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

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from __________________ to __________________

Commission File Number 001-33572

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

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

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

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

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

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

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

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

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

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

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

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

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

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

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

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

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

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

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

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Introductory Explanation

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

Note 1: Basis of Presentation

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

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

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

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

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

Note 2: Recently Issued Accounting Standards

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

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

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

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

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

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

Note 3: Acquisition

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

Note 4: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Disclosures about Fair Value of Financial Instruments

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

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

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

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

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

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

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

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

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

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

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

Note 5: Investment Securities

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

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

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

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

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

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

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

Other-Than-Temporarily Impaired Debt Securities

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

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

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

December 31, 2012	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
(In thousands)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity						
Obligations of state & political subdivisions	$33,196	$(427)	$—	$—	$33,196	$(427)
Corporate bonds	15,649	(107)	—	—	15,649	(107)
Total held-to-maturity	48,845	(534)	—	—	48,845	(534)
Available-for-sale						
MBS pass-through securities issued by FNMA and FHLMC	3,569	(40)	—	—	3,569	(40)
CMOs issued by FNMA	3,185	(2)	—	—	3,185	(2)
CMOs issued by GNMA	1,550	(1)	—	—	1,550	(1)
Debentures of government-sponsored agencies	9,899	(101)	—	—	9,899	(101)
Privately issued CMOs	4,214	(89)	203	(1)	4,417	(90)
Total available-for-sale	22,417	(233)	203	(1)	22,620	(234)
Total temporarily impaired securities	$71,262	$(767)	$203	$(1)	$71,465	$(768)

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

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

Securities Carried at Cost

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

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

Note 6: Loans and Allowance for Loan Losses

Credit Quality of Loans

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

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

(dollars in thousands; 2013 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential [1]	Installment and other consumer	Total
June 30, 2013								
30-59 days past due	$ 264	$ —	$ —	$ —	$ 198	$ —	$ 9	$ 471
60-89 days past due	94	—	—	—	—	—	1	95
Greater than 90 days past due (non-accrual) [2]	2,022	1,403	6,024	7,046	524	1,148	321	18,488
Total past due	2,380	1,403	6,024	7,046	722	1,148	331	19,054
Current	168,063	204,788	529,236	20,682	89,574	42,142	17,943	1,072,428
Total loans [3]	$ 170,443	$ 206,191	$ 535,260	$ 27,728				