conversion fee, recorded in the first quarter of 2008 , related to credit card customers.

Professional services for the second quarter of 2008 increased $\$ 35$ thousand, or $9.1 \%$, from the second quarter of 2007 and increased $\$ 13$ thousand, or $3.2 \%$ from the first quarter of 2008 . The increase in the second quarter compared to the prior quarter and the same quarter a year ago was mainly attributable to higher professional fees related to Bank initiatives.

Other non-interest expense for the second quarter of 2008 increased by $\$ 117$ thousand, or $11.5 \%$ compared to the second quarter of 2007 and increased by $\$ 230$ thousand, or $25.4 \%$, from the first quarter of 2008 . The increase from second quarter 2007 is primarily due to higher FDIC insurance (for an industry-wide FDIC assessment), other processing costs (due to increased correspondent bank analysis fees) and information technology (for new products and special projects), partially offset by lower miscellaneous expense. The increase from the prior quarter reflects the reversal of a $\$ 242$ thousand Visa litigation accrual for the potential obligation to Visa Inc. in connection with certain litigation indemnifications provided to Visa Inc. by Visa member banks. Excluding this reversal, other non interest expense remained relatively unchanged when compared to the first quarter of 2008.

Non-interest expense totaled $\$ 14.1$ million for the first six months of 2008, an increase of $\$ 422$ thousand, or $3.1 \%$, from the corresponding period of 2007. Salaries and benefits increased by $\$ 67$ thousand, or $0.8 \%$, primarily reflecting a higher bonus accrual, partially offset by lower salaries, due to lower FTE. Occupancy and equipment expense increased by $\$ 122$ thousand, or $8.5 \%$, in the first six months of 2008 compared to the same period in 2007, mainly due to increases in premise rent, including a new branch facility. Depreciation and amortization increased by $\$ 34$ thousand, or $5.6 \%$. This increase reflects the remodeling of the San Rafael and Northgate branches. Data processing increased by $\$ 32$ thousand, or $3.8 \%$, which primarily reflects a one time de-conversion fee that was booked in the first six months of 2008. Professional services increased in the first six months of 2008 compared to the same period in the prior year by $\$ 123$ thousand, or $17.5 \%$, largely attributable to Bank initiatives. Other non-interest expense increased by $\$ 44$ thousand, or $2.2 \%$. Excluding the $\$ 242$ thousand accrual reversal discussed above, in the first six months of 2008 other non-interest expense increased $\$ 286$ thousand, or $14.3 \%$ when compared to that same time period last year. The change reflects increases in FDIC insurance, information technology costs, and other processing costs.

## Provision for Income Taxes

Bancorp reported a provision for income taxes of $\$ 2.2$ million, $\$ 2.1$ million, and $\$ 1.9$ million for the quarters ended June 30, 2008, March 31, 2008, and June 30, 2007, respectively. The effective tax rates were $38.9 \%, 39.1 \%$ and $39.1 \%$ for those same periods. These provisions reflect accruals for taxes at the applicable rates for federal income and California franchise taxes based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities and certain life insurance products). Therefore, there are normal fluctuations in the effective rate from period to period based on the relationship of net permanent differences to income before tax. The Bank has not been subject to an alternative minimum tax (AMT).

Bancorp and the Bank have entered into a tax allocation agreement which provides that income taxes shall be allocated between the parties on a separate entity basis. The intent of this agreement is that each member of the consolidated group will incur no greater tax liability than it would have incurred on a stand-alone basis.

## FINANCIAL CONDITION

## Summary

During the first six months of 2008, total assets increased $\$ 18.6$ million to $\$ 952.5$ million from December 31, 2007. This increase in assets primarily reflects an increase in net loans of $\$ 73.7$ million, offset by declines in Federal funds sold of $\$ 46.7$ million and investment securities of $\$ 7.7$ million. The decrease in Federal funds sold and related increase in borrowings of $\$ 46.8$ million are attributable to the increase in loans as well as a decrease in deposits of $\$ 33.4$ million. The decline in deposits reflects a $\$ 53.0$ million deposit from one customer placed with the Bank in the last week of December 2007, which left the Bank in early January 2008. As reflected in the table below, the increase in loans primarily reflects an increase in commercial real estate, residential and commercial loans.

