Bank of Marin Bancorp
Form 10-Q
August 07, 2015
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

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

For the quarterly period ended June 30, 2015
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
(Address of principal executive office)

20-8859754
(IRS Employer Identification No.)
94947
(Zip Code)

Registrant's telephone number, including area code: (415) 763-4520
Indicate by check mark whether the registrant (1) has filed all reports to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o Smaller reporting company o Indicate by check mark if the registrant is a shell company, as defined in Rule 12b-2 of the Exchange Act. Yes o No x

As of July 31, 2015, there were 5,988,926 shares of common stock outstanding.

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## PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements
BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CONDITION
at June 30, 2015 and December 31, 2014
(in thousands, except share data; 2015 unaudited)
June 30, $2015 \quad$ December 31, 2014
Assets
Cash and due from banks \$117,533 \$41,367
Investment securities
Held-to-maturity, at amortized cost
94,475
116,437
Available-for-sale, at fair value (amortized cost \$252,709 and \$199,045 a
June 30, 2015 and December 31, 2014, respectively)
Total investment securities
348,493
200,848

Loans, net of allowance for loan losses of \$14,354 and \$15,099 at June 30, 2015 and December 31, 2014, respectively
Bank premises and equipment, net
1,324,851
317,285

Goodwill
9,673
1,348,252

Core deposit intangible
Interest receivable and other assets
6,436
9,859
3,423
6,436

Total assets
60,353 60,199

Liabilities and Stockholders' Equity
Liabilities
Deposits
Non-interest-bearing
\$741,107
\$670,890
Interest-bearing
Transaction accounts
Savings accounts
95,622
Money market accounts
132,377
93,758

Time accounts
502,263
133,714

Total deposits
Federal Home Loan Bank ("FHLB") borrowings
Subordinated debentures
Interest payable and other liabilities
159,114
503,543

Total liabilities
1,630,483
149,714

Stockholders' Equity
Preferred stock, no par value
Authorized - 5,000,000 shares, none issued
Common stock, no par value
Authorized - 15,000,000 shares;
Issued and outstanding - 5,983,551 and 5,939,482 at
$83,826 \quad 82,436$
June 30, 2015 and December 31, 2014, respectively
Retained earnings
15,000 15,000
1,551,619
5,291 $\quad 5,185$
12,806 15,300
$1,663,580 \quad 1,587,104$

Accumulated other comprehensive income, net
122,625
116,502
Total stockholders' equity
731
1,088
Total liabilities and stockholders' equity
207,182
200,026
\$1,870,762
\$1,787,130

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

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands, except per share amounts; unaudited)
Interest income
Interest and fees on loans
Interest on investment securities
Securities of U.S. government agencies
Obligations of state and political subdivisions
Corporate debt securities and other
Interest on Federal funds sold and due from banks
Total interest income
Interest expense
Interest on interest-bearing transaction accounts
Interest on savings accounts
Interest on money market accounts
Interest on time accounts
Three months ended

June 30 2015 - 2014

Six months ended June 30, June 30, 20152014
$\$ 15,287 \quad \$ 16,363 \quad \$ 30,666 \quad \$ 32,682$

Interest on FHLB and overnight borrowings
Interest on subordinated debentures
Total interest expense
Net interest income
Provision for loan losses
Net interest income after provision for loan losses
Non-interest income
Service charges on deposit accounts
Wealth Management and Trust Services
Debit card interchange fees
Merchant interchange fees
Earnings on bank-owned life insurance
Dividends on FHLB stock
Gain on sale of securities
Other income
Total non-interest income
Non-interest expense
Salaries and related benefits
Occupancy and equipment
Depreciation and amortization
Federal Deposit Insurance Corporation insurance
Data processing
Professional services

| 603 | 613 | 1,241 | 1,177 |
| :--- | :--- | :--- | :--- |
| 368 | 360 | 715 | 660 |
| 129 | 207 | 259 | 405 |
| 203 | 211 | 406 | 424 |
| 461 | 130 | 608 | 260 |
| - | 97 | 8 | 89 |
| 340 | 222 | 531 | 485 |
| 2,608 | 2,368 | 4,797 | 4,584 |
|  |  |  |  |
| 6,672 | 6,232 | 13,462 | 13,162 |
| 1,493 | 1,329 | 2,835 | 2,663 |
| 650 | 403 | 1,071 | 819 |
| 253 | 269 | 489 | 519 |
| 792 | 748 | 1,578 | 2,108 |
| 515 | 412 | 1,079 | 1,040 |
| 247 | 157 | 438 | 312 |
| 216 | 173 | 368 | 338 |
| $(109$ | $)(15$ | $)$ | $(310$ |
| 1,590 | 1,749 | 3,166 | 3,354 |
| 12,319 | 11,457 | 24,176 | 24,300 |
| 6,743 | 8,185 | 13,682 | 15,302 |
| 2,457 | 3,017 | 4,939 | 5,601 |
| $\$ 4,286$ | $\$ 5,168$ | $\$ 8,743$ | $\$ 9,701$ |

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Net income per common share:
$\begin{array}{lllll}\text { Basic } & \$ 0.72 & \$ 0.88 & \$ 1.47 & \$ 1.65\end{array}$
Diluted
\$0.71 \$0.86
\$1.44 \$1.62
Weighted average shares used to compute net income per common share:

| Basic | 5,945 |  | 5,888 | 5,933 |  | 5,879 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Diluted | 6,062 |  | 5,993 | 6,055 |  | 5,987 |
| Dividends declared per common share | \$0.22 |  | \$0.19 | \$0.44 |  | \$0.38 |
| Comprehensive income: |  |  |  |  |  |  |
| Net income | \$4,286 |  | \$5,168 | \$8,743 |  | \$9,701 |
| Other comprehensive income |  |  |  |  |  |  |
| Change in net unrealized (loss) gain on available-for-sale securities | (1,803 | ) | 976 | (486 | ) | 2,391 |
| Reclassification adjustment for (gain) loss on available-for-sale securities included in net income | - |  | - | (8) | ) | 15 |
| Net change in unrealized (loss) gain on available-for-sale securities, before tax | (1,803 | ) | 976 | (494 | ) | 2,406 |
| Deferred tax (benefit) expense | (691 | ) | 450 | (137 | ) | 969 |
| Other comprehensive (loss) income, net of tax | (1,112 | ) | 526 | (357 | ) | 1,437 |
| Comprehensive income | \$3,174 |  | \$5,694 | \$8,386 |  | \$11,138 |

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

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY for the year ended December 31, 2014 and the six months ended June 30, 2015

| (in thousands, except share data; 2015 unaudited) | Common Stock |  |  | Accumulated <br> Other <br> Comprehensive <br> Income, <br> Net of Taxes |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Shares | Amount | Retained <br> Earnings |  | Total |
| Balance at December 31, 2013 | 5,877,524 | \$80,095 | \$ 101,464 | \$(672 ) | \$180,887 |
| Net income | - | - | 19,771 | - | 19,771 |
| Other comprehensive income | - | - | - | 1,760 | 1,760 |
| Stock options exercised | 49,415 | 1,452 | - | - | 1,452 |
| Excess tax benefit - stock-based compensation | - | 172 | - | - | 172 |
| Stock issued under employee stock purchase plan | 521 | 23 | - | - | 23 |
| Restricted stock granted | 8,523 | - | - | - | - |
| Restricted stock forfeited / cancelled | (2,067 | - | - | - | - |
| Stock-based compensation - stock options | - | 200 | - | - | 200 |
| Stock-based compensation - restricted stock | - | 246 | - | - | 246 |
| Cash dividends paid on common stock | - | - | (4,733 | - | (4,733 |
| Stock purchased by directors under director stock plan | 260 | 12 | - | - | 12 |
| Stock issued in payment of director fees | 5,306 | 236 | - | - | 236 |
| Balance at December 31, 2014 | 5,939,482 | \$82,436 | \$116,502 | \$1,088 | \$200,026 |
| Net income | - | - | 8,743 | - | 8,743 |
| Other comprehensive loss | - | - | - | (357 ) | ) (357 |
| Stock options exercised | 25,233 | 774 | - | - | 774 |
| Excess tax benefit - stock-based compensation | - | 162 | - | - | 162 |
| Stock issued under employee stock purchase plan | 171 | 8 | - | - | 8 |
| Restricted stock granted | 15,970 | - | - | - | - |
| Stock-based compensation - stock options | - | 127 | - | - | 127 |
| Stock-based compensation - restricted stock | - | 181 | - | - | 181 |
| Cash dividends paid on common stock | - | - | (2,620 | - | (2,620 |
| Stock issued in payment of director fees | 2,695 | 138 | - | - | 138 |
| Balance at June 30, 2015 | 5,983,551 | \$83,826 | \$122,625 | \$731 | \$207,182 |

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 six months ended June 30, 2015 and 2014
(in thousands; unaudited)
June 30, $2015 \quad$ June 30, 2014
Cash Flows from Operating Activities:
Net income
$\$ 8,743 \quad \$ 9,701$
Adjustments to reconcile net income to net cash provided by operating activities:
Provision for loan losses - 750
Reversal of losses on off-balance sheet commitments (310) (15
Compensation expense-common stock for director fees 138
Stock-based compensation expense 308
Excess tax benefits from exercised stock options
(141
Amortization of core deposit intangible 309
Amortization of investment security premiums, net of accretion of discounts 1,217
Accretion of discount on acquired loans
Accretion of discount on subordinated debentures
(1,076

Net amortization of deferred loan origination costs/fees
106

Write-down of other real estate owned
(294

Gain on sale of investment securities
40

Depreciation and amortization
Loss on disposal of premises and equipment
Earnings on bank-owned life insurance policies
(8
1,071
4

Net change in operating assets and liabilities:
$\begin{array}{ll}\text { Interest receivable } & 109\end{array}$
Interest payable
Deferred rent and other rent-related expenses
(4

Other assets
86
Other liabilities
Total adjustments
Net cash provided by operating activities
1,504

Cash Flows from Investing Activities:
Purchase of held-to-maturity securities
(2,271
382

Purchase of available-for-sale securities
9,125
(2,375 ) -

Proceeds from sale of available-for-sale securities
Proceeds from sale of held-to-maturity securities
$(76,708)(9,872)$

Proceeds from paydowns/maturity of held-to-maturity securities
1,559 2,023

Proceeds from paydowns/maturity of available-for-sale securities
23,723
2,146

20,814 23,584
Proceeds from the sale of loan
1,502
Loans originated and principal collected, net
22,818
Purchase of FHLB stock
(136
Purchase of premises and equipment
Cash paid for low income housing tax credit investment
(889

Net cash provided by investing activities
(10,126
Cash Flows from Financing Activities:
Net increase in deposits
78,864
11,721
Proceeds from stock options exercised
774
672
Proceeds from stock issued under employee and director stock purchase plans8
Cash dividends paid on common stock
$(2,620$

14
) $(2,243)$

| Excess tax benefits from exercised stock options | 141 | 67 |
| :--- | :--- | :--- |
| Net cash provided by financing activities | 77,167 | 10,231 |
| Net increase (decrease) in cash and cash equivalents | 76,166 | $(22,393$ |
| Cash and cash equivalents at beginning of period | 41,367 | 103,773 |
| Cash and cash equivalents at end of period | $\$ 117,533$ | $\$ 81,380$ |
| Supplemental disclosure of cash flow information: | $\$ 1,035$ | $\$ 1,126$ |
| Cash paid for interest | $\$ 5,270$ | $\$ 4,680$ |
| Cash paid for income taxes |  |  |
| Supplemental disclosure of non-cash investing and financing activities: | $\$(494$ | $\$ 2,406$ |
| Change in unrealized (loss) gain on available-for-sale securities | $\$-$ | $\$ 14,297$ |
| Securities transferred from available-for-sale to held-to-maturity | $\$ 1,502$ | $\$-$ |
| Transfer of loan to loans held-for-sale at fair value | $\$ 1,023$ | $\$ 1,000$ |
| Subscription in low income housing tax credit investment | $\$ 138$ | $\$ 103$ |

The accompanying notes are an integral part of these consolidated financial statements.
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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation
The consolidated financial statements include the accounts of Bank of Marin Bancorp ("Bancorp"), a bank holding company, and its wholly-owned bank subsidiary, Bank of Marin (the "Bank"), a California state-chartered commercial bank. References to "we," "our," "us" mean the holding company and the Bank that are consolidated for financial reporting purposes. The accompanying unaudited consolidated interim financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to those rules and regulations. Although we believe that the disclosures are adequate and the information presented is not misleading, we suggest that these interim financial statements be read in conjunction with the financial statements and the notes thereto included in our 2014 Annual Report on Form 10-K. In the opinion of Management, the unaudited consolidated financial statements reflect all adjustments which are necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in stockholders' equity, and cash flows for the periods presented. All material intercompany transactions have been eliminated. The results of these interim periods may not be indicative of the results for the full year or for any other period. We have evaluated subsequent events through the date of filing with the SEC and have determined that there are no subsequent events that require additional recognition or disclosure.

In connection with the acquisition of NorCal Community Bancorp ("NorCal") (the "Acquisition"), Bancorp assumed ownership of Norcal Community Bancorp Trusts I and II (the "Trusts"). Bancorp is not considered the primary beneficiary of the Trusts (variable interest entities), therefore the Trusts are not consolidated in our consolidated financial statements, but rather the subordinated debentures due to the Trusts are shown as a liability on our consolidated statements of condition (see Note 6). Bancorp's investment in the common stock of the Trusts is accounted for under the equity method and is included in interest receivable and other assets on the consolidated statements of condition.

The following table shows: 1) weighted average basic shares, 2) potentially dilutive common shares related to stock options, unvested restricted stock awards and stock warrant, and 3) weighted average diluted shares. Basic earnings per share ("EPS") are calculated by dividing net income by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock awards. Diluted EPS are calculated using the weighted average number of potentially dilutive common shares, which is based on the average market prices during the three months of the reporting period, under the treasury stock method. The number of potentially dilutive common shares included in year-to-date diluted EPS is a year-to-date weighted average of potentially dilutive common shares included in each quarterly diluted EPS computation. We have two forms of outstanding stock: common stock and unvested restricted stock awards. Holders of unvested restricted stock awards receive non-forfeitable dividends at the same rate as common shareholders and they both share equally in undistributed earnings. Therefore, under the two-class method, the difference in EPS is not significant for these participating securities.

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|  | Three months ended |  | Six months ended |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| (in thousands, except per share data; unaudited) | June 30, 2015 | June 30, 2014 | June 30, 2015 |  | June 30, 2014

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Note 2: Recently Issued Accounting Standards
In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The ASU is a converged standard involving FASB and International Financial Reporting Standards that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount and at a time that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In July 2015, the FASB adopted a one-year deferral of the effective date of this amendment to January 1, 2018. Because this ASU does not apply to financial instruments and we do not have a significant source of non-interest income subject to this ASU, we do not expect it to have a material impact on our financial condition or results of operations.

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

In April 2015, the FASB issued ASU No. 2015-05, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40) Customer's Accounting for Fees Paid in a Cloud Computing Arrangement. The amendments in this ASU provide guidance about a customer's accounting for fees paid in a cloud computing arrangement. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, then the customer should account for the arrangement as a service contract. The two criteria that must be met to be considered a software license are: 1) the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty; and 2 ) it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. ASU 2015-05 is effective for annual periods, including interim periods within those annual periods beginning after December 15, 2015. We do not expect this ASU to have a material impact on our financial condition or results of operations.

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Note 3: Fair Value of Assets and Liabilities
Fair Value Hierarchy and Fair Value Measurement
We group our assets and liabilities that are measured at fair value into three levels within the fair value hierarchy, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

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

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

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

Transfers between levels of the fair value hierarchy are recognized through our monthly and/or quarterly valuation process in the reporting period during which the event or circumstances that caused the transfer occurred.

