Bank of Marin Bancorp
Form 10-Q
May 09, 2011

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

FORM 10-Q
(Mark One)

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

For the quarterly period ended March 31, 2011
OR

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

For the transition period from __________________ to __________________

Commission File Number 001-33572
Bank of Marin Bancorp
(Exact name of Registrant as specified in its charter)

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

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

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

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

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

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

As of April 29, 2011 there were 5,319,610 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

(in thousands, except share data; 2011 unaudited)	March 31, 2011	December 31, 2010
Assets		
Cash and due from banks	$ 109,850	$ 65,724
Short-term investments	19,110	19,508
Cash and cash equivalents	128,960	85,232
Investment securities Held to maturity, at amortized cost	34,866	34,917
Available for sale (at fair market value, amortized cost $107,118and $109,070 at March 31, 2011 and December 31, 2010,respectively)	108,726	111,736
Total investment securities	143,592	146,653
Loans, net of allowance for loan losses of $13,069 and $12,392at March 31, 2011 and December 31, 2010, respectively	965,881	929,008
Bank premises and equipment, net	8,750	8,419
Interest receivable and other assets	43,516	38,838
Total assets	$ 1,290,699	$ 1,208,150
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest bearing	$ 313,599	$ 282,195
Interest bearing		
Transaction accounts	119,331	105,177
Savings accounts	67,711	56,760
Money market accounts	393,867	371,352
CDARS® time accounts	31,670	67,261
Other time accounts	162,182	132,994
Total deposits	1,088,360	1,015,739
Federal Home Loan Bank borrowings	55,000	55,000
Subordinated debenture	5,000	5,000
Interest payable and other liabilities	16,855	10,491
Total liabilities	1,165,215	1,086,230
Stockholders' Equity		
Preferred stock, no par value, $1,000 per share liquidation preference Authorized - 5,000,000 shares none issued	---	---
Common stock, no par value Authorized - 15,000,000 shares Issued and outstanding - 5,307,247 and 5,290,082 at March 31, 2011 and December 31,	55,898	55,383

2010, respectively				
Retained earnings		68,653		64,991
Accumulated other comprehensive income, net		933		1,546
Total stockholders' equity		125,484		121,920
Total liabilities and stockholders' equity	$	1,290,699	$	1,208,150

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

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BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF INCOME
for the three months ended March 31, 2011, December 31, 2010, and March 31, 2010

	Three months ended		
(in thousands, except per share amounts; unaudited)	March 31, 2011	December 31, 2010	March 31, 2010
Interest income			
Interest and fees on loans	$15,900	$14,093	$13,681
Interest on investment securities			
Securities of U.S. Government agencies	733	792	728
Obligations of state and political subdivisions	302	291	286
Corporate debt securities and other	111	141	170
Interest on Federal funds sold and short-term investments	40	47	22
Total interest income	17,086	15,364	14,887
Interest expense			
Interest on interest bearing transaction accounts	38	29	23
Interest on savings accounts	29	25	25
Interest on money market accounts	337	339	797
Interest on CDARS® time accounts	94	179	209
Interest on other time accounts	358	373	354
Interest on borrowed funds	352	360	351
Total interest expense	1,208	1,305	1,759
Net interest income	15,878	14,059	13,128
Provision for loan losses	1,050	1,050	1,550
Net interest income after provision for loan losses	14,828	13,009	11,578
Non-interest income			
Service charges on deposit accounts	443	442	446
Wealth Management and Trust Services	434	394	395
Other income	722	524	508
Total non-interest income	1,599	1,360	1,349
Non-interest expense			
Salaries and related benefits	4,929	4,408	4,606
Occupancy and equipment	907	884	898
Depreciation and amortization	308	311	338
Federal Deposit Insurance Corporation insurance	387	381	362
Data processing	582	494	446
Professional services	733	481	432
Other expense	1,284	1,078	1,140
Total non-interest expense	9,130	8,037	8,222
Income before provision for income taxes	7,297	6,332	4,705
Provision for income taxes	2,788	2,424	1,758
Net income	$4,509	$3,908	$2,947

Net income per common share:			
Basic	$0.85	$0.74	$0.56
Diluted	$0.84	$0.73	$0.56
Weighted average shares used to compute net income per common share:			
Basic	5,283	5,259	5,218
Diluted	5,366	5,342	5,295
Dividends declared per common share	$0.16	$0.16	$0.15

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

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BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
for the year ended December 31, 2010 and the three months ended March 31, 2011

(dollars in thousands; 2011 unaudited)	Preferred Stock	Common Stock Shares	Amount	Retained Earnings	Accumulated Other Comprehensive income Net of Taxes	Total
Balance at December 31, 2009	---	5,229,529	$ 53,789	$ 54,644	$ 618	$ 109,051
Comprehensive income:						
Net income	---	---	---	13,552	---	13,552
Other comprehensive income						
Net change in unrealized gain on available for sale securities (net of tax effect of $672)	---	---	---	---	928	928
Comprehensive income	---	---	---	13,552	928	14,480
Stock options exercised	---	49,940	895	---	---	895
Excess tax benefit - stock-based compensation	---	---	132	---	---	132
Stock issued under employee stock purchase plan	---	563	17	---	---	17
Restricted stock granted	---	6,150	---	---	---	---
Restricted stock forfeited / cancelled	---	(2,320)	---	---	---	---
Stock-based compensation - stock options	---	---	241	---	---	241
Stock-based compensation - restricted stock	---	---	109	---	---	109
Cash dividends paid on common stock	---	---	---	(3,205)	---	(3,205)
Stock issued in payment of director fees	---	6,220	200	---	---	200
Balance at December 31, 2010	---	5,290,082	$ 55,383	$ 64,991	$ 1,546	$ 121,920
Comprehensive income:						
Net income	---	---	---	4,509	---	4,509
Other comprehensive income						
Net change in unrealized gain on available for sale securities (net of tax effect of $445)	---	---	---	---	(613)	(613)
Comprehensive income	---	---	---	4,509	(613)	3,896
Stock options exercised	---	14,205	265	---	---	265
Excess tax benefit - stock-based compensation	---	---	51	---	---	51