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| (Dollars in thousands) | June 30,2008 | December 31,2007 |  |
| :--- | ---: | ---: | ---: |
| Commercial loans | $\$$ | 132,049 | $\$$ |
| Real estate |  | 124,336 |  |
| Commercial owner-occupied | 144,793 |  |  |
| Commercial investor | 288,806 | 132,614 |  |
| Construction | 101,815 | 257,127 |  |
| Residential (a) | 95,708 | 97,153 |  |
| Installment and other consumer | 36,339 | 78,860 |  |
| Total loans | 799,510 | 34,788 |  |
| Allowance for loan losses | 8,555 | 724,878 |  |
| Total net loans | $\$$ | 790,955 | $\$$ |

(a) The residential loan portfolio includes no sub-prime loans at June 30, 2008 and December 31, 2007.

The Bank's investment securities portfolio at June 30, 2008, consisting primarily of U.S. government agency securities, state and municipal securities, and corporate collateralized mortgage obligations (CMO's), decreased \$7.7 million or $7.7 \%$ from December 31, 2007, mainly due to reduction of corporate debt securities of $\$ 10$ million from December 31, 2007. U.S. government agency securities, which made up $76.8 \%$ of the portfolio, decreased by $\$ 3.5$ million. Corporate CMO's made up $2.1 \%$ of the portfolio and decreased by $\$ 518$ thousand, while state and municipal securities, which represented $21.1 \%$ of the portfolio, increased by $\$ 6.3$ million. Mortgage-backed securities in the portfolio totaled $\$ 58.3$ million at June 30, 2008, which consisted of $\$ 8.0$ million of pass-through securities issued by Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC), \$48.3 million of CMO's issued or guaranteed by FNMA, FHLMC, or Government National Mortgage Association (GNMA), and $\$ 2.0$ million of corporate CMO's. The Bank generally invests in mortgage-backed securities with collateral compositions reflecting low loan-to-values and/or borrowers with strong credit scores. Investment securities carried at $\$ 24.7$ million and $\$ 20.7$ million were pledged at June 30, 2008 and December 31, 2007, respectively.

Other assets include net deferred tax assets of $\$ 6.2$ million and $\$ 5.1$ million at June 30, 2008 and December 31, 2007, respectively. These deferred tax assets consist primarily of tax benefits expected to be realized in future periods related to temporary differences of allowance for loan losses, depreciation, net unrealized loss on securities available for sale and deferred compensation. Management believes these assets to be realizable due to the Bank's consistent record of earnings and the expectation that earnings will continue at a level adequate to realize such benefits.

During the first six months of 2008 , total liabilities increased $\$ 13.9$ million to $\$ 860.0$ million. The increase in total liabilities was primarily due to increases in overnight borrowings of $\$ 31.8$ million and a $2.07 \%$ fixed-rate putable 10 -year advance of $\$ 15.0$ million from the FHLB. The increase in borrowings was partially offset by the decrease in deposits of $\$ 33.4$ million, as discussed above. The overall decrease in deposits was a result of an anticipated withdrawal in January 2008 of a $\$ 53.0$ million short-term deposit, which had been placed with the Bank in December of 2007. Growth in deposits was positively impacted by the introduction of an on-balance sheet sweep account program in June of 2008 , which allowed $\$ 29.7$ million of customer deposits, which previously would have been swept off the balance sheet, to remain on the balance sheet at June 30, 2008.

Stockholders' equity increased $\$ 4.8$ million to $\$ 92.5$ million during the first six months of 2008 . The increase in stockholders' equity primarily reflects the Bank's earnings of $\$ 6.7$ million and the exercise of stock options (including the associated excess tax benefits) of $\$ 960$ thousand, partially offset by the repurchase of the Bank's common stock of $\$ 1.7$ million and the payment of cash dividends of $\$ 1.4$ million.

## Capital Adequacy

Bancorp and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a material effect on Bancorp's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Bancorp and the Bank must meet specific capital guidelines that involve quantitative measures of Bancorp's and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and the Bank's prompt corrective action classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies such as Bancorp.

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Quantitative measures established by regulation to ensure capital adequacy require Bancorp and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk weighted assets and of Tier 1 capital to quarterly average assets.