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

| (in thousands) | Carrying <br> Value | Quoted Prices |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  |  | in Active Markets for | Significant | Significant |
| Description of Financial Instruments |  | Identical | Observable | Unobservable |
|  |  | Assets | Inputs (Level 2) | Inputs (Level 3) |
|  |  | (Level 1) |  |  |

At June 30, 2015 (unaudited):
Securities available-for-sale:
Mortgage-backed securities and collateralized mortgage obligations issued by U.S.
government-sponsored agencies
Debentures of government-sponsored agencies
Privately-issued collateralized mortgage
obligations
Obligations of state and political subdivisions
Corporate bonds
Derivative financial assets (interest rate contracts) \$116 \$-
Derivative financial liabilities (interest rate contracts)
\$1,631 \$\$1,631

At December 31, 2014:
Securities available-for-sale:
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies

| Debentures of government-sponsored agencies | \$14,557 | \$- | \$ 14,557 | \$- |
| :---: | :---: | :---: | :---: | :---: |
| Privately-issued collateralized mortgage obligations | \$7,294 | \$- | \$7,294 | \$- |
| Obligations of state and political subdivisions | \$15,880 | \$- | \$15,771 | \$- |
| Corporate bonds | \$4,998 | \$- | \$5,437 | \$- |
| Derivative financial assets (interest rate contracts) | \$61 | \$- | \$61 | \$- |
| Derivative financial liabilities (interest rate | \$ 1,996 | \$- | \$ 1,996 | \$- |

Securities available-for-sale are recorded at fair value on a recurring basis. When available, quoted market prices (Level 1) are used to determine the fair value of securities available-for-sale. If quoted market prices are not available, we obtain pricing information from a reputable third-party service provider, who may utilize valuation techniques that use current market-based or independently sourced parameters, such as bid/ask prices, dealer-quoted prices, interest rates, benchmark yield curves, prepayment speeds, probability of default, loss severity and credit spreads (Level 2). Level 2 securities include obligations of state and political subdivisions, U.S. agencies or government sponsored agencies' debt securities, mortgage-backed securities, government agency-issued and privately-issued collateralized mortgage obligations. As of June 30, 2015 and December 31, 2014, there were no securities that were considered Level 1 securities. As of June 30, 2015, we had one available-for-sale security that was considered a Level 3 security. The security is a U.S. government agency obligation collateralized by a small pool of business equipment loans guaranteed by the Small Business Administration program. This security is not actively traded and is owned only by a few investors. The significant unobservable data that is reflected in the fair value measurement include dealer quotes, projected prepayment speeds/average life and credit information, among other things. It was transferred to a Level 3 security during the second quarter of 2014. The increase in unrealized gain during the first six months of 2015 was
\$13 thousand.
Securities held-to-maturity may be written down to fair value (determined using the same techniques discussed above for securities available-for-sale) as a result of an other-than-temporary impairment, if any.

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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 risk 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") and Overnight Index Swap ("OIS") rates (for the very short term), quoted prices for LIBOR futures contracts, observable market prices for LIBOR and OIS swap rates, and one-month and three-month LIBOR basis spreads at commonly quoted intervals. Mid-market pricing of the inputs is used as a practical expedient in the fair value measurements. We project spot rates at reset days specified by each swap to determine future cash flows, then discount to present value using either LIBOR or OIS curves depending on the collateral posted as of the measurement date. When the value of any collateral placed with counterparties is less than the interest rate derivative liability, a credit valuation adjustment ("CVA") is applied to reflect the credit risk we pose to counterparties. We have used the spread between the Standard \& Poor's BBB rated U.S. Bank Composite rate and LIBOR for the closest maturity term corresponding to the duration of the swaps to derive the CVA. A similar credit risk adjustment, correlated to the credit standing of the counterparty, is made when collateral posted by the counterparty does not fully cover their liability to Bank of Marin.

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

The following table presents the carrying value of financial instruments that were measured at fair value on a non-recurring basis and that were held in the consolidated statements of condition at each respective period end, by level within the fair value hierarchy as of June 30, 2015 and December 31, 2014.

| (in thousands) |  | Quoted Prices in | Significant Other | Significant |
| :--- | :--- | :--- | :--- | :--- |
| Description of Financial | Carrying | Active Markets for | Onobservable |  |
| Instruments | Value $^{1}$ | Identical Assets | (Level 2) | Inputs |
| (Level 1) | (Level 3) ${ }^{1}$ |  |  |  |

At June 30, 2015 (unaudited): Impaired loans carried at fair value: None

At December 31, 2014:
Impaired loans carried at fair value:
Installment and other consumer \$77 \$- \$- \$77
${ }^{1}$ Represents collateral-dependent loan principal balances that had been generally written down to the values of the underlying collateral, net of specific valuation allowances. At December 31, 2014, the $\$ 77$ thousand carrying value of a consumer loan was net of a $\$ 26$ thousand specific valuation allowance. The carrying value of loans fully charged-off, which includes unsecured lines of credit, overdrafts and all other loans, is zero.

When a loan is identified as impaired, it is reported at the lower of cost or fair value, measured based on the loan's observable market price (Level 1) or the current net realizable value of the underlying collateral securing the loan, if the loan is collateral dependent (Level 3). Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted
to reflect differences between them and the subject property such as property type, leasing status and physical condition. When appraisals are received, Management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a $6 \%$ discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by Management on a case-by-case basis and are generally unobservable valuation inputs as they

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are specific to the underlying collateral. There have been no significant changes in the valuation techniques during the six months ended June 30, 2015.

OREO represents collateral acquired through foreclosure and is initially recorded at fair value as established by a current appraisal, adjusted for disposition costs. Subsequently, OREO is measured at lower of cost or fair value. OREO values are reviewed on an ongoing basis and any subsequent decline in fair value is recorded as a foreclosed asset expense in the current period. The value of OREO is determined based on independent appraisals, similar to the process used for impaired loans, discussed above, and is generally classified as Level 3. We had $\$ 421$ thousand and $\$ 461$ thousand of OREO as of June 30, 2015 and December 31, 2014, respectively, all of which was acquired from Bank of Alameda as part of the Acquisition. There was a $\$ 40$ thousand decline in the estimated fair value of the OREO during the first six months ended June 30, 2015.

## Disclosures about Fair Value of Financial Instruments

The table below is a summary of fair value estimates for financial instruments as of June 30, 2015 and December 31, 2014, excluding financial instruments recorded at fair value on a recurring basis (summarized in the first table in this note). The carrying amounts in the following table are recorded in the consolidated statements of condition under the indicated captions. We have excluded non-financial assets and non-financial liabilities defined by the Codification (ASC 820-10-15-1A), such as Bank premises and equipment, deferred taxes and other liabilities. In addition, we have not disclosed the fair value of financial instruments specifically excluded from disclosure requirements of the Financial Instruments Topic of the Codification (ASC 825-10-50-8), such as Bank-owned life insurance policies.

| (in thousands; 2015 unaudited) | June 30, 2015 |  |  | December 31, 2014 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Carrying <br> Amounts | Fair Value | Fair Value Hierarchy | Carrying <br> Amounts | Fair Value | Fair Value Hierarchy |
| Financial assets |  |  |  |  |  |  |
| Cash and cash equivalents | \$117,533 | \$117,533 | Level 1 | \$41,367 | \$41,367 | Level 1 |
| Investment securities held-to-maturity | 94,475 | 96,017 | Level 2 | 116,437 | 118,643 | Level 2 |
| Loans, net | 1,324,851 | 1,332,708 | Level 3 | 1,348,252 | 1,361,244 | Level 3 |
| Interest receivable | 5,800 | 5,800 | Level 2 | 5,909 | 5,909 | Level 2 |
| Financial liabilities |  |  |  |  |  |  |
| Deposits | 1,630,483 | 1,631,106 | Level 2 | 1,551,619 | 1,552,446 | Level 2 |
| Federal Home Loan Bank borrowings | 15,000 | 15,445 | Level 2 | 15,000 | 15,484 | Level 2 |
| Subordinated debentures | 5,291 | 5,192 | Level 3 | 5,185 | 5,290 | Level 3 |
| Interest payable | 209 | 209 | Level 2 | 213 | 213 | Level 2 |

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

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

Held-to-maturity Securities - Held-to-maturity securities, which generally consist of mortgage-backed securities, obligations of state and political subdivisions and corporate bonds, are recorded at their amortized cost. The fair value for disclosure purposes is determined using methodologies similar to those described above for available-for-sale securities using Level 2 inputs. If Level 2 inputs are not available, we may utilize pricing models that incorporate unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities (Level 3). As of June 30, 2015 and December 31, 2014, we did not hold any held-to-maturity securities whose fair value was measured using significant unobservable inputs.

Loans - The fair value of loans with variable interest rates approximates current carrying value, because their rates are regularly adjusted to current market rates. The fair value of fixed rate loans or variable loans at negotiated interest rate floors or ceilings with remaining maturities in excess of one year is estimated by discounting the future cash flows using current market rates at which similar loans would be made to borrowers with similar creditworthiness and similar

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remaining maturities. The allowance for loan losses ("ALLL") is considered to be a reasonable estimate of the portion of loan discount attributable to credit risks.

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

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

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

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

Commitments - The value of unrecognized financial instruments is estimated based on the fee income associated with the commitments which, in the absence of credit exposure, is considered to approximate their settlement value.

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Note 4: Investment Securities
Our investment securities portfolio consists of obligations of state and political subdivisions, corporate bonds, U.S. government agency securities, including mortgage-backed securities ("MBS") and collateralized mortgage obligations ("CMOs") issued or guaranteed by Federal National Mortgage Association ("FNMA"), Federal Home Loan Mortgage Corporation ("FHLMC"), or Government National Mortgage Association ("GNMA"), debentures issued by government-sponsored agencies such as FNMA, FHLB and FHLMC, as well as privately issued CMOs, as reflected in the table below:

| (in thousands; 2015 unaudited) | June 30, 2015 |  | December 31, 2014 |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | AmortizedCost | Fair <br> Value | Gross Unrealized |  |  | Amortized Fair |  | Gross Unrealized |  |
|  |  |  | Gains | (Losses) |  | Cost | Value | Gains | (Losses) |
| Held-to-maturity |  |  |  |  |  |  |  |  |  |
| Obligations of state and political subdivisions | \$54,183 | \$55,455 | \$ 1,332 | \$ 60 | ) | \$63,425 | \$65,121 | \$1,736 | \$(40 |
| Corporate bonds | 27,615 | 27,732 | 122 | (5 | ) | 40,257 | 40,448 | 216 | (25 |
| MBS pass-through securities |  |  |  |  |  |  |  |  |  |
| issued by FHLMC and | 12,677 | 12,830 | 160 | (7 | ) | 12,755 | 13,074 | 319 | - |
| FNMA |  |  |  |  |  |  |  |  |  |
| Total held-to-maturity | 94,475 | 96,017 | 1,614 | (72 | ) | 116,437 | 118,643 | 2,271 | (65 |

Available-for-sale
Securities of U.S. government agencies:
MBS pass-through securities

| issued by FHLMC and | 120,719 | 121,273 | 748 | (194 | ) | 92,963 | 94,214 | 1,262 | (11 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| FNMA |  |  |  |  |  |  |  |  |  |
| CMOs issued by FNMA | 12,993 | 13,106 | 150 | (37 | ) | 14,771 | 14,790 | 77 | (58 |
| CMOs issued by FHLMC | 27,065 | 27,191 | 164 | (38 | ) | 31,238 | 31,260 | 109 | (87 |
| CMOs issued by GNMA | 13,950 | 14,216 | 274 | (8) | ) | 17,573 | 17,855 | 298 | (16 |
| Debentures of governmentsponsored agencies | 31,121 | 31,072 | 98 | (147 | ) | 14,694 | 14,557 | 95 | (232 |
| Privately issued CMOs | 5,011 | 5,209 | 200 | (2 | ) | 7,137 | 7,294 | 172 | (15 |
| Obligations of state and political subdivisions | 36,909 | 36,937 | 123 | (95 | ) | 15,733 | 15,880 | 155 | (8) |
| Corporate bonds | 4,941 | 5,014 | 73 | - |  | 4,936 | 4,998 | 66 | (4 |
| Total available-for-sale | 252,709 | 254,018 | 1,830 | (521 |  | 199,045 | 200,848 | 2,234 | (431 |

Total investment securities $\$ 347,184 \quad \$ 350,035 \quad \$ 3,444 \quad \$(593 \quad) \$ 315,482 \quad \$ 319,491 \quad \$ 4,505 \quad \$(496)$

The amortized cost and fair value of investment debt securities by contractual maturity at June 30,2015 are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

| (in thousands; 2015 | June 30, 2015 |  |  |  | December 31, 2014 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Held-to-M | turity | Available-f | or-Sale | Held-to-M | aturity | Available- | r-Sale |
|  | Amortized |  | Amortized | Fair Value | Amortized | Fair Value | Amortized | Fair Val |
| unaudited) | Cost | Value | Cost | Fair Value | Cost | Fair Value | Cost | Fair Val |
| Within one year | \$30,306 | \$30,400 | \$11,426 | \$11,508 | \$39,778 | \$39,913 | \$2,378 | \$2,388 |


| After one year but | 41,659 | 42,429 | 56,275 | 56,324 | 50,983 | 51,953 | 43,866 | 43,919 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| within five years |  |  |  |  |  |  |  |  |
| After five years through | 10,965 | 11,477 | 45,935 | 45,885 | 11,679 | 12,426 | 9,644 | 9,749 |
| ten years | 11,545 | 11,711 | 139,073 | 140,301 | 13,997 | 14,351 | 143,157 | 144,792 |
| After ten years | $\$ 94,475$ | $\$ 96,017$ | $\$ 252,709$ | $\$ 254,018$ | $\$ 116,437$ | $\$ 118,643$ | $\$ 199,045$ | $\$ 200,848$ |
| Total |  |  |  |  |  |  |  |  |

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

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We sold one available-for-sale and six held-to-maturity securities in the first six months of 2014 with total proceeds of $\$ 2.0$ million and $\$ 2.1$ million, respectively, and incurred a gross loss of $\$ 15$ thousand and gross gains of $\$ 104$ thousand, respectively. The sales of the held-to-maturity securities were due to evidence of significant deterioration of creditworthiness of the issuers since purchase.

Investment securities carried at $\$ 70.1$ million and $\$ 74.7$ million at June 30, 2015 and December 31, 2014, respectively, were pledged to the State of California: $\$ 69.3$ million and $\$ 73.8$ million to secure public deposits in compliance with the Local Agency Security Program at June 30, 2015 and December 31, 2014, respectively, and $\$ 848$ thousand and $\$ 856$ thousand to provide collateral for trust deposits at June 30, 2015 and December 31, 2014, respectively. In addition, investment securities carried at $\$ 1.1$ million were pledged to collateralize a Wealth Management and Trust Services ("WMTS") checking account at both June 30, 2015 and December 31, 2014.

Other-Than-Temporarily Impaired Debt Securities
We have evaluated the credit of our investment securities and their issuer and/or insurers. Based on our evaluation, Management has determined that no investment security in our investment portfolio is other-than-temporarily impaired as of June 30, 2015. We do not have the intent, and it is more likely than not that we will not have to sell securities temporarily impaired at June 30, 2015 before recovery of the cost basis.