Stock issued under employee stock purchase plan	---	160	6	---	---	6
Stock-based compensation - stock options	---	---	65	---	---	65
Stock-based compensation - restricted stock	---	---	28	---	---	28
Cash dividends paid on common stock	---	---	---	(847)	---	(847)
Stock issued in payment of director fees	---	2,800	100	---	---	100
Balance at March 31, 2011	---	5,307,247	$ 55,898	$ 68,653	$ 933	$ 125,484

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

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BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
for the three months ended March 31, 2011 and 2010

(in thousands, unaudited)	March 31, 2011	March 31, 2010
Cash Flows from Operating Activities:		
Net income	$4,509	$2,947
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,050	1,550
Compensation expense--common stock for director fees	55	50
Stock-based compensation expense	93	91
Excess tax benefits from exercised stock options	(38)	(35)
Amortization of investment security premiums net of accretion of discounts	343	299
Accretion of discount on acquired loans	(1,324)	---
Depreciation and amortization	308	338
Bargain purchase gain on acquisition	(85)	---
Loss on sale of repossessed assets	---	17
Net change in operating assets and liabilities:		
Interest receivable	(420)	125
Interest payable	61	40
Deferred rent and other rent-related expenses	107	57
Other assets	972	573
Other liabilities	951	186
Total adjustments	2,073	3,291
Net cash provided by operating activities	6,582	6,238
Cash Flows from Investing Activities:		
Proceeds from sale of furniture and equipment	18	---
Purchase of securities available-for-sale	(6,428)	(6,762)
Proceeds from paydowns maturity of securities available-for-sale	13,307	8,817
Loans originated and principal collected, net	24,827	(3,930)
Purchase of bank owned life insurance policies	(2,500)	---
Purchase of premises and equipment	(622)	(233)
Proceeds from sale of repossessed assets	---	77
Cash receipt from acquisition	44,042	---
Net cash provided by (used in) investing activities	72,644	(2,031)
Cash Flows from Financing Activities:		
Net (decrease) increase in deposits	(21,460)	43,237
Proceeds from stock options exercised	265	83
Repayment of Federal Home Loan Bank borrowings	(13,500)	---
Cash dividends paid on common stock	(847)	(785)
Stock issued under employee stock purchase plan	6	6
Excess tax benefits from exercised stock options	38	35
Net cash (used in) provided by financing activities	(35,498)	42,576
Net increase in cash and cash equivalents	43,728	46,783
Cash and cash equivalents at beginning of period	85,232	38,660
Cash and cash equivalents at end of period	$128,960	$85,443

Supplemental disclosure of non-cash investing and financing activities:		
Purchase of available-for-sale security on account and unsettled	$5,218	---
Loans transferred to repossessed assets	---	$23
Stock issued in payment of director fees	$100	$100
Acquisition:		
Fair value of assets acquired	$107,763	---
Fair value of liabilities assumed	$107,678	---

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Introductory Explanation

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

Note 1: Basis of Presentation

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

Certain information and footnote disclosures presented in the annual consolidated financial statements are not included in the interim consolidated financial statements. Accordingly, the accompanying unaudited interim consolidated financial statements should be read in conjunction with our 2010 Annual Report on Form 10-K. The results of operations for the three months ended March 31, 2011 are not necessarily indicative of the operating results for the full year.

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

	Three months ended		
(in thousands, except per share data; unaudited)	March 31, 2011	December 31, 2010	March 31, 2010
Weighted average basic shares outstanding	5,283	5,259	5,218
Add: Potential common shares related to stock options	42	47	49
Potential common shares related to non-vested restricted stock	5	4	5
Potential common shares related to warrant	36	32	23
Weighted average diluted shares outstanding	5,366	5,342	5,295

Net income available to common stockholders	$	4,509	$	3,908	$	2,947
Basic EPS	$	0.85	$	0.74	$	0.56
Diluted EPS	$	0.84	$	0.73	$	0.56
Weighted average anti-dilutive shares not included in the calculation of diluted EPS Stock options		64		98		188
Non-vested restricted stock		---		---		---
Total anti-dilutive shares		64		98		188

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Note 2: Recently Issued Accounting Standards

In April 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. The ASU clarifies which loan modifications constitute troubled debt restructurings. It is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring ("TDR"), both for purposes of recording an impairment loss and for disclosure of a TDR. In evaluating whether a restructuring constitutes a TDR, a creditor must separately conclude that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. The amendments to ASU Topic 310, Receivables, clarify the guidance on a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. ASU No. 2011-02 is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption.

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

In December 2010, the FASB also issued ASU No. 2010-28, Intangibles—Goodwill and Other (Topic 350), When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts. The amendments in this ASU affect all entities that have recognized goodwill and have one or more reporting units whose carrying amount for purposes of performing Step 1 of the goodwill impairment test is zero or negative. The amendments in this ASU modify Step 1 so that for those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. The qualitative factors are consistent with existing guidance, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The above two ASUs did not have a significant impact on our financial condition or results of operations.

In July 2010, the FASB issued ASU No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The ASU amends FASB Accounting Standards Codification™ (the "Codification" or "ASC") Topic 310, Receivables, to improve the disclosures about the credit quality of an entity's financing receivables and the related allowance for credit losses. As a result of these amendments, an entity is required to disaggregate, by portfolio segment or class of financing receivable, certain existing disclosures and provide certain new disclosures about its financing receivables and related allowance for credit losses.

