Bank of Commerce Holdings
Form 10-Q
November 03, 2006

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

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 0-25135

Bank of Commerce Holdings

(Exact name of Registrant as specified in its charter)

California	94-2823865
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1951 Churn Creek Road Redding, California	96002
(Address of principal executive offices)	(Zip code)

Registrant s telephone number, including area code: (530) 224-3333

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, no par value per share

Indicate by check mark whether the Registrant (1) has filed all reports required 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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See the definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One)

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes o No þ

Outstanding shares of Common Stock, no par value, as of September 29, 2006: 8,926,842

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Index to Form 10-Q

		Page:
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements	
	Condensed Consolidated Balance Sheets September 30, 2006, December 31, 2005 and September 30, 2005	4
	Condensed Consolidated Statements of Income Three and nine months ended September 30, 2006 and 2005	5
	Condensed Consolidated Statements of Cash Flows Three and nine months ended September 30, 2006 and 2005	6
	Notes to Unaudited Condensed Consolidated Financial Statements	7
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	15
	Corporate Overview	15
	Lending Risks Associated with Commercial Banking and Construction Activities	18
	Dependence on Real Estate	18
	Risks Specific to Operations in California	18
	Interest Rate Risk	18
	Potential Volatility of Deposits	19
	Dividends	19
	Government Regulation and Legislation	19
	Economic Conditions and Geographic Concentration	19
	Reliance on Key Employees and Others	19
	Adequacy of Allowance for Loan and Lease Losses (ALLL)	20
	Certain Ownership Restrictions under California and Federal Law	20
	Shares Eligible for Future Sale	20
	Technology and Computer Systems	21
	Environmental Risks	21
	Dilution	21
	Unresolved Staff Comments	21
	Executive Overview	22
	Sources of Income	22
	Financial Highlights Results of Operations	23
	Net Interest Income and Net Interest Margin	23
	Liquidity	23
	Capital Management	24
	Short and long term borrowings	24
	Provision for loan and lease losses	25
	Factors that may affect future results	25
	Critical accounting policies	26
	Average balances, Interest Income/Expense and yields/rates paid	29
	Analysis of changes in net interest income and interest expense	30
	Noninterest Income	31
	Noninterest Expense	31
	Income taxes	32
	Asset quality	33
	Allowance for loan and lease losses (ALLL)	34

Securities portfolio 35
EXHIBIT 31.1
EXHIBIT 31.2
EXHIBIT 32.0

Table of Contents

Index to Form 10-Q

		Page:
Item 3.	Quantitative and Qualitative Disclosure about Market Risk	37
Item 4.	Controls and Procedures	39
PART II. OTHER INFORMATION		
Item 1.	Legal proceedings	40
Item 1a.	Risk Factors	40
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	40
Item 3.	Defaults Upon Senior Securities	40
Item 4.	Submission of Matters to a Vote of Security Holders	40
Item 5.	Other Information	40
Item 6.	Exhibits	40
SIGNATURES		40
EXHIBITS		41,42,43

Table of Contents

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Condensed Consolidated Balance Sheets
(Unaudited)

Amounts in thousands, except per share data	September 30, 2006	December 31, 2005	September 30, 2005
ASSETS			
Cash and due from banks	$ 17,535	$ 17,436	$ 14,759
Federal funds sold and securities purchased under agreements to resell	28,010	9,120	8,550
Cash and cash equivalents	45,545	26,556	23,309
Securities available-for-sale (including pledged collateral of $74,022 at September 30, 2006; $50,102 at December 31, 2005 and $52,988 at September 30, 2005)	97,614	94,014	98,107
Securities held-to-maturity, at cost (estimated fair value of $10,788 at September 30, 2006, $6,881 at December 31, 2005 and $5,834 at September 30, 2005)	10,841	6,933	5,813
Loans, net of the allowance for loan losses of $4,753 at September 30, 2006, $4,316 at December 31, 2005 and $4,251 at September 30, 2005	403,657	363,305	342,004
Bank premises and equipment, net	7,350	5,631	5,547
Other assets	20,211	15,205	13,228
TOTAL ASSETS	$ 585,218	$ 511,644	$ 488,008
LIABILITIES AND STOCKHOLDERS EQUITY			
Demand noninterest bearing	$ 81,125	$ 86,219	$ 80,516
Demand interest bearing	111,439	109,101	116,137
Savings	22,610	27,540	26,078
Certificates of deposits	214,019	149,256	150,260
Total deposits	429,193	372,116	372,991
Securities sold under agreements to repurchase	35,260	22,886	20,461
Federal Home Loan Bank borrowings	55,000	55,000	35,000
Other liabilities	6,352	7,194	5,809
Guaranteed Preferred Beneficial Interests in Company s Junior Subordinated Debt payable to unconsolidated subsidiary grantor trust	15,465	15,310	15,310
Total Liabilities	541,270	472,506	449,571