Thirty-five and twenty-eight investment securities were in unrealized loss positions at June 30, 2015 and December 31, 2014, respectively. Those securities are summarized and classified according to the duration of the loss period in the table below:


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| Total available-for-sale | 49,191 | $(297$ | $)$ | 16,276 | $(224$ | $)$ | 65,467 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Total temporarily impaired | $\$ 69,438$ | $\$(356$ | $)$ | $\$ 16,633$ | $\$(237$ | $)$ | $\$ 86,071$ |
| securities | $\$(593$ |  |  |  |  |  |  |

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

As of June 30, 2015, there were six investment positions that had been in a continuous loss position for more than twelve months. These securities consisted of a government-sponsored agency debenture, obligations of U.S. state and political subdivisions, and CMOs. We have evaluated each of the bonds and believe that the decline in fair value is primarily driven by factors other than credit. It is probable that we will be able to collect all amounts due according to the contractual terms and no other-than-temporary impairment exists on these securities. The CMOs issued by FNMA and FHLMC are supported by the U.S. Federal Government to protect us from credit losses. Additionally, the obligations of state and political subdivisions were deemed creditworthy based on our review of the issuers' recent financial information and their insurers, if any. Based upon our assessment of the credit fundamentals and the credit enhancements, we concluded that these securities were not other-than-temporarily impaired at June 30, 2015.

Twenty-nine investment securities in our portfolio were in a temporary loss position for less than twelve months as of June 30, 2015. They consisted of a U.S. Agency CMO, MBS pass-through securities, obligations of U.S. state and political subdivisions, corporate bonds and privately issued CMOs. We determine that the strengths of GNMA through the U.S. Federal Government guarantee is sufficient to protect us from credit losses. Other temporarily impaired securities are deemed creditworthy after internal analysis. Additionally, all are rated as investment grade by at least one major rating agency. As a result of this impairment analysis, we concluded that these securities were not other-than-temporarily impaired at June 30, 2015.

## Non-Marketable Securities

As a member of the FHLB, we are required to maintain a minimum investment in the FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can increase in the event we increase our total asset size or borrowings with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at the $\$ 100$ per share par value. We held $\$ 8.4$ million and $\$ 8.2$ million of FHLB stock recorded at cost in
other assets on the consolidated statements of condition at June 30, 2015 and December 31, 2014, respectively. The carrying amounts of these investments are reasonable estimates of fair value because the securities are restricted to member banks and they do not have a readily determinable market value. Management does not believe that the FHLB stock is other-than-temporarily-impaired, as we expect to be able to redeem this stock at cost. FHLB distributed on May 14, 2015 a cash dividend at an annualized dividend rate of $7.67 \%$ in addition to a special dividend distributed

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on June 23, 2015 at an annualized dividend rate of $14.98 \%$ for shares outstanding during the first quarter of 2015. On July 28, 2015, FHLB announced a cash dividend for the second quarter of 2015 at an annualized dividend rate of $10.01 \%$ to be distributed in mid August. Cash dividends paid on FHLB capital stock are recorded as non-interest income.

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock with a carrying value of zero, which is equal to our cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s covered litigation escrow account. As a result of the restriction, these shares are not considered available-for-sale and are not carried at fair value. When converting this Class B common stock to Class A common stock under the current conversion rate of 1.6483 and the closing stock price of Class A shares, the value of our shares of Class B common stock would have been $\$ 1.9$ million at June 30, 2015 and $\$ 1.8$ million at December 31, 2014. The conversion rate is subject to further reduction upon the final settlement of the covered litigation against Visa Inc. and its member banks. See Note 8 herein.

We invest in low income housing tax credit funds as a limited partner, which totaled $\$ 2.8$ million and $\$ 1.8$ million recorded in other assets as of June 30, 2015 and December 31, 2014, respectively. In the first six months of 2015, we recognized $\$ 132$ thousand of low income housing tax credits and other tax benefits, net of $\$ 102$ thousand of amortization expense of low income housing tax credit investment, as a component of income tax benefit. As of June 30,2015 , our unfunded commitments for these low income housing tax credit funds totaled $\$ 2.0$ million. We did not recognize any impairment losses on these low income housing tax credit investments during the first six months of 2015, or the year ended December 31, 2014.

Note 5: Loans and Allowance for Loan Losses

## Credit Quality of Loans

Outstanding loans by class and payment aging as of June 30, 2015 and December 31, 2014 are as follows: Loan Aging Analysis by Class as of June 30, 2015 and December 31, 2014


| $\begin{aligned} & 30-59 \text { days } \\ & \text { past due } \end{aligned}$ | \$183 | \$- | \$- | \$- | \$646 | \$- | \$180 | \$ 1,009 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| $\begin{aligned} & 60-89 \text { days } \\ & \text { past due } \end{aligned}$ |  | - | - | - | - | - | - | - |
| Greater than 90 days past due (non-accrual) ${ }^{2}$ | $-$ | 1,403 | 2,429 | 5,134 | 280 | - | 104 | 9,350 |
| Total past due | 183 | 1,403 | 2,429 | 5,134 | 926 | - | 284 | 10,359 |
| Current | 210,040 | 229,202 | 671,070 | 43,279 | 109,862 | 73,035 | 16,504 | 1,352,992 |
| Total loans ${ }^{3}$ | \$210,223 | \$ 230,605 | \$673,499 | \$48,413 | \$110,788 | \$73,035 | \$16,788 | \$1,363,351 |
| Non-accrual loans to total | - | 0.6 | 0.4 | 10.6 | 0.3 | - | 0.6 | 0.7 |

loans
${ }^{1}$ Our residential loan portfolio does not include sub-prime loans, nor is it our practice to underwrite loans commonly referred to as "Alt-A mortgages", the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or higher loan-to-value ratios.
${ }^{2}$ Amounts include $\$ 1.4$ million of Purchased Credit Impaired ("PCI") loans that had stopped accreting interest at both June 30, 2015 and December 31, 2014. Amounts exclude accreting PCI loans of $\$ 3.7$ million and $\$ 3.8$ million at June 30, 2015 and December 31, 2014, respectively, as we have a reasonable expectation about future cash flows to be collected and we continue to recognize accretable yield on these loans in interest income. There were no accruing loans past due more than ninety days at June 30, 2015 or December 31, 2014.
${ }^{3}$ Amounts include net deferred loan costs of $\$ 781$ thousand and $\$ 487$ thousand at June 30, 2015 and December 31, 2014 , respectively. Amounts are also net of unaccreted purchase discounts on non-PCI loans of $\$ 3.7$ million and $\$ 4.4$ million at June 30, 2015 and December 31, 2014, respectively.

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Our commercial loans are generally made to established small and mid-sized businesses to provide financing for their working capital needs, equipment purchases and/or acquisitions. Management examines historical, current, and projected cash flows to determine the ability of the borrower to repay obligations as agreed. Commercial loans are made based primarily on the identified cash flows of the borrower and secondarily on the underlying collateral and/or guarantor support. The cash flows of borrowers, however, may not occur as expected, and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed, such as accounts receivable and/or inventory, and typically include a personal guarantee. We target stable businesses with guarantors that have proven to be resilient in periods of economic stress. Typically, the guarantors provide an additional source of repayment for most of our credit extensions.

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

Construction loans are generally made to developers and builders to finance construction, renovation and occasionally land acquisitions. These loans are underwritten after evaluation of the borrower's financial strength, reputation, prior track record, and independent appraisals. The construction industry can be impacted by significant events, including: the inherent volatility of real estate markets and vulnerability to delays due to weather, change orders, inability to obtain construction permits, labor or material shortages, and price changes. Estimates of construction costs and value associated with the complete project may be inaccurate. Repayment of construction loans is largely dependent on the ultimate success of the project.

Consumer loans primarily consist of home equity lines of credit, other residential (tenancy-in-common, or "TIC") loans, and installment and other consumer loans. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. Diversification, coupled with relatively small loan amounts that are spread across many individual borrowers, mitigates risk. Additionally, trend reports are reviewed by Management on a regular basis. Underwriting standards for home equity lines of credit include, but are not limited to, a conservative loan-to-value ratio, the number of such loans a borrower can have at one time, and documentation requirements. Our residential loan portfolio includes TIC units in San Francisco. These loans tend to have more equity in their properties than conventional residential mortgages, which mitigates risk. Installment and other consumer loans include mostly loans for floating homes and mobile homes along with a small number of installment loans.

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

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

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

Substandard - Inadequately protected by either the current sound worth and paying capacity of the obligor or the collateral pledged, if any. A Substandard asset has a well-defined weakness or weaknesses that jeopardize(s) the liquidation of the debt. Substandard assets are characterized by the distinct possibility that we will sustain some loss

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if such weaknesses or deficiencies are not corrected. Well-defined weaknesses include adverse trends or developments of the borrower's financial condition, managerial weaknesses and/or significant collateral deficiencies.

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

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

Generally, commercial borrowers with lines of credit are required to submit financial information with reporting intervals ranging from monthly to annually depending on credit size, risk and complexity.
Investor commercial real estate borrowers are generally required to submit rent rolls or property income statements at least annually.
Construction loans are monitored monthly, and reviewed on an ongoing basis.
Home equity and other consumer loans are reviewed based on delinquency.
Loans graded "Watch" or more severe, regardless of loan type, are reviewed no less than quarterly.
The following table represents an analysis of loans by internally assigned grades, including the PCI loans, at June 30, 2015 and December 31, 2014:


## Troubled Debt Restructuring

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

A loan may no longer be reported as a TDR if all of the following conditions are met:
The loan is subsequently refinanced or restructured at current market interest rates and the new terms are consistent with the treatment of creditworthy borrowers under regular underwriting standards;
The borrower is no longer considered to be in financial difficulty;
Performance on the loan is reasonably assured; and;
Existing loan did not have any forgiveness of principal or interest.
The removal of TDR status must be approved by the same management level that approved the upgrading of the loan classification.

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During the first half of 2015, three loans with a recorded investment totaling \$396 thousand were removed from TDR designation. There were no loans removed from TDR designation during 2014.

The table below summarizes outstanding TDR loans by loan class as of June 30, 2015 and December 31, 2014. The summary includes both TDRs that are on non-accrual status and those that continue to accrue interest.
(in thousands; 2015 unaudited)
Recorded investment in Troubled Debt Restructurings ${ }^{1}$
Commercial and industrial
Commercial real estate, owner-occupied
Commercial real estate, investor
Construction ${ }^{2}$
Home equity
Other residential
Installment and other consumer
Total

As of
June 30, 2015
\$4,149 \$3,584
8,396
740
3,277
558
2,029
1,400
\$20,549

December 31, 2014

8,459
524
5,684
694
2,045
1,713
\$22,703
${ }^{1}$ Includes $\$ 16.1$ million and $\$ 15.9$ million of TDR loans that were accruing interest as of June 30, 2015 and December 31, 2014, respectively. Includes $\$ 1.6$ million and $\$ 1.8$ million of acquired loans at June 30, 2015 and December 31, 2014, respectively.
${ }^{2}$ In June 2015, one TDR loan was transferred to loans held-for-sale at fair value totaling $\$ 1.5$ million, net of an $\$ 839$ thousand charge-off to the allowance for loan losses. The loan was subsequently sold in June 2015 for no gain or loss.

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

| Number of | Pre-Modification Post-Modification |  |
| :--- | :--- | :--- |
| Contracts | Outstanding | Outstanding |
| Modified | Recorded | Recorded |
|  | Investment | Investment |

Post-Modification
Outstanding
Recorded
Investment at period end
Troubled Debt Restructurings during the three months ended June 30, 2015:
Commercial and industrial 4
Commercial real estate, investor 1
1

| $\$ 782$ | $\$ 882$ | $\$ 882$ |
| :--- | :--- | :--- |
| 222 | 221 | 221 |
| $\$ 1,004$ | $\$ 1,103$ | $\$ 1,103$ |

Troubled Debt Restructurings during the three months ended June 30, 2014:
Commercial and industrial Installment and other consumer
Total
3

| $\$ 308$ | $\$ 354$ | $\$ 354$ |
| :--- | :--- | :--- |
| 111 | 110 | 109 |
| $\$ 419$ | $\$ 464$ | $\$ 463$ |

Troubled Debt Restructurings during the six months ended June 30, 2015:

| Commercial and industrial | 4 | $\$ 782$ | $\$ 882$ | $\$ 882$ |
| :--- | :--- | :--- | :--- | :--- |
| Commercial real estate, investor | 1 | 222 | 221 | 221 |
| Total | 5 | $\$ 1,004$ | $\$ 1,103$ | $\$ 1,103$ |

Troubled Debt Restructurings during the six months ended June 30, 2014:

| Commercial and industrial | 6 | $\$ 1,728$ | $\$ 1,759$ | $\$ 1,471$ |
| :--- | :--- | :--- | :--- | :--- |
| Home equity | 1 | 150 | 150 | 149 |
| Installment and other consumer | 6 | 281 | 278 | 276 |
| Total | 13 | $\$ 2,159$ | $\$ 2,187$ | $\$ 1,896$ |

Modifications during the six months ended June 30, 2015 primarily involved maturity extensions and renewals, while modifications during the six months ended June 30, 2014 primarily involved maturity extensions. During the first six

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months of 2015 and 2014, there were no defaults on loans that had been modified in a TDR within the prior twelve-month period. We report defaulted TDRs based on a payment default definition of more than ninety days past due.

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

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


June 30, 2015
Recorded investment in impaired loans:
With no specific
allowance recorded
With a specific
allowance recorded
Total recorded investment in impaired $\$ 4,495 \quad \$ 8,396 \quad \$ 3,018 \quad \$ 3,283 \quad \$ 658 \quad \$ 2,029 \quad \$ 1,420 \quad \$ 23,299$
loans
Unpaid principal balance of impaired loans:
With no specific
allowance recorded

| With a specific |  |  |  |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| allowance recorded | 2,656 | 2,882 | - | 741 | 393 | 1,007 | 1,139 | 8,818 |

Total unpaid principal

| balance of impaired | $\$ 4,555$ | $\$ 9,396$ | $\$ 5,010$ | $\$ 3,468$ | $\$ 658$ | $\$ 2,029$ | $\$ 1,420$ | $\$ 26,536$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

loans
$\begin{array}{lllllllll}\text { Specific allowance } & \$ 772 & \$ 70 & \$- & \$ 6 & \$ 3 & \$ 79 & \$ 149 & \$ 1,079\end{array}$
Average recorded
investment in impaired
$\begin{array}{lllllllll}\text { loans during the } & \$ 4,173 & \$ 8,412 & \$ 2,947 & \$ 4,475 & \$ 610 & \$ 2,033 & \$ 1,557 & \$ 24,207\end{array}$
quarter ended June 30,
2015
Interest income
recognized on

| impaired loans during <br> the quarter ended June | $\$ 56$ | $\$ 78$ | $\$ 8$ | $\$ 9$ | $\$ 4$ | $\$ 23$ | $\$ 17$ | $\$ 195$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

30, 2015
Average recorded investment in impaired
loans during the six $\quad \$ 3,946 \quad \$ 8,427 \quad \$ 2,931 \quad \$ 5,078 \quad \$ 618 \quad \$ 2,037 \quad \$ 1,650 \quad \$ 24,687$
months ended June 30, 2015

| Interest income <br> recognized on | $\$ 118$ | $\$ 144$ | $\$ 14$ | $\$ 18$ | $\$ 9$ | $\$ 46$ | $\$ 36$ | $\$ 385$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

impaired loans during the six months ended
June 30, 2015
Average recorded investment in impaired $\begin{array}{lllllllll}\text { loans during the } & \$ 6,217 & \$ 5,476 & \$ 3,186 & \$ 6,503 & \$ 755 & \$ 1,686 & \$ 1,898 & \$ 25,721\end{array}$ quarter ended June 30, 2014
Interest income recognized on

| impaired loans during | $\$ 103$ | $\$ 83$ | $\$ 7$ | $\$ 23$ | $\$ 5$ | $\$ 19$ | $\$ 19$ | $\$ 259$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

the quarter ended June
30, 2014
Average recorded investment in impaired

loans during the six | $\$ 6,081$ | $\$ 5,480$ | $\$ 3,235$ | $\$ 6,513$ | $\$ 666$ | $\$ 1,870$ | $\$ 1,891$ | $\$ 25,736$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

months ended June 30, 2014
Interest income
recognized on

| impaired loans during | $\$ 221$ | $\$ 166$ | $\$ 14$ | $\$ 44$ | $\$ 9$ | $\$ 42$ | $\$ 37$ | $\$ 533$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | the six months ended

June 30, 2014

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December 31, 2014
Recorded investment in impaired loans:
With no specific
allowance recorded
With a specific allowance recorded
Total recorded investment in $\quad \$ 3,584 \quad \$ 8,459 \quad \$ 2,954 \quad \$ 5,695 \quad \$ 693 \quad \$ 2,045 \quad \$ 1,793 \quad \$ 25,223$ impaired loans Unpaid principal balance of impaired loans: With no specific allowance recorded With a specific allowance recorded Total unpaid principal

| balance of impaired | $\$ 3,710$ | $\$ 9,459$ | $\$ 4,945$ | $\$ 8,573$ | $\$ 1,180$ | $\$ 2,045$ | $\$ 1,793$ | $\$ 31,705$ |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| loans |  |  |  |  |  |  |  |  |  |
| Specifi |  |  |  |  |  |  |  |  |  |

 2014

Management monitors delinquent loans continuously and identifies problem loans, generally loans graded substandard or worse, to be evaluated individually for impairment testing. Generally, the recorded investment in impaired loans is net of any charge-offs from estimated losses related to specifically-identified impaired loans when they are deemed uncollectible. The charged-off portion of impaired loans outstanding at June 30, 2015 totaled approximately $\$ 2.7$ million. In addition, the recorded investment in impaired loans is net of purchase discounts or premiums on acquired loans. At June 30, 2015, there were $\$ 767$ thousand outstanding commitments to extend credit on impaired loans, including loans to borrowers whose terms have been modified in TDRs.