Existing disclosures are amended to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis:

(1) A rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method;

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(2) For each disaggregated ending balance in item (1) above, the related recorded investment in financing receivables;

(3) The nonaccrual status of financing receivables by class of financing receivables;

(4) Impaired financing receivables by class of financing receivables.

The amendments in the ASU also require an entity to provide the following additional disclosures about its financing receivables:

(1) Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables;

(2) The aging of past due financing receivables at the end of the reporting period by class of financing receivables;

(3) A description of the entity's accounting policies and methodology used to estimate the allowance for credit losses by portfolio segments;

(4) The nature and extent of TDR that occurred during the period by class of financing receivables and their effect on the allowance for credit losses, as well as the nature and extent of financing receivables modified as TDR within the previous twelve months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses; and

(5) Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segments.

The disclosures as of the end of a reporting period were effective for interim and annual reporting periods ended December 31, 2010, which we have provided in Note 3 and Note 4. The disclosures about activity that occurs during a reporting period is effective for interim and annual reporting periods began January 1, 2011. As this ASU is disclosure-related only, it did not have an impact on our financial condition or results of operations.

In April 2010, the FASB issued ASU No. 2010-18, Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset. This ASU codifies the consensus reached in Emerging Issues Task Force ("EITF") Issue No. 09-I, Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset. The amendments to the Codification provide that modifications of loans that are accounted for within a pool under Subtopic 310-30 do not result in the removal of those loans from the pool even if the modification of those loans would otherwise be considered a troubled debt restructuring. An entity will continue to be required to consider whether the pool of assets in which the loan is included is impaired if expected cash flows for the pool change. ASU 2010-18 does not affect the accounting for loans under the scope of Subtopic 310-30 that are not accounted for within pools. Loans accounted for individually under Subtopic 310-30 continue to be subject to the TDR accounting provisions within Subtopic 310-40.

ASU 2010-18 was effective prospectively for modifications of loans accounted for within pools under Subtopic 310-30 occurring in the first interim or annual period ended on or after July 15, 2010. Upon initial adoption of ASU 2010-18, an entity may make a one-time election to terminate accounting for loans as a pool under Subtopic 310-30. This election may be applied on a pool-by-pool basis and does not preclude an entity from applying pool accounting to subsequent acquisitions of loans with credit deterioration. This ASU did not have any impact on our financial condition or results of operations, as we do not have loans that are accounted for on a pool basis.

Note 3: Acquisition

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

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

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

In FDIC-assisted transactions, only certain assets and liabilities are transferred to the acquirer and, depending on the nature and amount of the acquirer's bid, the FDIC may be required to make a cash payment to the acquirer or the acquirer may be required to make payment to the FDIC. We received cash totaling $32.6 million from the FDIC upon initial settlement of the transaction and recorded a receivable from the FDIC of $196 thousand (included in other assets on the consolidated statements of condition), for consideration of the net liabilities assumed (i.e., the net difference between the liabilities assumed and the assets acquired). This amount is receivable within one year of the acquisition date and is outstanding at March 31, 2011.

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

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

The bargain purchase gain represents the excess of the estimated fair value of the assets acquired over the estimated fair value of the liabilities assumed. We did not immediately acquire the banking facilities, including outstanding lease agreements, furniture, fixtures, and equipment, as part of the P&A Agreement. However, we have the option within ninety days after the acquisition date to purchase these assets and assume leases from the FDIC based on current appraisals. We have engaged an appraiser to value these fixed assets and to help evaluate which banking facilities and equipment we may lease or purchase. These facilities and assets are currently leased from the FDIC on a month-to-month basis. We have since decided to consolidate our Napa offices by closing the smaller St. Helena branch acquired from Charter Oak Bank effective April 29, 2011.

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

(Dollars in thousands, unaudited)	Acquisition Date (February 18, 2011)
Assets:	
Cash and due from banks	$ 34,144
Interest bearing deposits in banks	5,663
Federal funds sold	4,235
Total cash and cash equivalents	44,042
Loans	61,765
Core deposit intangible	725
Other assets (including the receivable from the FDIC)	1,231
Total assets acquired	107,763
Liabilities:	
Deposits:	
Noninterest bearing	27,874
Interest bearing	65,987
Total deposits	93,861
Advances from the Federal Home Loan Bank	13,502
Deferred tax liabilities	62
Other liabilities	253
Total liabilities assumed	107,678
Bargain purchase gain, net of tax (included in other non-interest income)	$ 85

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

Loans

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

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

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

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

For single family residential loans, a prepayment rate of twenty percent CPR was used, based on current research associated with these loan types;
For home equity lines of credit, a CPR of fifteen percent was assumed based on the refinance likelihood and other research; and,
For other consumer loans, a CPR of one and a half percent was used based on current capital markets research data for consumer unsecured credit.

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

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

Deposits

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

Advances from the Federal Home Loan Bank

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

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Pro Forma Results of Operations

The contribution of the acquired operations of the former Charter Oak Bank to our results of operations for the period February 18 to March 31, 2011 is as follows: interest income of $1.9 million, interest expense of $32 thousand, noninterest income of $187 thousand, noninterest expense of $694 thousand and income before income taxes of $1.3 million. These amounts include the bargain purchase gain, acquisition-related costs, accretion of the discount on the acquired loans, and amortization of the fair value mark on time deposits and the core deposit intangible amortization. Charter Oak Bank's results of operations prior to the acquisition date are not included in our operating results for 2011.