The Bank's and Bancorp's capital adequacy ratios as of June 30, 2008 and December 31, 2007 are presented in the following table. Capital ratios are reviewed by Management on a regular basis to ensure that capital exceeds the prescribed regulatory minimums and is adequate to meet the Bank's anticipated future needs. For all periods presented, the Bank's ratios exceed the regulatory definition of "well capitalized" under the regulatory framework for prompt corrective action and Bancorp's ratios exceed the required minimum ratios for capital adequacy purposes.

| Capital Ratios for Bancorp (in thousands) |  | Actual |  |  | Ratio Adequa |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| As of June 30, 2008 |  | mount | Ratio |  | mount |  |  |
| Total Capital (to risk-weighted assets) | \$ | 106,921 | 11.84\% | $\geq \$$ | 72,218 | $\geq$ | 8.00\% |
| Tier I Capital (to risk-weighted assets) | \$ | 92,882 | 10.29\% | $\geq \$$ | 36,109 | $\geq$ | 4.00\% |
| Tier I Capital (to average assets) | \$ | 92,882 | 10.08\% | $\geq \$$ | 36,848 | $\geq$ | 4.00\% |

As of December 31, 2007

| Total Capital (to risk-weighted |  |  |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| assets) | $\$$ | 101,066 | $12.06 \%$ | $\geq \$$ | 67,015 | $\geq$ |


| Capital Ratios for the Bank (in thousands) <br> As of June 30, 2008 | Actual Ratio |  |  | Ratio for Capital Adequacy Purposes |  |  |  | Ratio to be Well Capitalized under Prompt Corrective Action Provisions |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | mount | Ratio |  | mount |  |  |  | mount |  | atio |
| Total Capital (to risk-weighted assets) | \$ | 104,375 | 11.56\% | $\geq \$$ | 72,206 | $\geq$ | 8.00\% | $\geq \$$ | 90,257 | $\geq$ | 10.00\% |
| Tier I Capital (to risk-weighted assets) | \$ | 90,337 | 10.01\% | $\geq \$$ | 36,103 | $\geq$ | 4.00\% | $\geq \$$ | 54,154 | $\geq$ | 6.00\% |
| Tier I Capital (to average assets) | \$ | 90,337 | 9.81\% |  | 36,847 | $\geq$ | 4.00\% |  | 46,059 | $\geq$ | 5.00\% |

As of December 31, 2007
Total Capital (to
risk-weighted assets) $\quad \$ \quad 97,179 \quad 11.61 \% \geq \$ 66,983 \geq 8.00 \% \geq \$ 83,729 \geq 10.00 \%$

| Tier I Capital (to <br> risk-weighted assets) | $\$ 84,155$ | $10.05 \%$ | $\geq \$ 33,491 \geq 4.00 \% \geq \$ \quad 50,237 \geq$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Tier I Capital (to average assets) $\quad \$ 84,155 \quad 9.20 \% \geq \$ 36,587 \geq 4.00 \% \geq \$ 45,374 \geq 35.00 \%$

## Liquidity

The goal of liquidity management is to provide adequate funds to meet both loan demands and unexpected deposit withdrawals. This goal is accomplished by maintaining an appropriate level of liquid assets, and formal lines of credit with the Federal Home Loan Bank of San Francisco and correspondent banks that enable the Bank to borrow funds as needed. The Bank's Asset/Liability Management Committee is responsible for establishing and monitoring the Bank's liquidity targets and strategies.

Bank management regularly adjusts its investments in liquid assets based upon its assessment of expected loan demand, expected deposit flows, yields available on interest-earning securities and the objectives of the Bank's asset/liability management program.

The Bank obtains funds from the repayment and maturity of loans as well as deposit inflows, investment security maturities and paydowns, Federal funds purchased and FHLB advances, and other borrowings. The Bank's primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposit, maturity of certificate of deposits, repayment of borrowings and dividends to common stockholders.

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The Bank must retain and attract new deposits, which depends upon the variety and effectiveness of its customer account products, service and convenience, and rates paid to customers. Any long-term decline in retail deposit funding would adversely impact the Bank's liquidity. Bank management anticipates that Federal funds purchased and FHLB advances will continue to be important sources of funding in the future, and management expects there to be adequate collateral for such funding requirements. A decline in Bancorp's or the Bank's credit rating would adversely affect the Bank's ability to borrow and/or the related borrowing costs, thus impacting the Bank's liquidity.

As presented in the accompanying unaudited consolidated statements of cash flows, the sources of liquidity vary between periods. Consolidated cash and cash equivalents at June 30, 2008 totaled $\$ 31.2$ million. The primary sources of funds during the six months ended June 30, 2008 were $\$ 46.8$ million in Federal funds purchased and FHLB borrowings, $\$ 34.4$ million in the maturities and paydowns of securities available for sale and $\$ 21.5$ million in securities sales. The primary uses of funds were $\$ 74.8$ million in loan originations (net of principal collections), $\$ 40.6$ million investment securities purchases, and a $\$ 33.4$ million decline in deposits. The decline in deposits was mainly due to an anticipated withdrawal in January 2008 of a $\$ 53.0$ million short-term deposit placed with the Bank in December 2007.