The following tables disclose loans by major portfolio category and activity in the ALLL, as well as the related ALLL disaggregated by impairment evaluation method.
Allowance for Loan Losses Rollforward for the Period


For the three months ended June 30, 2015

Allowance for loan losses:

| Beginning balance | \$ 2,620 |  | \$ 2,094 |  | \$ 6,292 |  | \$ 778 |  | \$923 |  | \$ 430 | \$ 462 |  | \$ 1,557 | \$15,156 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Provision (reversal) | (117 | ) | (42 | ) | (351 | ) | 596 |  | (81 | ) 5 | 5 | (14 | ) | 4 | - |
| Charge-offs | (1 | ) | - |  | - |  | (839 | ) | - |  | - | (5 | ) | - | (845 |
| Recoveries | 38 |  | - |  | 3 |  | - |  | 1 |  | - |  |  | - | 43 |
| Ending balance | \$ 2,540 |  | \$ 2,052 |  | \$ 5,944 |  | \$ 535 |  | \$843 |  | \$ 435 | \$ 444 |  | \$ 1,561 | \$14,354 |

For the six months ended June 30, 2015
Allowance for loan losses:

| Beginning <br> balance <br> Provision | $\$ 2,837$ | $\$ 1,924$ | $\$ 6,672$ | $\$ 839$ | $\$ 859$ | $\$ 433$ | $\$ 566$ | $\$ 969$ | $\$ 15,099$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| (reversal) | $(392$ | $)$ | 128 | $(734$ | $)$ | 535 | $(18$ | $)$ | 2 |
| $(113$ | $)$ | 592 | - |  |  |  |  |  |  |
| Charge-offs | $(3$ | $)-$ | - | $(839$ | - | - | $(11$ | - | $(853$ |
| Recoveries | 98 | - | 6 | - | 2 | - | 2 | - | 108 |
| Ending balance | $\$ 2,540$ | $\$ 2,052$ | $\$ 5,944$ | $\$ 535$ | $\$ 843$ | $\$ 435$ | $\$ 444$ | $\$ 1,561$ | $\$ 14,354$ |

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Allowance for Loan Losses Rollforward for the Period


For the three months ended June 30, 2014
Allowance for loan losses:

| Beginning <br> balance | $\$ 2,772$ | $\$ 1,985$ | $\$ 6,469$ | $\$ 536$ | $\$ 887$ | $\$ 409$ | $\$ 565$ | $\$ 609$ | $\$ 14,232$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Provision <br> (reversal) | 310 | $(6$ | $)$ | 213 | 42 | 56 | 45 | $(84$ | $)$ |
| Charge-offs | $(5$ | $)$ | - | - | $(7$ | $)$ | 600 |  |  |
| Recoveries | 48 | - | 31 | - | 1 | - | 1 | - | $(13$ |
| Ending balance | $\$ 3,125$ | $\$ 1,979$ | $\$ 6,713$ | $\$ 571$ | $\$ 944$ | $\$ 454$ | $\$ 481$ | $\$ 633$ | $\$ 14,900$ |

For the six months ended June 30, 2014
Allowance for loan losses:

| Beginning balance | \$ 3,056 |  | \$ 2,012 |  | \$ 6,196 | \$ 633 |  | \$875 | \$ 317 | \$ 629 |  | \$ 506 | \$14,224 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Provision (reversal) | 55 |  | (33 | ) | 481 | 142 |  | 67 | 137 | (226 | ) | 127 | 750 |
| Charge-offs | (66 | ) | - |  | - | (204 | ) | - | - | (4 | ) | - | (274 |
| Recoveries | 80 |  | - |  | 36 | - |  | 2 | - | 82 |  | - | 200 |
| Ending balance | \$ 3,125 |  | \$ 1,979 |  | \$ 6,713 | \$ 571 |  | \$944 | \$ 454 | \$ 481 |  | \$ 633 | \$14,900 |

Allowance for Loan Losses and Recorded Investment in Loans


As of June 30, 2015:
Ending ALLL related to $\begin{array}{lllllllll}\text { loans collectively } & \$ 1,768 & \$ 1,982 & \$ 5,944 & \$ 529 & \$ 840 & \$ 356 & \$ 295 & \$ 1,561\end{array}$
evaluated for impairment
Ending ALLL related to

| loans individually <br> evaluated for impairment | $\$ 771$ | $\$ 70$ | $\$-$ | $\$-$ | $\$ 3$ | $\$ 79$ | $\$ 149$ | $\$-$ | $\$ 1$, |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Ending ALLL related to <br> purchased credit-impaired <br> loans | $\$ 1$ | $\$-$ | $\$-$ | $\$ 6$ | $\$-$ | $\$-$ | $\$-$ | $\$-$ | $\$ 7$ |
| Total | $\$ 2,540$ | $\$ 2,052$ | $\$ 5,944$ | $\$ 535$ | $\$ 843$ | $\$ 435$ | $\$ 444$ | $\$ 1,561$ | $\$ 1$ |

Loans outstanding:
Collectively evaluated for impairment

| $\$ 180,489$ | $\$ 225,057$ | $\$ 658,604$ | $\$ 45,471$ | $\$ 114,768$ | $\$ 71,692$ | $\$ 16,319$ | $\$-$ | $\$ 1$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| 4,340 | 6,993 | 3,018 | 3,277 | 657 | 2,029 | 1,420 | - | 21, |

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Individually evaluated for impairment ${ }^{1}$

${ }^{1}$ Total excludes $\$ 1.6$ million of PCI loans that have experienced post-acquisition declines in cash flows expected to be collected. These loans are included in the "purchased credit-impaired" amount in the next line below.

NM - Not Meaningful
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Allowance for Loan Losses and Recorded Investment in Loans

${ }^{1}$ Total excludes $\$ 1.7$ million PCI loans that have experienced credit deterioration post-acquisition, which are included in the "purchased credit-impaired" amount in the next line below.

## NM - Not Meaningful

## Purchased Credit-Impaired Loans

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

The following table reflects the outstanding balance and related carrying value of PCI loans as of June 30, 2015 and December 31, 2014.

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| PCI Loans | Unpaid principal | Carrying | Unpaid principal | Carrying |
| :--- | :--- | :--- | :--- | :--- |
| (in thousands; 2015 unaudited) | balance | value | balance | value |
| Commercial and industrial | $\$ 280$ | $\$ 191$ | $\$ 479$ | $\$ 324$ |
| Commercial real estate | 6,782 | 4,806 | 6,831 | 4,790 |
| Construction | 128 | 6 | 136 | 11 |
| Home equity | 228 | 68 | 232 | 67 |
| Total purchased credit-impaired loans | $\$ 7,418$ | $\$ 5,071$ | $\$ 7,678$ | $\$ 5,192$ |

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

## Accretable Yield

(dollars in thousands, unaudited)
Balance at beginning of period
Removals ${ }^{1}$
Accretion
Reclassifications from nonaccretable difference ${ }^{2}$
Balance at end of period

| Three months ended |  | Six months ended |  |
| :--- | :--- | :--- | :--- |
| June 30, 2015 | June 30, 2014 | June 30, 2015 | June 30, 2014 |
| $\$ 3,831$ | $\$ 5,301$ | $\$ 4,027$ | $\$ 3,649$ |
| - | $(273$ | $)(77$ | $)(273$ |
| $(120$ | $(187$ | $)(239$ | $)(367$ |
| - | $(327$ | $)-$ | 1,505 |
| $\$ 3,711$ | $\$ 4,514$ | $\$ 3,711$ | $\$ 4,514$ |

${ }^{1}$ Represents the accretable difference that is relieved when a loan exits the PCI population due to pay-off, full charge-off, or transfer to repossessed assets, etc.
${ }^{2}$ Primarily relates to changes in expected credit performance and changes in expected timing of cash flows.
Pledged Loans
Our FHLB line of credit is secured under terms of a blanket collateral agreement by a pledge of certain qualifying loans with an unpaid principal balance of $\$ 827.5$ million and $\$ 868.1$ million at June 30, 2015 and December 31, 2014, respectively. In addition, we pledge a certain residential loan portfolio, which totaled $\$ 41.1$ million and $\$ 34.0$ million at June 30, 2015 and December 31, 2014, respectively, to secure our borrowing capacity with the Federal Reserve Bank ("FRB"). Also see Note 6 below.

## Note 6: Borrowings

Federal Funds Purchased - We had unsecured lines of credit totaling $\$ 72.0$ million with correspondent banks for overnight borrowings at June 30, 2015 and December 31, 2014. In general, interest rates on these lines approximate the federal funds target rate. At June 30, 2015 and December 31, 2014, we had no overnight borrowings outstanding under these credit facilities.

Federal Home Loan Bank Borrowings - As of June 30, 2015 and December 31, 2014, we had lines of credit with the FHLB totaling $\$ 456.5$ million and $\$ 450.6$ million, respectively, based on eligible collateral of certain loans. At June 30, 2015 and December 31, 2014, we had no FHLB overnight borrowings.

On February 5, 2008, we entered into a ten-year borrowing agreement under the same FHLB line of credit for $\$ 15.0$ million at a fixed rate of $2.07 \%$, which remained outstanding at June 30, 2015. Interest-only payments are required every three months until the entire principal is due on February 5, 2018. The FHLB has the unconditional right to accelerate the due date on August 5, 2015 and every three months thereafter (the "put dates"). If the FHLB exercises its right to accelerate the due date, the FHLB will offer replacement funding at the current market rate, subject to certain conditions. We must comply with the put date, but are not required to accept replacement funding.

At June 30, 2015, $\$ 441.2$ million was remaining as available for borrowing from the FHLB, net of the term borrowing and letters of credit acquired from NorCal totaling $\$ 241$ thousand.

Federal Reserve Line of Credit - We have a line of credit with the FRB secured by certain residential loans. At June 30, 2015 and December 31, 2014, we had borrowing capacity under this line totaling $\$ 32.8$ million and $\$ 27.7$ million, respectively, and had no outstanding borrowings with the FRB.

As part of the Acquisition, we assumed two subordinated debentures due to NorCal Community Bancorp Trusts I and II (the "Trusts"), established for the sole purpose of issuing trust preferred securities on September 22, 2003 and December 29, 2005, respectively. The subordinated debentures were recorded at fair values totaling $\$ 4.95$ million at acquisition date with contractual values totaling $\$ 8.2$ million. The difference between the contractual balance and the fair value at acquisition date is accreted into interest expense over the lives of the debentures. Accretion on the subordinated debentures totaled \$106 thousand in the first six months of 2015 and $\$ 108$ thousand in the first six months of 2014. We have the option to defer payment of the interest on the subordinated debentures for a period of up to five years, as long as there is no default on the subordinated debentures. In the event of interest deferral, dividends to Bank of Marin Bancorp common stockholders are prohibited. The trust preferred securities were sold and issued in private transactions pursuant to an exemption from registration under the Securities Act of 1933, as amended. Bancorp has guaranteed, on a subordinated basis, distributions and other payments due on trust preferred securities
totaling $\$ 8.0$ million issued by the Trusts which have identical maturity, repricing and payment terms as the subordinated debentures.

The following is a summary of the contractual terms of the subordinated debentures due to the Trusts as of June 30, 2015:
(in thousands; unaudited)
Subordinated debentures due to NorCal Community Bancorp Trust I on October 7, 2033 with interest payable quarterly, based on 3-month LIBOR plus 3.05\%, repricing quarterly ( $3.33 \%$ as of $\$ 4,124$ June 30, 2015), redeemable, in whole or in part, on any interest payment date Subordinated debentures due to NorCal Community Bancorp Trust II on March 15, 2036 with interest payable quarterly, based on 3-month LIBOR plus $1.40 \%$, repricing quarterly ( $1.69 \%$ as of4,124 June 30, 2015), redeemable, in whole or in part, on any interest payment date Total \$8,248

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Note 7: Stockholders' Equity
Warrant
Under the United States Department of the Treasury Capital Purchase Program (the "TCPP"), Bancorp issued to the U.S. Treasury a warrant to purchase 154,242 shares of common stock at a per share exercise price of $\$ 27.23$. The warrant was immediately exercisable and expires on December 5, 2018. The warrant was subsequently auctioned to two institutional investors in November 2011 and remains outstanding. It is adjusted for cash dividend increases and represents a right to purchase 157,445 shares of common stock at $\$ 26.68$ per share as of June 30, 2015 in accordance with Section 13(c) of the Form of Warrant to Purchase Common Stock.

## Dividends

Presented below is a summary of cash dividends paid to common shareholders, recorded as a reduction of retained earnings.
(in thousands, except per share data; unaudited)
Cash dividends to common stockholders
Cash dividends per common share

| Three months ended |  | Six months ended |  |
| :--- | :--- | :--- | :--- |
| June 30, 2015 | June 30, 2014 | June 30, 2015 | June 30, 2014 |
| $\$ 1,313$ | $\$ 1,123$ | $\$ 2,620$ | $\$ 2,243$ |
| $\$ 0.22$ | $\$ 0.19$ | $\$ 0.44$ | $\$ 0.38$ |

## Share-Based Payments

The fair value of stock options as of the grant date is recorded as a stock-based compensation expense in the consolidated statements of comprehensive income over the requisite service period with a corresponding increase in common stock. Stock-based compensation also includes compensation expense related to the issuance of unvested restricted stock awards and performance-based stock awards pursuant to the 2007 Equity Plan. The grant-date fair value of the restricted stock awards and performance-based stock awards, which is equal to the intrinsic value on that date, is being recorded as compensation expense over the requisite service period with a corresponding increase in common stock as the shares vest.

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

In addition, we record excess tax benefits on the exercise of non-qualified stock options, the disqualifying disposition of incentive stock options and vesting of restricted stock awards as an addition to common stock with a corresponding decrease in current taxes payable.