Charter Oak Bank's revenue(interest income and noninterest income) and earnings included in our consolidated statement of income for the three months ended March 31, 2011, and the revenue and earnings of the combined entity had the acquisition date been January 1, 2010, are as follows:

Pro Forma Revenue and Earnings	Charter Oak Bank Only		Combined	
(in thousands; unaudited)	Revenue	Earnings	Revenue	Earnings
Actual from February 18, 2011 to March 31, 2011	$2,045	$815	N/A	N/A
2011 pro forma from January 1, 2011 to March 31, 2011	2,753	948	$19,393	$4,642
2011 supplemental pro forma from January 1, 2011 to March 31, 20111	2,606	1,071	19,246	4,765
2010 supplemental pro forma from January 1, 2010 to March 31, 20101	3,128	1,118	19,364	4,065

1 2011 supplemental pro forma earnings were adjusted to exclude $348 of acquisition-related costs incurred in 2011 and $147 of nonrecurring pre-tax bargain purchase gain related to the fair value adjustment to acquisition-date assets and liabilities. 2010 supplemental pro forma earnings were adjusted to include these nonrecurring items.

Acquisition-related expenses are recognized as incurred and continue until all systems have been converted and operational functions become fully integrated. We incurred third-party acquisition-related expenses in the following line items in the consolidated statement of income for the three month period ended March 31, 2011 as follows:

Acquisiton-related Expenses (in thousands)	Three months ended March 31, 2011
Professional services	$ 304
Data processing	30
Other	14
Total	$ 348

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Note 4: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

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

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

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

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

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

(in thousands) Description of Financial Instruments	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Balance at March 31, 2011 (unaudited):				
Securities available for sale:				
Mortgage-backed securities and collaterized mortgage obligations issued by U.S. government agencies	$91,045	$---	$ 91,045	$ ---
Debentures of government sponsored agencies	$2,991	$---	$ 2,991	$ ---
Corporate collateralized mortgage obligations	$14,690	$---	$ 14,690	$ ---
Derivative financial liabilities (interest rate contracts)	$2,116	$---	$ 2,116	$ ---
Balance at December 31, 2010:				
Securities available for sale:				
Mortgage-backed securities and collaterized mortgage obligations issued by U.S. government agencies	$95,258	$---	$ 95,258	$ ---
Corporate collateralized mortgage obligations	$15,870	$---	$ 15,870	$ ---
Equity securities	$608	$608	$ ---	$ ---
Derivative financial liabilities (interest rate contracts)	$2,470	$---	$ 2,470	$ ---

Securities available for sale are recorded at fair value on a recurring basis. When available, quoted market prices (Level 1) are used to determine the fair value of securities available for sale. If quoted market prices are not available, we obtain pricing information from a reputable third-party service provider, who may utilize valuation techniques that use current market-based or independently sourced parameters, such as bid/ask prices, dealer-quoted prices, interest rates, benchmark yield curves, prepayment speeds, and credit spreads (Level 2). Level 1 securities include those traded on active markets, including U.S. Treasury securities and equity securities. Level 2 securities include U.S. agencies' debt securities, mortgage-backed securities, and corporate collateralized mortgage obligations.

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

Certain financial assets may be measured at fair value on a non-recurring basis. These assets are subject to fair value adjustments that result from the application of the lower of cost or fair value accounting or write-downs of individual assets. For example, when a loan is identified as impaired, it is reported at the lower of cost or fair value, measured based on the loan's observable market price (Level 1), the present value of expected future cash flows discounted at a market-based interest rate for similar loans (Level 2), or the current appraised value of the underlying collateral securing the loan if the loan is collateral dependent (Level 3). Securities held to maturity may be written down to fair value (determined using the same techniques discussed above for securities available for sale) as a result of an other-than-temporary impairment, if any.

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

(in thousands) Description of Financial Instruments	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) (a)	Losses for the three months ended March 31, 2011 (b)	Losses for the three months ended March 31, 2010 (b)
At March 31, 2011 (unaudited):						
Impaired loans carried at fair value (c)	$ 4,785	$ ---	$ ---	$ 4,785	$1,213	$ 1,643
					Losses for the year ended December 31, 2010 (b)	
At December 31, 2010:						
Impaired loans carried at fair value	$ 8,635	$ --	$ --	$ 8,635	$ 4,610	

(a) Represents collateral-dependent loan principal balances that had been generally written down to the appraised value or estimated market value of the underlying collateral, net of specific valuation allowance of $1.2 million and

$936 thousand at March 31, 2011 and December 31, 2010, respectively. The carrying value of loans fully charged-off, which includes unsecured lines of credit, overdrafts and all other loans, is zero.
(b) Represents net charge-offs during the period presented and the specific valuation allowance established on loans during the period.
(c) Represents the portion of impaired loans that have been written down to their estimated fair value.

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Disclosures about Fair Value of Financial Instruments

The table below is a summary of fair value estimates for financial instruments as of March 31, 2011 and December 31, 2010, excluding financial instruments recorded at fair value on a recurring basis (summarized in a separate table). The carrying amounts in the following table are recorded in the statements of condition under the indicated captions. We have ecluded non-financia assets and non-financial liabilities defined by the Codification (ASC 820-10-15-1A), such as Bank premises and equipment, deferred taxes and other liabilities. In addition, we have not disclosed the fair value of financial instruments specifically excluded from disclosure requirements of the Financial Instruments Topic of the Codification (ASC 825-10-50-8), such as Bank-owned life insurance policies.

	March 31, 2011		December 31, 2010	
(in thousands; 2011 amounts unaudited)	Carrying Amounts	Fair Value	Carrying Amounts	Fair Value
Financial assets				
Cash and cash equivalents	$128,960	$128,960	$85,232	$85,232
Investment securities held to maturity	34,866	35,517	34,917	35,090
Loans, net	965,881	984,954	929,008	952,763
Interest receivable	4,627	4,627	4,207	4,207
Financial liabilities				
Deposits	1,088,360	1,088,952	1,015,739	1,016,401
Federal Home Loan Bank long-term borrowings	55,000	56,766	55,000	57,090
Subordinated debenture	5,000	5,066	5,000	4,994
Interest payable	475	475	414	414

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

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

Held-to-maturity Securities - Held-to-maturity securities, which generally consist of obligations of state & political subdivisions, are recorded at their amortized cost. Their fair value for disclosure purposes is determined using methodologies similar to those described above for available-for-sale securities using Level 2 inputs. If Level 2 inputs are not available, we may utilize pricing models that incorporate unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities (Level 3). As of March 31, 2011, we did not hold any securities whose fair value was measured using significant unobservable inputs.