The Bank anticipates that it will be in a borrowing position in the short-term. If competition for deposits in the marketplace increases, the Bank's liquidity and net interest margin may be negatively affected.

At June 30, 2008, the Bank's cash and cash equivalents, Federal funds sold and unpledged assets maturing within one year totaled $\$ 33.3$ million. The remainder of the unpledged securities portfolio of $\$ 65.7$ million provides additional liquidity. Taken together, these liquid assets equaled $10.2 \%$ of the Bank's assets at June 30, 2008, compared to $16.6 \%$ at December 31, 2007. The decreased liquidity at June 30, 2008 was primarily due to a lower Federal funds sold level resulting from loan growth and the decline in deposits.

The Bank anticipates that cash and cash equivalents on hand and its sources of funds will provide adequate liquidity for its operating, investing and financing needs and its regulatory liquidity requirements for the foreseeable future. Management monitors the Bank's liquidity position daily, balancing loan fundings/payments with changes in deposit activity and overnight investments. The Bank's emphasis on local deposits combined with its $9.4 \%$ equity to assets ratio, provides a very stable funding base. In addition to cash and cash equivalents, the Bank has substantial additional borrowing capacity including unsecured lines of credit totaling $\$ 65.0$ million with correspondent banks and a $\$ 3.2$ million line of credit with the Federal Reserve Bank to borrow overnight, which were not drawn upon at June 30, 2008. The Bank is a member of the FHLB and has a line of credit (secured under terms of a blanket collateral agreement by a pledge of loans) for advances of $\$ 160.5$ million, of which $\$ 113.7$ million was available at June 30, 2008, at an interest rate determined daily, which generally approximates the Federal funds target rate. Borrowings under the line of credit are limited to eligible collateral.

Undisbursed loan commitments, which are not reflected on the statement of condition, totaled $\$ 241.9$ million at June 30,2008 at rates ranging from $3.93 \%$ to $10.00 \%$. This amount included $\$ 139.1$ million under commercial lines of credit (these commitments are contingent upon customers maintaining specific credit standards), $\$ 63.1$ million under revolving home equity lines and $\$ 33.4$ million under undisbursed construction loans. These commitments, to the extent used, are expected to be funded through repayment of existing loans, deposit growth and FHLB borrowings. Over the next twelve months $\$ 67.2$ million of time deposits will mature. The Bank expects these funds to be replaced with new time or savings accounts.

The primary source of funds for Bancorp is dividends from the Bank. The primary uses of funds are stockholder dividends, stock repurchases and ordinary operating expenses. Management anticipates that there will be sufficient
earnings at the Bank level to provide dividends to Bancorp to meet its funding requirements for the foreseeable future.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Bancorp's most significant form of market risk is interest rate risk. The risk is inherent in its deposit and lending activities. Bancorp's management together with the Asset Liability Management Committee (ALCO), comprised of certain directors of the Bank, has sought to manage rate sensitivity and maturities of assets and liabilities to minimize the exposure of its earnings and capital to changes in interest rates. Additionally, interest rate risk exposure is managed with the goal of minimizing the impact of interest rate volatility on its net interest margin.

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Activities in asset and liability management include, but are not limited to, lending, accepting deposits and investing in securities. Interest rate risk is the primary market risk associated with asset and liability management. Sensitivity of net interest income (NII) and capital to interest rate changes results from differences in the maturity, or repricing, of asset and liability portfolios. To mitigate interest rate risk, the structure of the Statement of Condition is managed with the objective of correlating the movements of interest rates on loans and investments with those of deposits and borrowings. The asset and liability policy sets limits on the acceptable amount of change to NII and capital in changing interest rate environments. The Bank uses simulation models to forecast NII and capital.

Exposure to interest rate risk is reviewed at least quarterly by the ALCO and the Board of Directors. They utilize interest rate sensitivity simulation models as a tool for achieving these objectives and for developing ways in which to improve profitability. The simulation model, prepared on a quarterly basis, uses actual loans, investments and deposit detail as a starting point. If potential changes to capital and net interest income resulting from hypothetical interest changes are not within the limits established by the Board of Directors, management may adjust the asset and liability mix to bring interest rate risk within approved limits.