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

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Note 8: Commitments and Contingencies

## Financial Instruments with Off-Balance Sheet Risk

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

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

The contractual amount of loan commitments and standby letters of credit not reflected on the consolidated statements of condition was $\$ 347.8$ million at June 30, 2015. This amount included $\$ 185.1$ million under commercial lines of credit (these commitments are generally contingent upon customers maintaining specific credit standards), $\$ 119.5$ million under revolving home equity lines, $\$ 28.8$ million under undisbursed construction loans, $\$ 3.3$ million under standby letters of credit, and a remaining $\$ 11.1$ million under personal and other lines of credit. We record an allowance for losses on these off-balance sheet commitments based on an estimate of probabilities of these commitments being drawn upon according to our historical utilization experience on different types of commitments and expected loss severity. We set aside an allowance for losses on off-balance sheet commitments in the amount of $\$ 703$ thousand and $\$ 1.0$ million for these commitments as of June 30, 2015 and December 31, 2014, respectively, which is recorded in interest payable and other liabilities on the consolidated statements of condition. A reduction in reserve requirements for off-balance sheet commitments due to the reduced effect of historical charge-offs resulted in the decline in the allowance for losses on off-balance sheet commitments in the first half of 2015.

## Operating Leases

We rent certain premises and equipment under long-term, non-cancelable operating leases expiring at various dates through the year 2028. Most of the leases contain certain renewal options and escalation clauses. At June 30, 2015, the approximate minimum future commitments payable under non-cancelable contracts for leased premises are as follows:

| (in thousands; unaudited) | 2015 | 2016 | 2017 | 2018 | 2019 | Thereafter | Total |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Operating leases ${ }^{1}$ | $\$ 1,880$ | $\$ 3,763$ | $\$ 3,755$ | $\$ 3,784$ | $\$ 3,526$ | $\$ 6,678$ | $\$ 23,386$ |

${ }^{1}$ Minimum payments have not been reduced by minimum sublease rentals of $\$ 295$ thousand due in the future under non-
cancelable subleases.

## Litigation Matters

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

We are responsible for our proportionate share of certain litigation indemnifications provided to Visa U.S.A. ("Visa") by its member banks in connection with lawsuits related to anti-trust charges and interchange fees ("Covered Litigation"). Visa Inc. maintains an escrow account from which settlements of, or judgments in, the covered litigation are paid. According to the latest SEC Form 10-Q filed by Visa, Inc. on July 23, 2015, at June 30, 2015, the balance of the escrow account was $\$ 1.1$ billion. On January 14, 2015, following a Court-approved process to give class members who previously opted out of the damages portion of the class settlement an option to rejoin it, the class administrator submitted a report stating that it had received 1,179 requests by merchants to rejoin the cash settlement class, some of which may include multiple merchants. The conversion rate of Visa Class B common stock held by us to Class A common stock (as discussed in Note 4) may reduce if Visa makes more Covered Litigation settlement payments in

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the future, and the full impact to member banks is still uncertain. However, we are not aware of significant future cash settlement payments required by us on the Covered Litigation.

Note 9: Derivative Financial Instruments and Hedging Activities
We have entered into interest rate swap agreements, primarily as an asset/liability management strategy, in order to mitigate the changes in the fair value of specified long-term fixed-rate loans (or firm commitments to enter into long-term fixed-rate loans) caused by changes in interest rates. These hedges allow us to offer long-term fixed rate loans to customers without assuming the interest rate risk of a long-term asset. Converting our fixed-rate interest payments to floating-rate interest payments, generally benchmarked to the one-month U.S. dollar LIBOR index, protects us against changes in the fair value of our loans associated with fluctuating interest rates.

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

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

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

Our credit exposure, if any, on interest rate swaps is limited to the favorable value (net of any collateral pledged to us) and interest payments of all swaps by each counterparty. Conversely, when an interest rate swap is in a liability position exceeding a certain threshold, we may be required to post collateral to the counterparty in an amount determined by the agreements (generally when our derivative liability position is greater than $\$ 100$ thousand or $\$ 250$ thousand, depending upon the counterparty). Collateral levels are monitored and adjusted on a regular basis for changes in interest rate swap values.

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As of June 30, 2015, we had eight interest rate swap agreements, which are scheduled to mature in September 2018, June 2020, August 2020, June 2031, October 2031, July 2032, August 2037 and October 2037. All of our derivatives are accounted for as fair value hedges. Our interest rate swaps are settled monthly with counterparties. Accrued interest on the swaps totaled $\$ 36$ thousand and $\$ 41$ thousand as of June 30, 2015 and December 31, 2014, respectively. Information on our derivatives follows:

Asset derivatives
(in thousands; 2015 unaudited)
June 30, 2015
Liability derivatives

Fair value hedges:

| Interest rate contracts notional | $\$ 4,499$ | $\$ 4,589$ | $\$ 26,000$ | $\$ 26,899$ |
| :--- | :--- | :--- | :--- | :--- |
| amount | $\$ 116$ | $\$ 61$ | $\$ 1,631$ | $\$ 1,996$ |

(in thousands; unaudited)
Increase (decrease) in value of designated interest rate swaps recognized in interest income
Payment on interest rate swaps recorded in interest income
December 31,
2014 June 30, $2015 \quad \begin{aligned} & \text { December 31, } \\ & 2014\end{aligned}$
(Decrease) increase in value of hedged loans recognized in interest income
Three months ended

| June 30, 2015 | June 30, 2014 |  |
| :--- | :--- | :--- |
| $\$ 966$ | $\$(423$ | $)$ |
| $(233$ | $)$ | $(252$ |
| $(1,023$ | 453 |  |
| $(13$ | $)$ | $(15$ |
| $\$(303$ | $)$ | $\$(237$ |

(in thousands; unaudited)
Increase in value of designated interest rate swaps recognized in interest income
Payment on interest rate swaps recorded in interest income (469) (505)
Decrease in value of hedged loans recognized in interest income
Decrease in value of yield maintenance agreement recognized against interest income
Net loss on derivatives recognized against interest income ${ }^{2}$

| Six months ended <br> June 30, 2015 |  |  |
| :--- | :--- | :--- |
| $\$ 420$ | June 30, 2014 |  |
| $(469$ | $)$ | $(505$ |
| $(451$ | $)$ | $(78$ |
| $(27$ | $)$ | $(62$ |
| $\$(527$ | $)$ | $)$ |
|  |  | $)$ |
|  |  |  |

${ }^{1}$ See Note 3 for valuation methodology.
${ }^{2}$ Includes hedge ineffectiveness loss of $\$ 70$ thousand and gain of $\$ 15$ thousand for the quarters ended June 30, 2015 and June 30, 2014, respectively. Ineffectiveness loss of $\$ 58$ thousand and gain of $\$ 173$ thousand was recorded in interest income during the six months ended June 30, 2015 and June 30, 2014, respectively. Changes in value of swaps were included in the assessment of hedge effectiveness. Hedge ineffectiveness is the measure of the extent to which the change in the fair value of the hedging instruments does not offset the change in the fair value of the hedged items.

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

Information on financial instruments that are eligible for offset in the consolidated statements of condition follows: Offsetting of Financial Assets and Derivative Assets
(in thousands; 2015 unaudited)
Gross Amounts Not Offset in the Statements of Condition

|  | Gross <br> Amounts | Gross Amounts Offset in the | Net Amounts of Assets Presented |  | 兂 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | of Recognized Assets ${ }^{1}$ | Statements of Condition | in the Statements <br> of Condition ${ }^{1}$ | Financial <br> Instruments | Cash <br> Collateral <br> Received | Net Amount |
| As of June 30, 2015 |  |  |  |  |  |  |
| Derivatives by |  |  |  |  |  |  |
| Counterparty A | \$116 | \$- | \$116 | \$(116 | )\$- | \$- |
| Counterparty B | - | - | - | - | - | - |
| Total | \$116 | \$- | \$116 | \$(116 | ) \$- | \$- |

As of December 31,
2014
Derivatives by
Counterparty

| Counterparty A | $\$ 61$ | $\$-$ | $\$ 61$ | $\$(61$ | $) \$-$ | $\$-$ |
| ---: | :--- | :--- | :--- | :--- | :--- | :--- |
| Counterparty B | - | - | - | - | - | - |
| Total | $\$ 61$ | $\$-$ | $\$ 61$ | $\$(61$ | $) \$-$ | $\$-$ |

${ }^{1}$ Amounts exclude accrued interest totaling \$1 thousand at both June 30, 2015 and December 31, 2014, respectively. Offsetting of Financial Liabilities and Derivative Liabilities

|  | Gross <br> Amounts <br> of Recognized | Gross Amounts Offset in the Statements of | Net Amounts of Liabilities <br> Presented in the Statements of Condition ${ }^{2}$ | e Statements of Condit |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  | Financial | Cash Collateral |  |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
|  | Liabilities ${ }^{2}$ | Condition |  | Instruments | Pledged | Net Amount |
| As of June 30, 2015 |  |  |  |  |  |  |
| Derivatives by |  |  |  |  |  |  |
| Counterparty |  |  |  |  |  |  |
| Counterparty A | \$1,301 | \$- | \$1,301 | \$(116 | ) \$(1,185 | )\$- |
| Counterparty B | 330 | - | 330 | - | (330 | )- |
| Total | \$1,631 | \$- | \$1,631 | \$(116 | ) $\$(1,515$ | )\$- |

(in thousands; 2015 unaudited)
Gross Amounts Not Offset in the Statements of Condition

As of June 30, 2015
Derivatives by
Counterparty

As of December 31,
2014
Derivatives by
Counterparty

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

${ }^{2}$ Amounts exclude accrued interest totaling \$35 thousand and \$40 thousand at June 30, 2015 and December 31, 2014, respectively.

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ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Management's discussion of the financial condition and results of operations should be read in conjunction with the related consolidated financial statements in this Form 10-Q and with the audited consolidated financial statements and accompanying notes included in our 2014 Annual Report on Form 10-K. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

## Forward-Looking Statements

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

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

Forward-looking statements are based on Management's current expectations regarding economic, legislative, and regulatory issues that may impact our earnings in future periods. A number of factors-many of which are beyond Management's control-could cause future results to vary materially from current Management expectations. Such factors include, but are not limited to, the monetary polices of the FRB, general economic conditions, economic uncertainty in the United States and abroad, changes in interest rates, deposit flows, real estate values, costs or effects of future acquisitions, competition, changes in accounting principles, policies or guidelines; changes in legislation or regulation; adverse weather conditions, including the drought in California; and other economic, competitive, governmental, regulatory and technological factors (including external fraud and cyber-security) affecting our operations, pricing, products and services.

These and other important factors are detailed in the Risk Factors section of our 2014 Form $10-\mathrm{K}$ as filed with the SEC, copies of which are available from us at no charge. Forward-looking statements apply only as of the date they are made. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.

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## RESULTS OF OPERATIONS

Highlights of the financial results are presented in the following table:
For the three months ended (dollars in thousands, except per share data; unaudited)
For the period:

| Net income | $\$ 4,286$ | $\$ 5,168$ | $\$ 8,743$ | $\$ 9,701$ |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Net income per share |  |  |  |  |  |
| Basic | $\$ 0.72$ | $\$ 0.88$ | $\$ 1.47$ | $\$ 1.65$ |  |
| Diluted | $\$ 0.71$ | $\$ 0.86$ | $\$ 1.44$ | $\$ 1.62$ |  |
| Return on average equity | 8.33 | $\% 10.96$ | $\% 8.62$ | $\% 10.47$ | $\%$ |
| Return on average assets | 0.93 | $\% 1.14$ | $\% 0.96$ | $\% 1.08$ | $\%$ |
| Common stock dividend payout ratio | 30.66 | $\% 21.74$ | $\% 29.98$ | $\% 23.11$ | $\%$ |
| Average shareholders' equity to average | 11.17 | $\% 10.41$ | $\% 11.18$ | $\% 10.26$ | $\%$ |
| total assets | 64.62 | $\% 56.60$ | $\% 63.86$ | $\% 60.22$ | $\%$ |
| Efficiency ratio | 3.86 | $\% 4.23$ | $\% 3.93$ | $\% 4.24$ | $\%$ |

(dollars in thousands, except per share data; unaudited)
At period end:
Book value per common share
Total assets
Total loans
Total deposits
Loan-to-deposit ratio
Total risk-based capital ratio - Bancorp
Common equity Tier 1 ratio - Bancorp
Tier 1 leverage ratio (to average assets) -
Bancorp

June 30, 2015 June 30, 2014
\$4,286
\$0.72
$\$ 0.71$
0.93
30.66
11.17
64.62
3.86

June 30, 2015
\$34.63 \$33.68
\$1,870,762 \$1,787,130
\$1,339,205 \$1,363,351
\$1,630,483 \$1,551,619
82.1 \%87.9 \%
14.1 \% 13.9 \%
12.8 \%NA
11.1 \% 10.6 \%

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## Executive Summary

Earnings in the second quarter of 2015 totaled $\$ 4.3$ million, compared to $\$ 4.5$ million in the first quarter of 2015 and $\$ 5.2$ million in the second quarter of 2014. Diluted earnings per share totaled $\$ 0.71$ in the second quarter of 2015, compared to $\$ 0.74$ in the prior quarter and $\$ 0.86$ in the same quarter last year. For the six-month period ended June 30 , 2015, earnings totaled $\$ 8.7$ million compared to $\$ 9.7$ million for the same period a year ago. Diluted earnings per share for the six-month period ended June 30, 2015 totaled $\$ 1.44$ compared to $\$ 1.62$ in the same period a year ago. Low interest rates and significantly compressed margins continue to affect earnings.

Loans totaled $\$ 1.34$ billion at June 30, 2015, compared to $\$ 1.36$ billion at December 31, 2014. Strong new loan volume of approximately $\$ 82$ million in the first half of 2015 was offset by pay-offs of approximately $\$ 95$ million, and combined with utilization and amortization on existing loans resulted in a net decrease of $\$ 24.1$ million since December 31, 2014. Pay-offs resulted from our borrowers' successful completion of several large construction projects and the sale of business and commercial real estate assets, and included the resolution of problem credits. We expect a lower level of loan pay-offs in the second half of 2015.

Credit quality remains strong with non-accrual loans continuing to trend downward, totaling $\$ 7.1$ million at June 30, 2015, compared to $\$ 9.4$ million at December 31, 2014, and representing $0.53 \%$ of total loans compared to $0.69 \%$ for the same time periods. The decrease in non-accrual loans primarily relates to a protracted problem land development loan that was sold in the second quarter resulting in an $\$ 839$ thousand charge-off to the allowance for loan losses. Classified loans totaled $\$ 27.8$ million at June 30, 2015, down from $\$ 36.2$ million at December 31, 2014. Accruing loans past due 30 to 89 days totaled $\$ 1.2$ million at June 30, 2015, compared to $\$ 1.0$ million at December 31, 2014.

There was no provision for loan losses recorded in the second quarter of 2015 as the continued reduction in credit risk did not warrant a provision. This compares to no provision in the prior quarter and a provision of $\$ 600$ thousand in the second quarter of 2014. The ratio of allowance for loan losses ("ALLL") to total loans decreased to $1.07 \%$ at June 30, 2015, compared to $1.11 \%$ at December 31, 2014. The ratio of ALLL to total loans excluding the impact of acquired loans would have been $1.18 \%$ and $1.24 \%$ at June 30, 2015 and December 31, 2014, respectively.

Deposits totaled $\$ 1.6$ billion at June 30, 2015 and grew $\$ 78.9$ million over December 31, 2014. Non-interest bearing deposits increased to $45.5 \%$ of total deposits at June 30, 2015, compared to $43.2 \%$ at December 31, 2014. While day-to-day deposit volatility continues due to normal seasonal activity and new business ventures by several of our largest business customers, both average and ending balances are on an increasing trend.

The total risk-based capital ratio for Bancorp was $14.1 \%$ at June 30, 2015, compared to $13.9 \%$ at December 31, 2014. The common equity tier one ratio, a regulatory ratio under Basel III (Basel Committee on Bank Supervision guidelines for determining regulatory capital), was $12.8 \%$ at June 30, 2015. As reported in the Capital Adequacy section of this document, all four of our capital ratios are well above regulatory requirements for a well-capitalized institution under the new requirements that took effect January 1, 2015.