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

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

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

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

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

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

Note 5: Investment Securities

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

	March 31, 2011				December 31, 2010			
(in thousands; March 31, 2011 unaudited)	Amortized Cost	Fair Value	Gross Unrealized Gains	(Losses)	Amortized Cost	Fair Value	Gross Unrealized Gains	(Losses)
Held-to-maturity								
Obligations of state and political subdivisions	$ 34,866	$ 35,517	$ 943	$ (292)	$ 34,917	$ 35,090	$ 666	$ (493)
Available-for-sale								
Securities of U. S. government agencies:								
MBS pass-through securities issued by FNMA and FHLMC	20,652	20,926	386	(112)	16,119	16,424	419	(114)
CMOs issued by FNMA	12,239	12,683	444	---	12,770	13,236	466	---
CMOs issued by FHLMC	13,802	14,163	361	---	19,725	20,177	452	---
CMOs issued by GNMA	42,757	43,273	584	(68)	44,607	45,421	884	(70)
Debentures of government sponsored agencies	3,000	2,991	---	(9)	---	---	---	---
Corporate CMOs	14,668	14,690	161	(139)	15,849	15,870	185	(164)
Equity security	---	---	---	---	---	608	608	---
Total available for sale	107,118	108,726	1,936	(328)	109,070	111,736	3,014	(348)
Total investment securities	$ 141,984	$ 144,243	$ 2,879	$ (620)	$ 143,987	$ 146,826	$ 3,680	$ (841)

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock at a zero cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s covered litigation escrow account. The conversion rate will be determined upon the final resolution of the Visa Inc. covered litigation described in Note 13 to the Consolidated Financial Statements in our 2010 Form 10-K. The stock was re-classified from available-for-sale securities to cost-basis accounting in March 2011 as the stock is still currently restricted from resale based on new information received from Visa Inc. Hence, the unrealized gain on the stock, net of tax, at December 31, 2010 was reversed from other comprehensive income. The fair value of the Class B common stock we own was $609 thousand and $608 thousand at March 31, 2011 and December 31, 2010, respectively, based on the Class A as-converted rate of 0.4881 and 0.5102, respectively.

The amortized cost and fair value of investment securities by contractual maturity at March 31, 2011 are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

	March 31, 2011			
	Held to Maturity		Available for Sale	
(in thousands; unaudited)	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	$ 1,475	$ 1,485	$ ---	$ ---
After one but within five years	5,998	6,150	4,117	4,108
After five years through ten years	20,439	20,957	16,403	16,776
After ten years	6,954	6,925	86,598	87,842
Total	$ 34,866	$ 35,517	$ 107,118	$ 108,726

At March 31, 2011, investment securities carried at $38.6 million were pledged with the State of California: $37.9 million to secure public deposits in compliance with the Local Agency Security Program and $665 thousand to provide collateral for trust deposits. In addition, at March 31, 2011, investment securities carried at $1.4 million were pledged to collateralize an internal Wealth Management Services checking account and $3.3 million were pledged to collateralize interest rate swaps as discussed in Note 11.

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Other-Than-Temporarily Impaired Debt Securities

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

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

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

March 31, 2011	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
(In thousands; unaudited)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity						
Obligations of state & political subdivisions	$5,868	$(60)	$1,698	$(232)	$7,566	$(292)
Available-for-sale						
Securities of U.S. government agencies	15,662	(189)	---	---	15,662	(189)
Corporate CMOs	8,018	(139)	---	---	8,018	(139)
Total available for sale	23,680	(328)	---	---	23,680	(328)
Total temporarily impaired securities	$29,548	$(388)	$1,698	$(232)	$31,246	$(620)

December 31, 2010	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
(In thousands)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity						
Obligations of state & political subdivisions	$11,622	$(250)	$1,687	$(243)	$13,309	$(493)
Available-for-sale						
	12,888	(184)	---	---	12,888	(184)

Securities of U.S. government agencies						
Corporate CMOs	7,070	(164)	---	---	7,070	(164)
Total available for sale	19,958	(348)	---	---	19,958	(348)
Total temporarily impaired securities	$31,580	$(598)	$1,687	$(243)	$33,267	$(841)

The unrealized losses associated with debt securities of U.S. government agencies are primarily driven by changes in interest rates and not due to the credit quality of the securities. Further, securities backed by GNMA, FNMA, or FHLMC have the guarantee of the full faith and credit of the U.S. Federal Government. Obligations of U.S. states and political subdivisions in our portfolio are all investment grade without delinquency history. The security in a loss position for more than twelve continuous months relates to one debenture issued by a local subdivision with payments collected through property tax assessments in an affluent community. This security will continue to be monitored as part of our ongoing impairment analysis, but is expected to perform. As a result, we concluded that this security was not other-than-temporarily impaired at March 31, 2011.

The unrealized losses associated with corporate CMO's are primarily related to securities backed by residential mortgages. All of these securities were AAA rated by at least one major rating agency. We estimate loss projections for each security by assessing loans collateralizing the security and determining expected default rates and loss severities. Based upon our assessment of expected credit losses of each security given the performance of the underlying collateral and credit enhancements where applicable, we concluded that these securities were not other-than-temporarily impaired at March 31, 2011.