Bancorp's interest rate risk has changed in 2008 from 2007. The decrease in 2008 in Federal funds sold and increase in loans has caused the Bank's assets to be less sensitive to interest rate changes. The decrease in deposits and increase in purchased funds in 2008 has caused the Bank's liabilities to become slightly more sensitive to interest rate movements. Also refer to "Market Risk Management" in Bank of Marin Bancorp's 2007 Annual Report.

## ITEM 4. CONTROLS AND PROCEDURES

Bancorp maintains a system of disclosure controls and procedures that is designed to provide reasonable assurance that information required to be disclosed is accumulated and communicated to management in a timely manner. Management has reviewed this system of disclosure controls and procedures as of the end of the period covered by this report and believes that the system is operating effectively to ensure appropriate disclosure. No significant changes were made in Bancorp's internal controls over financial reporting during the quarter that have materially affected, or are reasonably likely to materially affect, Bancorp's internal control over financial reporting.

## PART II OTHER INFORMATION

## Item 1 Legal Proceedings

There are no pending, or to management's knowledge, any threatened, material legal proceedings to which Bancorp is a party, or to which any of Bancorp's properties are subject. There are no material legal proceedings to which any director, any nominee for election as a director, any executive officer of Bancorp, or any associate of any such director, nominee or officer is a party adverse to Bancorp.

Bancorp recorded a liability of $\$ 242$ thousand in the fourth quarter of 2007 to cover its potential liability to Visa, Inc. in connection with its proportionate share of certain litigation indemnifications provided to Visa U.S.A. by its member banks prior to Visa U.S.A.'s merger into Visa Inc. In March of 2008, Bancorp reversed this liability because, subsequent to Visa Inc.'s initial public offering on March 19, 2008, it established an escrow account from which it plans to pay any potential settlements.

## Item 1A Risk Factors

Securities Guaranteed by FNMA or FHLMC May Lose Value if the Guarantee is Deemed Less Certain.

The Bank holds securities issued and/or guaranteed by FNMA and FHLMC. If either of these entities comes under further financial stress, or if they experience deterioration in credit worthiness, the fair value of the Bank's securities issued or guaranteed by these entities could be negatively affected.

Other than noted above, there have been no material changes from the risk factors previously disclosed in Bank of Marin Bancorp's 2007 Form 10-K. Refer to "Risk Factors" in Bank of Marin's 2007 Form 10-K, pages 9 through 13. Page - 32

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## BANK OF MARIN BANCORP

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds
In November 2007, Bancorp's Board of Directors approved a plan to repurchase common shares of Bancorp up to $\$ 5$ million. No regulatory approval was required for this repurchase plan as Bancorp was exempted under the provisions of Regulation Y of the Federal Reserve Board. In November and December of 2007, Bancorp repurchased a total of 51,732 shares at an average price of $\$ 29.96$ per share for a total cost of $\$ 1.6$ million. In the first quarter of 2008, Bancorp repurchased a total of 31,602 shares at an average price of $\$ 30.01$ for a total cost of $\$ 948$ thousand, plus commissions.

A schedule of purchases during the quarter ended June 30, 2008 follows.
(Dollars in thousands, except average

|  |  | Total Number <br> of Shares | Approximate <br> dollar Value <br> that May |
| :---: | :---: | :---: | :---: |
|  | Total |  |  |
| Purchases as Part |  |  |  | | Yet be |
| :---: |


| April 1-30, 2008 | --- | --- |  | --- |  | --- |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| May 1-31, 2008 | 11,257 | \$ | 28.87 | 11,257 | \$ | 2,177 |
| June 1-30, 2008 | 15,750 | \$ | 26.93 | 15,750 | \$ | 1,753 |
|  | 27,007 | \$ | 27.74 | 27,007 | \$ | 1,753 |

## Item 3 Defaults Upon Senior Securities

None.
Item 4 Submission of Matters to a Vote of Security Holders
At the Annual Meeting of Stockholders held May 13, 2008, the following matters were submitted to a vote of security holders with the indicated number of votes being cast for, against or withheld, and with the indicated number of abstentions:

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## BANK OF MARIN BANCORP

1.To elect fourteen members of the Board of Directors to hold office until the 2009 annual meeting of stockholders or until their successors are duly elected and qualified.