Net interest income totaled $\$ 16.5$ million in the second quarter of 2015, compared to $\$ 16.6$ million in the prior quarter and $\$ 17.9$ million in the same quarter a year ago. The tax-equivalent net interest margin was $3.86 \%, 4.00 \%$ and $4.23 \%$, for those respective periods. The decrease in tax-equivalent net interest margin from the prior quarter primarily relates to a higher concentration of low yielding cash balances and new loans and securities yielding lower rates. The decrease from the same quarter a year ago primarily relates to lower gains and accretion income related to acquired loans and new loans and securities yielding lower rates.

Non-interest income in the second quarter of 2015 totaled $\$ 2.6$ million, compared to $\$ 2.2$ million in the prior quarter and $\$ 2.4$ million in the same quarter a year ago. The increase from the prior quarter and same quarter a year ago
relates to a $\$ 305$ thousand special dividend from the Federal Home Loan Bank of San Francisco and a $\$ 147$ thousand payment from a bankruptcy claim recorded in miscellaneous income. The same increases from the second quarter of 2014 were partially offset by the absence of gains on the sale of investment securities and lower merchant card interchange fees in the second quarter of 2015.

Non-interest expense totaled $\$ 12.3$ million in the second quarter of 2015, compared to $\$ 11.8$ million in the prior quarter and $\$ 11.5$ million in the same quarter a year ago. The increase in non-interest expense from the prior quarter primarily relates to $\$ 337$ thousand in occupancy and depreciation expense relating to one-time lease accounting adjustments. The immaterial one-time lease accounting adjustments relate to the acceleration of leasehold amortization for one branch and the conversion of two leases to straight-line rent accounting. The increase in non-interest expense from

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the same quarter a year ago primarily relates to higher personnel expense due to annual merit increases and incentive compensation, and higher occupancy expense as discussed above.

## Critical Accounting Policies and Estimates

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

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

## Allowance for Loan Losses

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

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

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

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

We acquired certain loans with evidence of credit quality deterioration subsequent to their origination and for which it was probable, at acquisition, that we would be unable to collect all contractually required payments (Purchased Credit Impaired "PCI loans"). These loans were evaluated on an individual basis. The estimate of cash flows expected to be collected is updated each quarter and requires the continued use of key assumptions and estimates. We apply judgment to develop our estimate of cash flows given the current economic environment, impact of collateral value
changes, loan workout plans, changing probability of default, loss severities and prepayments. If we have probable decreases in cash flows expected to be collected on PCI loans, specific allowances are established to account for credit deterioration subsequent to acquisition. For acquired loans not considered credit impaired ("non-PCI"), we recognize the entire fair value discount accretion to interest income, based on contractual cash flows using an effective interest rate method for term loans, and on a straight line basis for revolving lines. When a non-PCI loan is placed on nonaccrual status subsequent to acquisition, accretion stops until the loan is returned to accrual status. The level of accretion on non-PCI loans varies from period to period due to maturities and early pay-offs of these loans during the reporting periods. Subsequent to acquisition, if the probable and estimable losses for non-PCI loans exceed the amount of the remaining unaccreted discount, the excess is established as an allowance for loan losses. All acquired loans were acquired in acquisitions and do not represent loans purchased from third parties.

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

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

While we believe we use the best information available to determine the allowance for loan losses, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A decline in local and national economic conditions, or significant changes in other assumptions, could result in a material increase in the allowance for loan losses and may adversely affect our financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance for loan losses based upon their judgment of information available to them at the time of their examination.

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

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

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

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

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

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

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

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

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

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

## Fair Value Measurements

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

When we develop our fair value measurement process, we maximize the use of observable inputs. Whenever there is no readily available market data, we use our best estimates and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these financial statements.

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

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## Net Interest Income

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

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

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

|  | Three months ended June 30, 2015 |  |  |  | Three months ended June 30, 2014 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | Interest |  |  |  | Interest |  |  |
|  | Average | Income/ | Yield/ |  | Average | Income/ | Yield/ |  |
| (dollars in thousands; unaudited) | Balance | Expense | Rate |  | Balance | Expense | Rate |  |
| Assets |  |  |  |  |  |  |  |  |
| Interest-bearing due from banks ${ }^{1}$ | \$76,710 | \$ 52 | 0.27 | \% | \$54,313 | \$37 | 0.27 | \% |
| Investment securities ${ }^{2,3}$ | 319,032 | 1,842 | 2.31 | \% | 350,938 | 2,208 | 2.52 | \% |
| Loans 1, 3, 4 | 1,336,249 | 15,587 | 4.61 | \% | 1,303,363 | 16,597 | 5.04 | \% |
| Total interest-earning assets ${ }^{1}$ | 1,731,991 | 17,481 | 3.99 | \% | 1,708,614 | 18,842 | 4.36 | \% |
| Cash and non-interest-bearing due from banks | 48,955 |  |  |  | 41,739 |  |  |  |
| Bank premises and equipment, net | 9,841 |  |  |  | 9,228 |  |  |  |
| Interest receivable and other assets, net | 58,744 |  |  |  | 56,954 |  |  |  |
| Total assets | \$ 1,849,531 |  |  |  | \$1,816,535 |  |  |  |
| Liabilities and Stockholders' Equity |  |  |  |  |  |  |  |  |
| Interest-bearing transaction accounts | \$94,960 | \$30 | 0.13 | \% | \$94,358 | \$26 | 0.11 | \% |
| Savings accounts | 131,564 | 12 | 0.04 | \% | 120,071 | 11 | 0.04 | \% |
| Money market accounts | 488,422 | 123 | 0.10 | \% | 504,597 | 131 | 0.10 | \% |
| Other time accounts | 157,982 | 215 | 0.55 | \% | 157,239 | 231 | 0.59 | \% |
| FHLB fixed-rate advance ${ }^{1}$ | 15,000 | 79 | 2.07 | \% | 15,000 | 78 | 2.07 | \% |
| Subordinated debenture ${ }^{1}$ | 5,259 | 105 | 7.90 | \% | 5,043 | 105 | 8.24 | \% |
| Total interest-bearing liabilities | 893,187 | 564 | 0.25 | \% | 896,308 | 582 | 0.26 | \% |
| Demand accounts | 735,481 |  |  |  | 716,774 |  |  |  |
| Interest payable and other liabilities | 14,358 |  |  |  | 14,281 |  |  |  |
| Stockholders' equity | 206,505 |  |  |  | 189,172 |  |  |  |
| Total liabilities \& stockholders' equity | \$ 1,849,531 |  |  |  | \$ 1,816,535 |  |  |  |
| Tax-equivalent net interest income/margin ${ }^{1}$ |  | \$ 16,917 | 3.86 | \% |  | \$ 18,260 | 4.23 | \% |
| Reported net interest income/margin ${ }^{1}$ |  | \$ 16,454 | 3.76 | \% |  | \$ 17,874 | 4.14 | \% |

# Tax-equivalent net interest rate spread 

3.74 \%
4.10

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|  | Six months June 30, 20 | $\begin{aligned} & \text { ended } \\ & 15 \end{aligned}$ |  |  | Six months <br> June 30, 20 | $\begin{aligned} & \text { ended } \\ & 14 \end{aligned}$ |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | Interest |  |  |  | Interest |  |  |
|  | Average | Income/ | Yield |  | Average | Income/ | Yield/ |  |
| (dollars in thousands; unaudited) | Balance | Expense | Rate |  | Balance | Expense | Rate |  |
| Assets |  |  |  |  |  |  |  |  |
| Interest-bearing due from banks ${ }^{1}$ | \$57,608 | \$72 | 0.25 | \% | \$69,945 | \$88 | 0.25 | \% |
| Investment securities ${ }^{2,3}$ | 315,525 | 3,770 | 2.39 | \% | 356,336 | 4,501 | 2.53 | \% |
| Loans 1, 3, 4 | 1,343,977 | 31,263 | 4.63 | \% | 1,286,197 | 33,117 | 5.12 | \% |
| Total interest-earning assets ${ }^{1}$ | 1,717,110 | 35,105 | 4.07 | \% | 1,712,478 | 37,706 | 4.38 | \% |
| Cash and non-interest-bearing due from banks | 45,036 |  |  |  | 41,766 |  |  |  |
| Bank premises and equipment, net | 9,840 |  |  |  | 9,158 |  |  |  |
| Interest receivable and other assets, net | 58,440 |  |  |  | 56,395 |  |  |  |
| Total assets | \$ 1,830,426 |  |  |  | \$ 1,819,797 |  |  |  |
| Liabilities and Stockholders' Equity |  |  |  |  |  |  |  |  |
| Interest-bearing transaction accounts | \$93,676 | \$60 | 0.13 | \% | \$ 110,637 | \$49 | 0.09 | \% |
| Savings accounts | 132,714 | 25 | 0.04 | \% | 120,671 | 22 | 0.04 | \% |
| Money market accounts | 487,630 | 250 | 0.10 | \% | 511,743 | 289 | 0.11 | \% |
| Other time accounts | 156,055 | 437 | 0.56 | \% | 159,080 | 466 | 0.59 | \% |
| FHLB borrowing and overnight borrowings ${ }^{1}$ | 15,197 | 156 | 2.07 | \% | 15,000 | 156 | 2.07 | \% |
| Subordinated debenture ${ }^{1}$ | 5,233 | 209 | 8.05 | \% | 5,015 | 210 | 8.48 | \% |
| Total interest-bearing liabilities | 890,505 | 1,137 | 0.26 | \% | 922,146 | 1,192 | 0.26 | \% |
| Demand accounts | 720,342 |  |  |  | 695,848 |  |  |  |
| Interest payable and other liabilities | 14,973 |  |  |  | 15,010 |  |  |  |
| Stockholders' equity | 204,606 |  |  |  | 186,793 |  |  |  |
| Total liabilities \& stockholders' equity | \$ 1,830,426 |  |  |  | \$ 1,819,797 |  |  |  |
| Tax-equivalent net interest income/margin ${ }^{1}$ |  | \$33,968 | 3.93 | \% |  | \$36,514 | 4.24 | \% |
| Reported net interest income/margin ${ }^{1}$ |  | 33,061 | 3.83 | \% |  | 35,768 | 4.15 | \% |
| Tax-equivalent net interest rate spread |  |  | 3.81 | \% |  |  | 4.12 | \% |

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## Second Quarter of 2015 Compared to Second Quarter of 2014

The tax-equivalent net interest margin was $3.86 \%$ in the second quarter of 2015 , compared to $4.23 \%$ in the same quarter a year ago. The decrease of thirty-seven basis points primarily relates to lower gains and accretion income related to acquired loans and new loans and securities yielding lower rates. The net interest spread decreased thirty-six basis points over the same period for the same reasons.

The average yield on interest-earning assets decreased thirty-seven basis points in the second quarter of 2015 compared to the second quarter of 2014 due to the reasons listed above. Average loans as a percentage of average interest-earning assets was $77.2 \%$ and $76.3 \%$ for the second quarter of 2015 and the second quarter of 2014, respectively. Total average interest-earning assets increased $\$ 23.3$ million, or $1.4 \%$, in the second quarter of 2015, compared to the second quarter of 2014 , due to an increase in average loans of $\$ 32.9$ million and an increase in average interest-bearing due from banks of $\$ 22.4$ million, partially offset by a decrease of $\$ 31.9$ million in average securities.

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

First Six Months of 2015 Compared to First Six Months of 2014
The tax-equivalent net interest margin was $3.93 \%$ in the first six months of 2015 compared to $4.24 \%$ in the same period last year. The decrease of thirty-one basis points was primarily due to lower gains and accretion income related to acquired loans and the impact of the low interest rate environment on our loan and investment portfolios, partially offset by a shift in the mix of earning assets to higher yielding loan balances. The net interest spread also decreased thirty-one basis points over the same period for the same reasons.

The average yield on interest-earning assets decreased thirty-one basis points in the first six months of 2015 compared to the first six months of 2014 due to the reasons listed above. The loan portfolio as a percentage of average interest-earning assets was $78.3 \%$ and $75.1 \%$ for the six months ended June 30, 2015 and 2014, respectively. Total average interest-earning assets increased $\$ 4.6$ million, or $.3 \%$, in the first six months of 2015 compared to the first six months of 2014 , due to an increase in average loans of $\$ 57.8$ million, partially offset by a decrease of $\$ 40.8$ million in average securities and a decrease in average interest-bearing due from banks of $\$ 12.3$ million.

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

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

Three months ended
June 30, 2015 June 30, 2014 June 30, $2015 \quad$ June 30, 2014


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## Provision for Loan Losses

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

There was no provision for loan losses recorded in the second quarter of 2015 as the continued reduction in credit risk did not warrant a provision, compared to a provision of $\$ 600$ thousand in the same quarter a year ago. There was no provision for loan losses recorded in the first six months of 2015 , compared to a provision of $\$ 750$ thousand for the same period a year ago.

The allowance for loan losses totaled $1.07 \%$ of loans at June 30, 2015, compared to $1.11 \%$ at December 31, 2014. Non-accrual loans totaled $\$ 7.1$ million, or $0.53 \%$ of Bancorp's loan portfolio at June 30, 2015, compared to $\$ 9.4$ million, or $0.69 \%$ at December 31, 2014. The decrease in non-accrual loans primarily relates to a protracted problem land development loan that was sold in the second quarter resulting in an $\$ 839$ thousand charge-off to the allowance for loan losses.

Impaired loan balances totaled $\$ 23.3$ million at June 30, 2015, compared to $\$ 25.2$ million at December 31, 2014, with specific valuation allowances of $\$ 1.1$ million at both June 30, 2015 and December 31, 2014. Classified loans, which have regulatory risk grades of "substandard" or "doubtful", decreased to $\$ 27.8$ million at June 30 , 2015, from $\$ 36.2$ million at December 31, 2014.

Net charge-offs in the second quarter of 2015 totaled $\$ 802$ thousand, compared to net recoveries of $\$ 68$ thousand in the same quarter a year ago. $\$ 839$ thousand of the charge-offs in the second quarter of 2015 related to the problem land loan that was sold as discussed above. Net charge-offs for the six months ended June 30, 2015 totaled $\$ 745$ thousand, compared to $\$ 75$ thousand for the same period a year ago. The percentage of net charge-offs/(recoveries) to average loans was $0.06 \%$ in the second quarter of 2015, compared to ( 0.01 )\% in the second quarter of 2014 and $0.06 \%$ for the six months ended June 30, 2015, compared to $0.01 \%$ for the same period a year ago.