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Securities Carried at Cost

As a member of the FHLB, we are required to maintain a minimum investment in the FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can also increase in the event we need to increase our borrowing capacity with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at its $100 per share par value. We held $5.5 million and $5.0 million of FHLB stock recorded at cost in other assets at March 31, 2011 and December 31, 2010, respectively. On April 28, 2011, FHLB declared a cash dividend for the first quarter of 2011 at an annualized dividend rate of 0.31%. Management expects to be able to redeem this stock at cost, and therefore does not believe the FHLB stock to be other-than-temporarily impaired.

Note 6: Loans and Allowance for Loan Losses

Credit Quality of Loans

Outstanding loans by class and payment aging, excluding credit-impaired loans purchased from the Acquisition accounted for under ASC 310-30 ("PCI" loans) of $9.2 million as of March 31, 2011, are as follows:

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

(Dollars in thousands; March 31, 2011 unaudited)	Commercial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential 1	Installment and other consumer	Total
March 31, 2011								
30-59 days past due	$ 2,829	$ -	$ -	$ 3,615	$ -	$ -	$ 382	$ 6,826
60-89 days past due	266	-	-	14,710	-	-	65	15,041
Greater than 90 days past due (accruing)	100	-	-	-	-	-	-	100
Greater than 90 days past due (non-accrual)	3,337	632	-	4,145	323	141	426	9,004
Total past due	6,532	632	-	22,470	323	141	873	30,971
Current	155,362	160,775	378,837	53,574	95,125	67,666	27,448	938,787
Total loans 3	$ 161,894	$ 161,407	$ 378,837	$ 76,044	$ 95,448	$ 67,807	$ 28,321	$ 969,758
Non-accrual loans to total loans	2.1 %	0.4 %	-	5.5 %	0.3 %	0.2 %	1.5 %	0.9 %
Troubled debt restructured loans 4								
Accruing	$ -	$ -	$ -	$ -	$ 258	$ 238	$ 1,142	$ 1,638
Non-accrual	-	-	-	-	-	-	54	54
	$ -	$ -	$ -	$ -	$ 258	$ 238	$ 1,196	$ 1,692

Total troubled debt restructured loans								
December 31, 2010								
30-59 days past due	$ 20	$ -	$ -	$ -	$ 25	$ -	$ 307	$ 352
60-89 days past due	-	-	-	-	-	-	-	-
Greater than 90 days past due (non-accrual) 2	2,486	632	-	9,297	-	148	362	12,925
Total past due	2,506	632	-	9,297	25	148	669	13,277
Current	151,330	141,958	383,553	68,322	86,907	69,843	26,210	928,123
Total loans 3	$ 153,836	$ 142,590	$ 383,553	$ 77,619	$ 86,932	$ 69,991	$ 26,879	$ 941,400
Non-accrual loans to total loans	1.6 %	0.4 %	-	12.0 %	-	0.2 %	1.3 %	1.4 %
Troubled debt restructured loans 3								
Accruing	$ -	$ -	$ -	$ -	$ 259	$ -	$ 925	$ 1,184
Non-accrual	-	-	-	-	-	-	55	55
Total troubled debt restructured loans	$ -	$ -	$ -	$ -	$ 259	$ -	$ 980	$ 1,239

1 Our residential loan portfolio includes no sub-prime loans, nor is it our normal practice to underwrite loans commonly referred to as "Alt-A mortgages", the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or higher loan-to-value ratios.

2 There were no accruing loans past due more than 90 days at December 31, 2010.

3 Amounts were net of deferred loan fees of $2.3 million and $2.8 million at March 31, 2011 and December 31, 2010, respectively,

4 Defined as loans whose contractual terms have been restructured in a manner which grants a concession to a borrower experiencing financial difficulties. These balances are included in the impaired loan totals in the table below.

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

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Repayment of commercial real estate loans is largely dependent on the successful operation of the property securing the loan, or the business conducted on the property securing the loan. Underwriting for these loans must meet a minimum debt coverage ratio of 1.20:1.00, and we also require a conservative loan-to-value of 65% or less. Furthermore, substantially all of our loans are guaranteed by the owners of the properties. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. In the event of a vacancy, strong guarantors have historically carried the loans until a replacement tenant can be found. The owner’s substantial equity investment provides a strong economic incentive to continue to support the commercial real estate projects. As such, we experience nominal delinquencies in this portfolio.

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

Consumer loans primarily consist of home equity lines of credit and loans, other residential (tenancy-in-common, or “TIC”) loans and other personal loans. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by Management on a regular basis. Underwriting standards for home equity loans include, but are not limited to, a maximum loan-to-value percentage of 75% of loans that are $1,250,000 or less (and even more conservatively for homes with values in excess of this amount), collection remedies, the number of such loans a borrower can have at one time and documentation requirements. Our underwriting of the other residential loans, mostly secured by TIC units in San Francisco, has been cautious compared to traditional residential mortgages due to the interest-only feature of these loans. However, these borrowers tend to have a larger equity in this category, which mitigates risk. Personal loans are nearly evenly split between mobile home loans and floating home loans along with a small number of direct auto loans and installment loans. Personal unsecured loans are offered to consumers with additional underwriting procedures in place, including net worth, and borrowers’ verified liquid assets analysis. In general, personal loans usually have a higher degree of risk than other types of loans.

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

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

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

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

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

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

- Generally, commercial borrowers with lines of credit are required to submit financial information with reporting intervals ranging from monthly to annually depending on credit size, risk and complexity.
- Investor commercial real estate borrowers with loans greater than $2.5 million are required to submit rent rolls or property income statements at least annually. It has been our practice to obtain rent rolls or property income statements for loans $750 thousand or greater for the last two years.
- Construction loans are monitored monthly, and assessed on an ongoing basis.
- Home equity and other consumer loans are assessed based on delinquency.
- Loans graded “Watch” or more severe, regardless of loan type, are assessed no less than quarterly.