| Number of Votes |  | For Withheld |
| :--- | ---: | ---: |
|  |  |  |
| Judith O'Connell |  |  |
| Allen | $4,243,199$ | 95,335 |
| Russell A. Colombo | $4,061,304$ | 277,230 |
| James E. Deitz | $4,156,344$ | 182,190 |
| Robert Heller | $4,239,314$ | 99,220 |
| Norma J. Howard | $4,243,744$ | 94,790 |
| J. Patrick Hunt | $4,243,404$ | 95,130 |
| James D. Kirsner | $4,243,499$ | 95,035 |
| Stuart D. Lum | $4,212,842$ | 125,692 |
| Joseph D. Martino | $4,243,929$ | 94,605 |
| William H. |  |  |
| McDevitt, Jr. | $4,215,031$ | 123,503 |
| Joel Sklar, MD | $4,243,860$ | 94,674 |
| Brian M. Sobel | $4,180,537$ | 157,997 |
| J. Dietrich Stroeh | $4,066,808$ | 271,726 |
| Jan I. Yanehiro | $4,111,978$ | 226,556 |

2. To ratify the selection of Moss Adams LLP, independent auditors, to perform audit services for the year 2009.

| For | $4,310,828$ |
| :--- | :--- |
| Against | 21,974 |
| Abstain | 5,732 |

Item 5 Other Information
None.

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## BANK OF MARIN BANCORP

## Item 6 Exhibits

The following exhibits are filed as part of this report or hereby incorporated by reference to filings previously made with the SEC.
3.01 Articles of Incorporation, as amended, incorporated by reference to Exhibit 3.01 to Bancorp's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2007.
3.02Bylaws, as amended, incorporated by reference to Exhibit 3.02 to Bancorp's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2007.
4.01 Rights Agreement dated as of July 2, 2007 is incorporated by reference to Exhibit 4.1 to Registration Statement on Form 8-A12B filed with the Securities and Exchange Commission on July 2, 2007.
10.012007 Employee Stock Purchase Plan is incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 filed with the Securities and Exchange Commission on July 24, 2007.
10.02 1989 Stock Option Plan is incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 filed with the Securities and Exchange Commission on July 24, 2007.
10.031999 Stock Option Plan is incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 filed with the Securities and Exchange Commission on July 24, 2007.
10.042007 Equity Plan is incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 filed with the Securities and Exchange Commission on July 24, 2007.
10.05Form of Change in Control Agreement is incorporated by reference to Exhibit 10.01 to Bancorp's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 30, 2007.
10.06Form of Indemnification Agreement for Directors and Executive Officers dated August 9, 2007 is incorporated by reference to Exhibit 10.06 to Bancorp's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2007.
10.07Retirement Agreement and Release between the Bank and W. Robert Griswold, Jr. dated March 11, 2006 is incorporated by reference to Exhibit 10.07 to Bancorp's Form 10-K for the year ended December 31, 2007.
10.08 Consulting Agreement between the Bank and W. Robert Griswold, Jr. dated March 11, 2006 is incorporated by reference to Exhibit 10.08 to Bancorp's Form 10-K for the year ended December 31, 2007.
14.01 Code of Ethics dated June 20, 2008 is incorporated by reference to Exhibit 14.01 to Bancorp's Current Report on Form 8-K filed with the Securities and Exchange Commission on June 26, 2008.
31.01Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.02Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.01 Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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## BANK OF MARIN BANCORP

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Bank of Marin Bancorp (registrant)

August 4, 2008
Date

August 4, 2008
Date

August 4, 2008
Date
/s/ Russell A. Colombo
Russell A. Colombo
President \&
Chief Executive Officer
/s/ Christina J. Cook
Christina J. Cook
Executive Vice President \&
Chief Financial Officer
/s/ Larry R. Olafson
Larry R. Olafson
Senior Vice President \&
Controller

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BANK OF MARIN BANCORP

## EXHIBIT INDEX

Exhibit
Number Description Location

| 31.01 Certification of Principal Executive Officer pursuant to Rule | Filed herewith. |
| :--- | :--- | :--- |
| 13a-14(a)/15d-14(a) as adopted pursuant to $\S 302$ of the |  |
| Sarbanes-Oxley Act of 2002. |  |

31.02 Certification of Principal Financial Officer pursuant to Rule Filed herewith. 13a-14(a)/15d-14(a) as adopted pursuant to $\S 302$ of the Sarbanes-Oxley Act of 2002.
32.01 Certification pursuant to 18 U.S.C. $\S 1350$ as adopted pursuant to Furnished herewith. $\S 906$ of the Sarbanes-Oxley Act of 2002.

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