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Non-interest Income
The table below details the components of non-interest income.
(dollars in thousands; unaudited)
Service charges on deposit accounts
Wealth Management and Trust Services
Debit card interchange fees
Merchant interchange fees
Earnings on bank-owned life insurance
Dividends on FHLB stock
Gain on sale of securities
Other income
Total non-interest income
(dollars in thousands; unaudited)
Service charges on deposit accounts Wealth Management and Trust Services
Debit card interchange fees
Merchant interchange fees
Earnings on bank-owned life insurance
Dividends on FHLB stock
Gain on sale of securities
Other income
Total non-interest income

Three months ended
June 30, 2015 June 30, 2014
$\$ 504 \quad \$ 528 \quad \$(24)(4.5 \quad) \%$
$603 \quad 613 \quad(10)(1.6) \%$
$368 \quad 360 \quad 8 \quad 2.2 \quad \%$
$129 \quad 207$ (78 ) (37.7 )\%
203 (8) 211 (3.8 )\%
$461 \quad 130 \quad 331 \quad 254.6 \quad \%$

- 97
$340 \quad 222$

| Amount | Percent |  |
| :--- | :--- | :--- |
| Increase | Increase |  |
| (Decrease) | (Decrease) |  |
| $\$(24$ | $)$ | $(4.5$ |
| $(10$ | $)$ | $(1.6$ |
|  | $) \%$ |  |
| $(78$ | 2.2 | $\%$ |
| $(8$ | $)$ | $(37.7$ |
| $(3.8$ | $) \%$ |  |
| 331 | 254.6 | $\%$ |
| $(97$ | $)$ | NM |
| 118 | 53.2 | $\%$ |
| $\$ 240$ | 10.1 | $\%$ |


| Six months ended |  | Amount <br> Increase <br> (Decrease) | Percent Increase (Decrease) |  |
| :---: | :---: | :---: | :---: | :---: |
| June 30, 2015 | June 30, 2014 |  |  |  |
| \$1,029 | \$1,084 | \$(55 ) | (5.1 | )\% |
| 1,241 | 1,177 | 64 | 5.4 | \% |
| 715 | 660 | 55 | 8.3 | \% |
| 259 | 405 | (146 ) | ) 36.0 | )\% |
| 406 | 424 | (18 ) | ) (4.2 | )\% |
| 608 | 260 | 348 | 133.8 | \% |
| 8 | 89 | (81 ) | ) NM |  |
| 531 | 485 | 46 | 9.5 | \% |
| \$4,797 | \$4,584 | \$213 | 4.6 | \% |

Non-interest income increased $\$ 240$ thousand to $\$ 2.6$ million in the second quarter of 2015 compared to $\$ 2.4$ million in the second quarter of 2014. The increase relates predominantly to a $\$ 305$ thousand special dividend from the Federal Home Loan Bank of San Francisco and a $\$ 147$ thousand payment from a bankruptcy claim recorded in miscellaneous income. The increase was partially offset by the absence of gains on the sale of investment securities and lower merchant card interchange fees.

Non-interest income increased $\$ 213$ thousand to $\$ 4.8$ million for the first six months of 2015 compared to $\$ 4.6$ million for the first six months of 2014. The increase resulted from the same reasons described above.

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Non-interest Expense

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

|  | Three months ended |  | $\begin{array}{l}\text { Amount } \\ \text { Increase }\end{array}$ | $\begin{array}{l}\text { Percent } \\ \text { Increase }\end{array}$ |
| :--- | :--- | :--- | :--- | :--- |
| (dollars in thousands; unaudited) | June 30,2015 | June 30, 2014 | $\begin{array}{l}\text { (Decrease) }\end{array}$ | $\begin{array}{l}\text { (Decrease) }\end{array}$ |
| Salaries and related benefits | $\$ 6,672$ | $\$ 6,232$ | $\$ 440$ | 7.1 |$)$

(dollars in thousands; unaudited)
$\begin{array}{ll}\text { Salaries and related benefits } & \$ 13 \\ \text { Occupancy and equipment } & 2,83 \\ \text { Depreciation and amortization } & 1,07 \\ \text { Federal Deposit Insurance Corporation insurance } & 48 \\ \text { Data processing } & 1,57\end{array}$
Professional services
Directors' expense
Information technology
Reversal of losses on off-balance sheet
commitments
Other non-interest expense

| Advertising | 122 | 199 | $(77$ | $(38.7$ | $) \%$ |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Other expense | 3,044 | 3,155 | $(111$ | $)$ | $(3.5$ | $) \%$ |
| Total other non-interest expense | 3,166 | 3,354 | $(188$ | $)$ | $(5.6$ | $) \%$ |
| Total non-interest expense | $\$ 24,176$ | $\$ 24,300$ | $\$(124$ | $)$ | $(0.5$ | $) \%$ |

Non-interest expense increased $\$ 862$ thousand to $\$ 12.3$ million in the second quarter of 2015 compared to $\$ 11.5$ million in the second quarter of 2014 . The increase was mainly due to $\$ 337$ thousand in occupancy and depreciation expenses for certain one-time lease accounting adjustments, higher personnel expenses due to annual merit increases and incentive compensation, an increase in director expenses due to education costs and strategic matters, and higher expenses related to other real estate owned ("OREO") included in other non-interest expense. The immaterial one-time
lease accounting adjustments relate to acceleration of leasehold amortization for one branch and the conversion Page-44
of two leases to straight-line rent accounting. The increase was partially offset by a $\$ 109$ thousand reversal of estimated losses on off-balance sheet loan commitments.

Non-interest expense decreased $\$ 124$ thousand to $\$ 24.2$ million for the first six months of 2015 compared to $\$ 24.3$ million for the first six months of 2014. The decrease was predominantly due to one-time NorCal acquisition costs for personnel, severance and data processing expenses recognized in the first six months of 2014 and a $\$ 310$ thousand reversal of estimated losses on off-balance sheet loan commitments in the first six months of 2015. The decrease was partially offset by higher incentive compensation, occupancy and depreciation, director expenses, and OREO expenses as noted above.

## Provision for Income Taxes

The provision for income taxes for the second quarter of 2015 totaled $\$ 2.5$ million at an effective tax rate of $36.4 \%$, compared to $\$ 3.0$ million at an effective tax rate of $36.9 \%$ in the same quarter last year. The provision for income taxes for the first half of 2015 totaled $\$ 4.9$ million at an effective tax rate of $36.1 \%$, compared to $\$ 5.6$ million at an effective tax rate of $36.6 \%$ for the first half of 2014. The decrease in the effective tax rate is primarily due to the expected increase in the amount of tax-exempt interest on municipal securities and loans in 2015. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax 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, BOLI and certain tax-exempt loans). As a result, there are fluctuations in the effective rate from period to period based on the relationship of net permanent differences to income before tax.

We file a consolidated return in the U.S. Federal tax jurisdiction and a combined return in the State of California tax jurisdiction. There were no ongoing federal or state income tax examinations at the issuance of this report. In June 2015, the State of California completed its examination of the 2011 and 2012 corporate income tax returns, resulting in a minor adjustment. At June 30, 2015, neither the Bank nor Bancorp had accruals for interest and penalties related to unrecognized tax benefits.

## FINANCIAL CONDITION SUMMARY

During the first six months of 2015, total assets increased $\$ 83.6$ million to $\$ 1.9$ billion. The primary components of the increase in assets were increases in cash and cash equivalents of $\$ 76.2$ million and investment securities of $\$ 31.2$ million, partially offset by a decrease of $\$ 24.1$ million in loans. New loan volume of approximately $\$ 82$ million in the first six months of 2015 was offset by pay-offs of approximately $\$ 95$ million, and combined with utilization and amortization on existing loans produced a net decrease of $\$ 24.1$ million over December 31, 2014. The decline in 2015 resulted from our borrowers' successful completion of several large construction projects and the sale of business and commercial real estate assets, and included the resolution of problem credits. Our loan and deposit pipelines are robust and we are seeing growth prospects in all of our markets.

## Investment Securities

Investment securities in our portfolio that may be backed by mortgages having sub-prime or Alt-A features (certain privately issued CMOs) represent $0.4 \%$ of our total investment portfolio at June 30, 2015, compared to $1.0 \%$ at December 31, 2014.

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

The table below summarizes our investment in obligations of state and political subdivisions at June 30, 2015 and December 31, 2014.

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| (dollars in thousands; unaudited) | June 30, 2015 |  | December 31, 2014 |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Amortized <br> Cost | Fair Value | \% of Total <br> State and <br> Political <br> Subdivisions | Amortized <br> Cost | Fair Value | $\%$ of <br> State a <br> Politic <br> Subdiv |  |
| Within California: |  |  |  |  |  |  |  |
| General obligation bonds | \$ 19,927 | \$ 19,955 | 21.9 \% | \$18,556 | \$ 18,734 | 23.4 | \% |
| Revenue bonds | 17,788 | 18,130 | 19.5 \% | 21,344 | 21,684 | 27.0 | \% |
| Tax allocation bonds | 6,229 | 6,336 | 6.8 \% | 6,280 | 6,446 | 7.9 | \% |
| Total in California | 43,944 | 44,421 | 48.2 \% | 46,180 | 46,864 | 58.3 | \% |
| Outside California: |  |  |  |  |  |  |  |
| General obligation bonds | 32,427 | 33,281 | 35.6 \% | 22,549 | 23,680 | 28.5 | \% |
| Revenue bonds | 14,720 | 14,690 | 16.2 \% | 10,429 | 10,457 | 13.2 | \% |
| Total outside California | 47,147 | 47,971 | 51.8 \% | 32,978 | 34,137 | 41.7 | \% |
| Total obligations of state and political subdivisions | \$91,091 | \$92,392 | 100.0 \% | \$79,158 | \$81,001 | 100.0 | \% |

The portion of the portfolio outside the state of California is distributed among eighteen states. The largest concentrations are in Washington (6.0\%), Ohio (5.4\%), Virginia (4.8\%), New York (4.5\%) and Texas (4.4\%). Revenue bonds, both within and outside California, primarily consisted of bonds relating to essential services (such as roads and utilities) and school district bonds.

Investments in states, municipalities and political subdivisions are subject to an initial pre-purchase credit assessment and ongoing monitoring. Key considerations include:

The soundness of a municipality's budgetary position and stability of its tax revenues
Debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority of the issuer Local demographics/economics including unemployment data, largest local employers, income indices and home values
For revenue bonds, the source and strength of revenue for municipal authorities including the obligor's financial condition and reserve levels, annual debt service and debt coverage ratio, and credit enhancement (such as insurer's strength)
Credit ratings by major credit rating agencies
There are two California tax allocation bonds totaling 2.1 million in both amortized cost and fair value for which Moody's credit ratings diverge from the internal assessment. In June 2012, Moody's Investor Service downgraded to Ba 1 all uninsured California redevelopment agency tax allocation bonds ("RDA"s) that were rated Baa3 or higher. The downgrade to Ba 1 was prompted by the increased risk of default resulting from the state's dissolution of all redevelopment agencies. The downgrade was based on the potential risk that new laws governing "successor" agencies (Assembly bills 26 and 1484) might further reduce credit quality, and uncertainty as to whether there was sufficient information available to assess the credit quality of tax allocation bonds. In 2013, certain ratings of RDAs were withdrawn by Moody's. Internal research shows the dispute between the California State Department of Finance and certain successor agencies regarding funds on hand required for payment of debt service, has been successfully resolved in the successor agencies' favor by the State Superior Court. In addition, the California State Department of Finance is in the process of approving refinancing requests from the successor agencies. Debt coverage ratios and assessed property value trends indicate that Moody's rating downgrade/withdrawal is not necessarily reflective of the issuers' credit profiles.

## Loans

New loan originations were strong at approximately $\$ 82$ million in the first six months of 2015 , reflecting our success in sourcing commercial real estate and commercial/industrial loans from new and existing customers. Our long term strategy to diversify and grow has produced strong loan growth in several markets. Loan originations were offset by pay-offs of approximately $\$ 95$ million resulting from the sale of real properties as customers took advantage of high

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valuations, the Bank's borrowers' successful completion of a number of large construction projects, and the resolution of problem credits. These activities led to a $\$ 24.1$ million decline in net loans from December 31, 2014.

Our residential loan portfolio does not include sub-prime loans, nor is it our practice to underwrite loans commonly referred to as "Alt-A mortgages," the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or collateral compositions reflecting high loan-to-value ratios. Refer to Note 5 for the composition of outstanding loans by class.

Liabilities
During the first six months of 2015, total liabilities increased $\$ 76.5$ million to $\$ 1.7$ billion. At June 30,2015 , deposits totaled $\$ 1.6$ billion and grew $\$ 78.9$ million over December 31, 2014. Non-interest-bearing deposits increased $\$ 70.2$ million and total time deposits increased $\$ 9.4$ million. CDARS time deposits increased $\$ 14.0$ million from December 31, 2014, as Management made a strategic decision to bring back CDARS reciprocal deposits in the first quarter of 2015 . While day-to-day deposit volatility continues due to normal seasonal activity and new business ventures by several of our largest business customers, both average and ending balances are on an increasing trend.

## Capital Adequacy

We 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 our consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our 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 directly applicable to bank holding companies such as Bancorp.

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.

Capital ratios are reviewed by Management on a regular basis to ensure that capital exceeds the prescribed regulatory minimums and is adequate to meet our 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.

In July 2013, the Board of Governors of the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency, finalized regulatory capital rules known as "Basel III". The rules became effective beginning January 2015, and will be phased-in and become fully implemented by January 2019. The guidelines, among other things, changed the minimum capital requirements of bank holding companies, by increasing the Tier 1 capital to risk-weighted assets ratio to $6 \%$, and introducing a new requirement to maintain a minimum ratio of common equity Tier 1 capital to risk-weighted assets of $4.5 \%$. By 2019 , when fully phased in, the rules will require further increases to certain minimum capital requirements and a capital conservation buffer of an additional $2.5 \%$ of risk-weighted assets. Basel III permits certain banks such as us to exclude accumulated other comprehensive income or loss from regulatory capital through a one-time election in the first quarter of 2015. As this is consistent with our existing treatment of excluding accumulated other comprehensive income or loss from regulatory capital, there were no changes to our capital ratios as a result of making this election. In addition, there are other deductions from capital and changes to risk-weighting of assets. The changes that affected us most significantly include:
shifting off-balance sheet items with an original maturity of one year or less from $0 \%$ to $20 \%$ risk weight, moving past due loan balances from $100 \%$ to $150 \%$ risk weight, deducting deferred tax assets associated with NOLs and tax credits from common equity Tier 1 capital, and subjecting deferred tax assets related to temporary timing differences that exceed certain thresholds to $250 \%$ risk-weighting, beginning in 2018.

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We have modeled our ratios under the fully phased-in Basel III rules, and we do not expect that we will be required to raise additional capital as a result of the fully phased-in rules.

To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 leverage, and common equity Tier 1 ratios as set forth in the second table below. As of June 30, 2015, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that Management believes have changed the Bank's categories and we expect the Bank to remain well capitalized under minimum requirements for capital adequacy in accordance with Basel III rules for prompt corrective action pursuant to Section 38 of the Federal Deposit Insurance Act on a fully phased-in basis.

The Bank's and Bancorp's capital adequacy ratios as of June 30, 2015 and December 31, 2014 are presented in the following tables. Bancorp's Tier 1 capital includes the subordinated debentures, which are not included at the Bank level. We continued to build capital in 2015 through the accumulation of net income.