The following table represents our analysis of loans by internally assigned grades as of March 31, 2011, including the PCI loans, and December 31, 2010:

Credit Quality Indicators As of March 31, 2011 and December 31, 2010

(Dollars in thousands; March 31, 2011 unaudited)	Commercial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Purchased credit-impaired	Total
Credit Risk Profile by Internally Assigned Grade:									
March 31, 2011									
Pass	$ 133,036	$ 153,602	$ 365,950	$ 48,354	$93,009	$ 62,164	$ 27,761	$ 440	$884,316
Special mention	8,945	1,127	1,032	9,962	499	238	-	816	22,619
Substandard	19,554	6,678	11,855	17,728	1,940	5,320	336	7,577	70,988
Doubtful	359	-	-	-	-	85	224	359	1,027

Total loans	$ 161,894	$ 161,407	$ 378,837	$ 76,044	$ 95,448	$ 67,807	$ 28,321	$ 9,192	$ 978,950
December 31, 2010									
Pass	$ 120,428	$ 135,443	$ 369,975	$ 57,779	$ 84,830	$ 64,570	$ 26,280	$ -	$ 859,305
Special mention	17,009	454	330	10,253	447	-	-	-	28,493
Substandard	16,169	6,693	13,248	9,587	1,655	5,421	427	-	53,200
Doubtful	230	-	-	-	-	-	172	-	402
Total loans	$ 153,836	$ 142,590	$ 383,553	$ 77,619	$ 86,932	$ 69,991	$ 26,879	$ -	$ 941,400

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

The table below summarizes information on impaired loans and their related ALLL. The information below excludes PCI loans purchased in the Acquisition, since based on current information and events, it is probable that we will be able to collect all cash flows expected at acquisition.

(Dollars in thousands; March 31, 2011 unaudited) March 31, 2011	Commercial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 1,028	$ 429	$ ---	$ 815	$ 25	$ ---	$ 70	$ 2,367
With a specific allowance recorded	2,309	203	$ ---	3,330	556	380	1,498	8,276
Total recorded investment in impaired loans	$ 3,337	$ 632	$ ---	$ 4,145	$ 581	$ 380	$ 1,568	$ 10,643
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	$ 1,028	$ 429	$ ---	$ 815	$ 25	$ ---	$ 112	$ 2,409
With a specific allowance recorded	3,487	259	---	5,843	966	380	1,498	12,433
Total recorded investment in impaired loans	$ 4,515	$ 688	$ ---	$ 6,658	$ 991	$ 380	$ 1,610	$ 14,842
Specific allowance	$ 782	$ 9	$ ---	$ 429	$ 233	$ 104	$ 362	$ 1,919
Average recorded investment in impaired loans during the quarter ended March 31, 2011	2,486	632	---	7,294	314	143	1,763	12,632
Interest income recognized on	13	---	---	---	---	---	---	13

impaired loans during the quarter ended March 31, 2011								
December 31, 2010								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 959	$ 633	$ ---	$ 8,742	$ ---	$ ---	$ 73	$ 10,407
With a specific allowance recorded	1,526	---	$ ---	555	259	148	1,214	3,702
Total recorded investment in impaired loans	$ 2,485	$ 633	$ ---	$ 9,297	$ 259	$ 148	$ 1,287	$ 14,109
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	$ 959	$ 689	$ ---	$ 11,485	$ ---	$ ---	$ 115	$ 13,248
With a specific allowance recorded	2,570	---	---	555	259	148	1,214	4,746
Total recorded investment in impaired loans	$ 3,529	$ 689	$ ---	$ 12,040	$ 259	$ 148	$ 1,329	$ 17,994
Specific allowance	$ 667	$ ---	$ ---	$ 3	$ 25	$ 93	$ 290	$ 1,078
Average recorded investment in impaired loans during the year	1,326	3,086	---	6,326	191	39	1,212	12,180
Interest income recognized on impaired loans during the year ended December 31, 2011	85	22	---	336	8	5	66	522

The gross interest income that would have been recorded had non-accrual loans been current totaled $220 thousand, $24 thousand and $236 thousand in the quarters ended March 31, 2011, December 31, 2010, and March 31, 2010, respectively. We recognized interest income of $13 thousand, $400 thousand and $1 thousand on these non-accrual loans for cash payments received during the quarters ended March 31, 2011, December 31, 2010 and March 31, 2010, respectively. PCI loans are excluded from the data above. See page 25, "PCI Loans" for further discussion.

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Management monitors delinquent loans continuously and identifies problem loans, generally loans graded substandard or worse, to be evaluated individually for impairment testing. Generally, we charge off our estimated losses related to specifically-identified impaired loans when it is deemed uncollectible. The charged-off portion of impaired loans outstanding at March 31, 2011 totaled approximately $3.8 million. At March 31, 2011, there were no significant commitments to extend credit on impaired loans, including loans to borrowers whose terms have been modified in troubled debt restructurings.

All acquired loans were recorded at fair value at acquisition date, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, ALLL is not carried over from Charter Oak Bank or recorded as of the acquisition date. As there was no significant change in the credit quality or expected cash flows of the acquired loan portfolio from the Acquisition date through the quarter end, Management has not provided significant reserves for loan losses on the acquired loans in the first quarter of 2011. If it is estimated that cash flows expected to be collected have decreased subsequent to the acquisition date, an ALLL is established on the acquired loan portfolio.