Capital Ratios for Bancorp
(dollars in thousands; 2015 unaudited)
As of June 30, 2015
Total Capital (to risk-weighted assets)
Tier 1 Capital (to risk-weighted assets)
Tier 1 Capital (to average assets)
Common Equity Tier 1 (to risk-weighted assets)
As of December 31, 2014
Total Capital (to risk-weighted assets)
Tier 1 Capital (to risk-weighted assets)
Tier 1 Capital (to average assets)

Actual Ratio

| Amount | Ratio | Amount | Ratio |
| :--- | :--- | :--- | :--- |
| $\$ 218,512$ | 14.10 | $\% \geq \$ 124,008$ | $\geq 8.0 \%$ |
| $\$ 203,455$ | 13.13 | $\% \geq \$ 93,006$ | $\geq 6.0 \%$ |
| $\$ 203,455$ | 11.07 | $\% \geq \$ 73,538$ | $\geq 4.0 \%$ |
| $\$ 198,799$ | 12.82 | $\% \geq \$ 69,755$ | $\geq 4.5 \%$ |


| $\$ 210,067$ | 13.94 | $\% \geq \$ 20,580$ | $\geq 8.0 \%$ |
| :--- | :--- | :--- | :--- |
| $\$ 193,956$ | 12.87 | $\% \geq \$ 0,290$ | $\geq 4.0 \%$ |
| $\$ 193,956$ | 10.62 | $\% \geq \$ 3,079$ | $\geq 4.0 \%$ |

Ratio to be Well
Capitalized under Prompt
Corrective Action
Provisions

| As of June 30, 2015 | Amount | Ratio |  | Amount | Ratio | Amount | Ratio |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Total Capital (to risk-weighted assets) | \$214,059 | 13.82 | \% | $\geq \$ 123,953$ | $\geq 8.0 \%$ | $\geq \$ 154,942$ | $\geq 10.0 \%$ |
| Tier 1 Capital (to risk-weighted assets) | \$199,001 | 12.84 | \% | $\geq \$ 92,965$ | $\geq 6.0 \%$ | $\geq \$ 123,953$ | $\geq 8.0 \%$ |
| Tier 1 Capital (to average assets) | \$199,001 | 10.83 | \% | $\geq \$ 73,513$ | $\geq 4.0 \%$ | $\geq \$ 91,891$ | $\geq 5.0 \%$ |
| Common Equity Tier 1 (to risk-weighted assets) | \$199,001 | 12.84 | \% | $\geq \$ 69,724$ | $\geq 4.5 \%$ | $\geq \$ 100,712$ | $\geq 6.5 \%$ |
| As of December 31, 2014 |  |  |  |  |  |  |  |
| Total Capital (to risk-weighted assets) | \$206,465 | 13.70 | \% | $\geq$ \$20,553 | $\geq 8.0$ | $\% \geq \$ 50,692$ | $\geq 10.0$ |
| Tier 1 Capital (to risk-weighted assets) | \$190,354 | 12.63 | \% | $\geq \$ 0,277$ | $\geq 4.0$ | $\% \geq 90,415$ | $\geq 6.0$ |
| Tier 1 Capital (to average assets) | \$ 190,354 | 10.42 |  | $\geq$ \$3,064 | $\geq 4.0$ | $\% \geq \$ 1,330$ | $\geq 5.0$ |

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## Liquidity

The goal of liquidity management is to provide adequate funds to meet loan demand and fund operating activities and deposit withdrawals. We accomplish this goal by maintaining an appropriate level of liquid assets and formal lines of credit with the FHLB, FRBSF and correspondent banks that enable us to borrow funds as needed. Our ALCO, which is comprised of certain directors of the Bank, is responsible for approving and monitoring our liquidity targets and strategies. ALCO has approved a contingency funding plan that addresses decreases in liquidity below internal requirements.

We obtain funds from the repayment and maturity of loans as well as deposit inflows, investment security maturities and pay-downs, federal funds purchases, FHLB advances, and other borrowings. Our primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposits, maturities of certificates of deposits, repayment of borrowings, and dividends to common stockholders.

Management monitors our liquidity position daily. Our liquid assets totaled $\$ 324.2$ million at June 30, 2015 which includes unencumbered available-for-sale securities and cash. We attract and retain new deposits, which depends upon the variety and effectiveness of our customer account products, service and convenience, and rates paid to customers; as well as, our financial strength. Any long-term decline in retail deposit funding would adversely impact our liquidity. Management regularly adjusts our investments in liquid assets based upon our assessment of expected loan demand, expected deposit flows, yields available on interest-earning securities and the objectives of our asset/liability management program. In addition, we have secured borrowing capacity through the FHLB and FRBSF that can be drawn upon. Management anticipates our current strong liquidity position and core deposit base will provide adequate liquidity to fund our operations.

As presented in the accompanying unaudited consolidated statements of cash flows, the sources of liquidity vary between periods. Our cash and cash equivalents at June 30, 2015 totaled $\$ 117.5$ million, an increase of $\$ 76.2$ million from December 31, 2014. The primary sources of funds during the first six months of 2015 included a net increase in deposits of $\$ 78.9$ million, $\$ 46.1$ million in proceeds from sales, pay-downs and maturities of investment securities, $\$ 22.8$ million in loan principal collections (net of loan originations), and $\$ 9.1$ million net cash provided by operating activities. The primary uses of funds were $\$ 79.1$ million in purchases of investment securities and cash dividends paid to common stockholders of $\$ 2.6$ million.

In addition to cash and cash equivalents, we have substantial additional borrowing capacity including unsecured lines of credit totaling $\$ 72.0$ million with correspondent banks. Further, we have borrowing capacity with the FRBSF, which totaled $\$ 32.8$ million at June 30, 2015 and is secured by a certain residential loan portfolio. As of June 30, 2015, there was no debt outstanding to correspondent banks or the FRBSF. We are also a member of the FHLB and have a line of credit (secured under terms of a blanket collateral agreement by a pledge of essentially all of our unencumbered financial assets) in the amount of $\$ 456.5$ million, of which $\$ 441.2$ million was available at June 30, 2015. Borrowings under the line are limited to a certain percentage of eligible collateral. The interest rates on overnight borrowings with both correspondent banks and the FHLB are determined daily and generally approximate the federal funds target rate.

Undisbursed loan commitments, which are not reflected on the consolidated statements of condition, totaled \$347.8 million at June 30, 2015. This amount included $\$ 185.1$ million under commercial lines of credit (these commitments are generally contingent upon customers maintaining specific credit standards), $\$ 119.5$ million under revolving home equity lines, $\$ 28.8$ million under undisbursed construction loans, $\$ 3.3$ million under standby letters of credit, and a remaining $\$ 11.1$ million under personal and other lines of credit. We have set aside an allowance for losses in the amount of $\$ 703$ thousand for these commitments as of June 30, 2015, which is recorded in interest payable and other liabilities on the consolidated statements of condition. These commitments, to the extent used, are expected to be
funded primarily through the repayment of existing loans, deposit growth and existing balance sheet liquidity. Over the next twelve months, $\$ 99.8$ million of time deposits will mature. We expect these funds to be replaced with new deposits. Our emphasis on local deposits combined with our well capitalized equity position, provides a very stable funding base.

Since Bancorp is a holding company and does not conduct regular banking operations, its primary source of liquidity is dividends from the Bank. Under the California Financial Code, payment of a dividend from the Bank to Bancorp without advance regulatory approval is restricted to the lesser of the Bank's retained earnings or the total of the Bank's undistributed net profits from the previous three fiscal years. The primary uses of funds for Bancorp are shareholder dividends, interest payments on subordinated debentures and ordinary operating expenses. Bancorp held $\$ 3.8$ million of cash at June 30, 2015. Bancorp obtained a dividend distribution from the Bank in the amount of $\$ 3.5$ million in

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January of 2015. These funds are deemed sufficient to cover Bancorp's operational needs and cash dividends to shareholders through the end of 2015. 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

Market risk is defined as the risk of loss arising from an adverse change in the market value (or prices) of financial instruments. Our most significant form of market risk is interest rate risk, which is inherent in our investment, borrowing, lending and deposit gathering activities. The Bank manages interest rate sensitivity to minimize the exposure of our net interest margin, earnings, and capital to changes in interest rates. 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.

To mitigate interest rate risk, the structure of the Consolidated Statement of Condition is managed with the objective of correlating the impacts of interest rate changes on loans and investments with those of deposits and borrowings. The asset liability management policy sets limits on the acceptable amount of change to net interest income and capital in different interest rate environments.

From time to time, we enter into interest rate swap contracts to mitigate the changes in the fair value of specified long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans caused by changes in interest rates. See Note 9 to the Consolidated Financial Statements in this Form 10-Q.

Exposure to interest rate risk is reviewed at least quarterly by ALCO and the Board of Directors. Simulation models are used to measure interest rate risk and to evaluate strategies to improve profitability. A simplified statement of condition is prepared on a quarterly basis as a starting point, using as inputs, actual loans, investments, borrowings and deposits. If potential changes to net equity value and net interest income resulting from hypothetical interest rate changes are not within the limits established by the Board of Directors, Management may adjust the asset and liability mix to bring the risk position within approved limits.

Since 2008, there have been no changes in the federal funds target rate which has been kept at an historic low level of $0-0.25 \%$. The Bank currently has low interest rate risk and is asset sensitive (net interest margin positioned to increase if rates go up). If market rates rise, we expect net interest income to increase as adjustable rate loans at their interest rate floors start to float again as they reprice.

Based on our most recent simulation, net interest income is positioned to increase by approximately $5.3 \%$ in year one given an immediate 200 basis point increase in interest rates. For modeling purposes, the likelihood of a decrease in interest rates beyond 25 basis points as of June 30, 2015 was considered to be remote given prevailing low interest rate levels. The interest rate risk is within policy guidelines established by ALCO and the Board of Directors.

## ITEM 4. Controls and Procedures

Bank of Marin Bancorp and its subsidiary (the "Company") conducted an evaluation under the supervision and with the participation of our Management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act of 1934 (the "Act")) as of the end of the period covered by this report. The term disclosure controls and procedures means controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Act ( 15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that
information required to be disclosed by us in the reports that we file or submit under the Act is accumulated and communicated to our Management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

During the last fiscal quarter, there was no significant change in our internal control over financial reporting that has materially affected, or is reasonably likely to affect, our internal control over financial reporting.

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## PART II OTHER INFORMATION

## ITEM 1 Legal Proceedings

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

We are responsible for our proportionate share of certain litigation indemnifications provided to Visa U.S.A. by its member banks in connection with lawsuits related to anti-trust charges and interchange fees. For further details, see Note 13 to the Consolidated Financial Statements in Item 8 of our 2014 Form 10-K and Note 8 to the Consolidated Financial Statements in this Form 10-Q herein.

## ITEM 1A Risk Factors

There have been no material changes from the risk factors previously disclosed in our 2014 Form 10-K. Refer to "Risk Factors" in Item 1A of our 2014 Form 10-K, pages 12 through 21.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds
We did not have any unregistered sales or repurchases of our equity securities during the three months ended June 30, 2015.

ITEM 3 Defaults Upon Senior Securities
None.

ITEM 4 Mine Safety Disclosures
Not applicable.
ITEM 5 Other Information
None.

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## ITEM 6 Exhibits

The following exhibits are filed as part of this report or hereby incorporated by references to filings previously made with the SEC.

| Exhibit <br> Number | Exhibit Description | Incorporated by Reference |  |  | Filing Date | Herewith |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | Form | File No. | Exhibit |  |  |
| 2.01 | Modified Whole Bank Purchase and Assumption Agreement dated February 18, 2011 among Federal Deposit Insurance Corporation, Receiver of Charter Oak Bank, Napa, California, Federal Deposit Insurance Corporation, and Bank of Marin | 8-K | 001-33572 | 99.2 | February 28, 2011 |  |
| 2.02 | Agreement and Plan of Merger with NorCal Community Bancorp, dated July 1, 2013 | 8-K | 001-33572 | 2.1 | July 5, 2013 |  |
| 3.01 | Articles of Incorporation, as amended | 10-Q | 001-33572 | 3.01 | $\begin{aligned} & \text { November 7, } \\ & 2007 \end{aligned}$ |  |
| 3.02 | Bylaws | 10-Q | 001-33572 | 3.02 | May 9, 2011 |  |
| 3.02a | Bylaw Amendment | 8-K | 001-33572 | 3.03 | July 6, 2015 |  |
| 4.01 | Rights Agreement dated as of July 2, 2007 | 8-A12B | 001-33572 | 4.1 | July 2, 2007 |  |
| 4.02 | Form of Warrant for Purchase of Shares of Common Stock, as amended | POS <br> AM S-3 | 333-156782 | 4.4 | $\begin{aligned} & \text { December 20, } \\ & 2011 \end{aligned}$ |  |
| 10.01 | 2007 Employee Stock Purchase Plan | S-8 | 333-144810 | 4.1 | July 24, 2007 |  |
| 10.02 | 1989 Stock Option Plan | S-8 | 333-144807 | 4.1 | July 24, 2007 |  |
| 10.03 | 1999 Stock Option Plan | S-8 | 333-144808 | 4.1 | July 24, 2007 |  |
| 10.04 | 2007 Equity Plan | S-8 | 333-144809 | 4.1 | July 24, 2007 |  |
| 10.05 | 2010 Director Stock Plan | S-8 | 333-167639 | 4.1 | June 21, 2010 |  |
| 10.06 | Form of Indemnification Agreement for Directors and Executive Officers dated August 9, 2007 | 10-Q | 001-33572 | 10.06 | $\begin{aligned} & \text { November 7, } \\ & 2007 \end{aligned}$ |  |
| 10.07 | Form of Employment Agreement dated January 23, 2009 | 8-K | 001-33572 | 10.1 | $\begin{aligned} & \text { January 26, } \\ & 2009 \end{aligned}$ |  |
| 10.08 | Intentionally left blank |  |  |  |  |  |
| 10.09 | 2010 Annual Individual Incentive Compensation Plan | 8-K | 001-33572 | 99.1 | $\begin{aligned} & \text { October 21, } \\ & 2010 \end{aligned}$ |  |
| 10.10a | Salary Continuation Agreements with executive officers, Russell Colombo, Chief Executive Officer and Peter Pelham, Director of Retail Banking, dated January 1, 2011 | 8-K | 001-33572 | $\begin{aligned} & 10.1 \\ & 10.4 \end{aligned}$ | $\begin{aligned} & \text { January 6, } \\ & 2011 \end{aligned}$ |  |
| 10.10b | Salary Continuation Agreements with executive officers, Tani Girton, Chief Financial Officer, dated October 18, 2013 and Elizabeth Reizman, Chief Credit Officer, dated July 20, 2014 | 8-K | 001-33572 | $\begin{aligned} & 10.2 \\ & 10.3 \end{aligned}$ | November 4, 2014 |  |
| 10.10c | Salary Continuation Agreements for executive officer Timothy Myers, Executive Vice President and Commercial Banking Manager, dated May 28, 2015 | 8-K | 001-33572 | 10.4 | June 2, 2015 |  |


| 10.11 | 2007 Form of Change in Control Agreement | 8-K | 001-33572 | 10.1 | $\begin{aligned} & \text { October 31, } \\ & 2007 \end{aligned}$ |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Information Technology Services |  |  |  |  |
| 10.12 | Agreement with Fidelity Information Services, LLC, dated July 11, 2012 | 8-K | 001-33572 | 10.1 | July 17, 2012 |

Earnings Per Share Computation - included
11.01 in Note 1 to the Consolidated Financial FiledStatementsCode of Ethical Conduct, dated October 17,2014Certification of Principal Executive Officerpursuant to Rule 13a-14(a)/15d-14(a) asadopted pursuant to Section 302 of theSarbanes-Oxley Act of 2002
Certification of Principal Financial Officerpursuant to Rule 13a-14(a)/15d-14(a) asadopted pursuant to Section 302 of theSarbanes-Oxley Act of 2002
Certification pursuant to 18 U.S.C. §1350 as
32.01 adopted pursuant to $\S 906$ of the ..... FiledSarbanes-Oxley Act of 2002
101.01* XBRL Interactive Data FileFurnished
*As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

## 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.

August 7, 2015
Date

August 7, 2015
Date

August 7, 2015
Date

Bank of Marin Bancorp (registrant)
/s/ Russell A. Colombo
Russell A. Colombo
President \&
Chief Executive Officer
(Principal Executive Officer)
/s/ Tani Girton
Tani Girton
Executive Vice President \&
Chief Financial Officer
(Principal Financial Officer)
/s/ Cecilia Situ
Cecilia Situ
First Vice President \&
Manager of Finance \& Treasury
(Principal Accounting Officer)


[^0]:    ${ }^{1}$ Interest income/expense is divided by actual number of days in the period times 360 days to correspond to stated interest rate terms, where applicable.
    2 Yields on available-for-sale securities are calculated based on amortized cost balances rather than fair value, as changes in fair value are reflected as a component of stockholders' equity. Investment security interest is earned on 30/360 day basis monthly.
    ${ }^{3}$ Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the Federal statutory rate of 35 percent.
    ${ }^{4}$ Average balances on loans outstanding include non-performing loans. The amortized portion of net loan origination fees is included in interest income on loans, representing an adjustment to the yield.