The following table discloses loans by major portfolio category and the related ALLL disaggregated by impairment evaluation method as of March 31, 2011 and December 31, 2010, as well as activity in the ALLL for the three months ended March 31, 2011:

Allowance for Loan Losses and Recorded Investment in Loans

(Dollars in thousands; 2011 unaudited)	Commercial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
For the three months ended March 31, 2011:									
Allowance for loan losses:									
Beginning balance	$3,114	$1,037	$4,134	$1,694	$643	$738	$835	$197	$12,392
Provision (reversal)	221	(4)	(108)	542	210	(14)	154	49	1,050
Charge-offs	(292)	-	-	(23)	-	-	(74)	-	(389)
Recoveries	10	-	-	-	-	-	6	-	16
Ending balance	$3,053	$1,033	$4,026	$2,213	$853	$724	$921	$246	$13,069
As of March 31, 2011:									
Ending ALLL related to loans collectively evaluated for impairment	$2,271	$1,024	$4,026	$1,784	$620	$620	$559	$246	$11,150

Ending ALLL related to loans individually evaluated for impairment	$782	$9	$-	$429	$233	$104	$362	$-	$1,919
Ending ALLL related to purchased credit-impaired loans	$-	$-	$-	$-	$-	$-	$-	$-	$-
Loans outstanding:									
Collectively evaluated for impairment	$158,557	$160,775	$378,837	$71,899	$94,867	$67,427	$26,753	$-	$959,115
Individually evaluated for impairment	3,337	632	-	4,145	581	380	1,568	-	10,643
Purchased credit-impaired	3,428	4,501	1,263	-	-	-	-	-	9,192
Total	$165,322	$165,908	$380,100	$76,044	$95,448	$67,807	$28,321	$-	$978,950
Ratio of allowance for loan losses to total loans	1.85 %	0.62 %	1.06 %	2.91 %	0.89 %	1.07 %	3.25 %	-	1.34 %
Allowance for loan losses to non-accrual loans	91 %	163 %	NA	53 %	147 %	191 %	59 %	-	123 %
As of December 31, 2010:									
Ending ALLL related to loans collectively evaluated for impairment	$2,447	$1,037	$4,134	$1,691	$618	$645	$545	$197	$11,314
Ending ALLL related to loans individually evaluated for impairment	$667	$-	$-	$3	$25	$93	$290	$-	$1,078

Loans outstanding:																	
Collectively evaluated for impairment	$151,351		$141,957		$383,553		$68,322		$86,673		$69,843		$25,592		$-	$927,291	
Individually evaluated for impairment	2,485		633		-		9,297		259		148		1,287		-	14,109	
Total	$153,836		$142,590		$383,553		$77,619		$86,932		$69,991		$26,879		$-	$941,400	
Ratio of allowance for loan losses to total loans at end of year	2.02	%	0.73	%	1.08	%	2.18	%	0.74	%	1.05	%	3.11	%	-	1.32	%
Allowance for loan losses to non-accrual loans at year end	125	%	164	%	NA		18	%	NA		499	%	231	%	-	96	%

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Activity in the allowance for loan losses for the three months ended March 31, 2010 follows:

(Dollars in thousands; unaudited)	Three months ended March 31, 2010
Allowance for loan losses:	
Beginning balance	$ 10,618
Provision	1,550
Charge-offs	(1,547)
Recoveries	27
Ending balance	$ 10,648
Total loans outstanding at March 31, 2010, before deducting allowance for loan losses	$ 920,356
Ratio of allowance for loan losses to total loans at March 31, 2010	1.16 %
Allowance for loan losses to non-accrual loans at March 31, 2010	93.29 %
Non-accrual loans to total loans at March 31, 2010	1.24 %
Average recorded investment in impaired loans	$ 12,356

Purchased Credit-Impaired Loans

During the first quarter of 2011, we evaluated loans purchased in the Acquisition in accordance with accounting guidance in ASC 310-30 related to loans acquired with deteriorated credit quality. Acquired loans are considered credit-impaired if there is evidence of deterioration of credit quality since origination and it is probable, at the acquisition date, that we will be unable to collect all contractually required payments receivable. Management has determined certain loans purchased in the Acquisition to be PCI loans based on credit indicators such as nonaccrual status, past due status, loan risk grade, loan-to-value ratio, etc. Revolving credit agreements (e.g. home equity lines of credit and revolving commercial loans), if at the acquisition date the borrower has revolving privileges, are not considered PCI loans as cash flows can not be reasonably estimated.

For acquired loans not considered credit-impaired, the difference between the contractual amounts due (principal amount) and the fair value is accounted for subsequently through accretion. We elect to recognize discount accretion based on the acquired loan’s contractual cash flows using an effective interest rate method. The accretion is recognized through the net interest margin as described in the guidance for accounting for loan origination fees and costs that is included in FASB ASC 310-20 (formerly FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases).

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

	February 18, 2011		
(Dollars in thousands; unaudited)	Purchased credit-impaired loans	Other purchased loans	Total
Contractually required payments including interest	$24,316	$69,702	$94,018
Less: nonaccretable difference	(13,044)	---	(13,044)
Cash flows expected to be collected (undiscounted)	11,272	69,702	80,974
Accretable yield	(1,902)	(17,307) 1	(19,209)
Fair value of purchased loans	$9,370	$52,395	$61,765

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

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

(1) Changes in interest rate indices for variable rate loans – Expected future cash flows are based on the variable rates in effect at the time of the regular evaluations of cash flows expected to be collected;

(2) Changes in prepayment assumptions – Prepayments affect the estimated life of the loans which may change the amount of interest income, and possibly principal, expected to be collected;

(3) Changes in the expected principal and interest payments over the estimated life – Updates to expected cash flows are driven by the credit outlook and actions taken with borrowers. Changes in expected future cash flows from loan modifications are included in the regular evaluations of cash flows expected to be collected.

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

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

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The following table reflects the outstanding balance and related carrying value of PCI loans as of the acquisition date (February 18, 2011) and March 31, 2011:

	February 18, 2011		March 31, 2011	
(Dollars in thousands)	Unpaid principal balance	Carrying value	Unpaid principal balance	Carrying value
Commercial	$ 10,860	$ 3,706	$ 9,231	$ 3,428
Commercial real estate	10,139	5,664	9,861	5,764
Total purchased credit-impaired loans	$ 20,999	$ 9,370	$ 19,092	