Commitments and contingencies						
Stockholders Equity:						
Preferred stock, no par value, 2,000,000 authorized no shares issued and outstanding in 2006 and 2005						
Common stock , no par value, 50,000,000 shares authorized; 8,926,842 shares issued and outstanding at September 30, 2006, 8,657,896 at December 31, 2005 and 8,654,896 at September 30, 2005		12,416		11,009		10,998
Retained earnings		32,526		29,419		28,240
Accumulated other comprehensive (loss), net of tax		(994)		(1,290)		(801)
Total Stockholders equity		43,948		39,138		38,437
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	585,218	$	511,644	$	488,008

See accompanying notes to condensed consolidated financial statements.

4

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Condensed Consolidated Statements of Income (Unaudited)
Three and nine months ended September 30, 2006 and 2005

Amounts in thousands, except for per share data	Three Months Ended Sept. 30, 2006	Three Months Ended Sept. 30, 2005	Nine Months Ended Sept. 30, 2006	Nine Months Ended Sept. 30, 2005
Interest income:				
Interest and fees on loans	$ 8,501	$ 6,146	$ 23,881	$ 17,393
Interest on tax exempt securities	231	99	494	230
Interest on U.S. government securities	849	718	2,575	2,026
Interest on federal funds sold and securities purchased under agreements to resell	383	220	658	385
Interest on other securities	25	16	113	16
Total interest income	9,989	7,199	27,721	20,050
Interest expense:				
Interest on demand deposits	449	276	968	688
Interest on savings deposits	69	56	209	127
Interest on time deposits	2,423	1,190	5,844	3,051
Securities sold under agreements to repurchase	328	146	794	264
Interest on FHLB and other borrowing expense	918	235	2,492	746
Interest on junior subordinated debt payable to unconsolidated subsidiary grantor trust	272	171	796	332
Total interest expense	4,459	2,074	11,103	5,208
Net interest income	5,530	5,125	16,618	14,842
Provision for loan and lease losses	72	88	226	442
Net interest income after provision for loan losses	5,458	5,037	16,392	14,400
Noninterest income:				
Service charges on deposit accounts	81	98	255	303
Payroll and benefit processing fees	89	81	287	264
Earnings on cash surrender value - Bank owned life insurance	80	52	231	156
Net loss on sale of securities available-for-sale	(171)	0	(171)	(2)
Net gain on sale of loans	90	23	90	91
Merchant credit card service income, net	110	91	280	268
Mortgage brokerage fee income	32	85	84	242
Other income	117	85	331	283
Total non-interest income	428	515	1,387	1,605
Noninterest expense:				
Salaries and related benefits	1,996	1,750	5,870	5,088

Occupancy and equipment expense	467	437	1,350	1,173
FDIC insurance premium	12	11	36	36
Data processing fees	53	71	169	209
Professional service fees	149	199	503	577
Payroll and Benefit fees	24	24	78	86
Deferred compensation expense	94	85	272	234
Stationery and Supplies	71	40	180	159
Postage	26	45	91	84
Directors expense	45	30	170	188
Other expenses	362	403	1,128	1,068
Total non-interest expense	3,299	3,095	9,847	8,902
Income before provision for income taxes	2,587	2,457	7,932	7,103
Provision for income taxes	915	897	2,979	2,696
Net Income	$ 1,672	$ 1,560	$ 4,953	$ 4,407
Basic earnings per share	$ 0.19	$ 0.18	$ 0.57	$ 0.51
Weighted average shares basic	8,764	8,619	8,723	8,582
Diluted earnings per share	$ 0.19	$ 0.18	$ 0.55	$ 0.50
Weighted average shares diluted	8,937	8,874	8,945	8,911

See accompanying notes to condensed consolidated financial statements

Table of Contents

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows (Unaudited)
Nine months ended September 30, 2006 and 2005

Dollars in thousands	September 30, 2006	September 30, 2005
Cash flows from operating activities:		
Net Income	$ 4,953	$ 4,407
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	226	442
Provision for depreciation and amortization	516	421
Compensation expense associated with stock options	40	4
Tax benefits from the exercise of stock options	(560)	(304)
Loss on sale of securities available for sale	171	2
Amortization of investment premiums and accretion of discounts, net	8	100
Gain on sale of loans	(90)	(91)
Proceeds from sales of loans	2,090	2,351
Loans originated for sale	(2,000)	(2,260)
Effect of changes in:		
Other assets	(5,119)	(231)
Deferred loan fees	(43)	(302)
Other liabilities	(842)	(2,266)
Net cash (used in) /provided by operating activities	(650)	2,273
Cash flows from investing activities:		
Proceeds from maturities of available-for-sale securities	8,100	20,005
Proceeds from sales of available-for-sale securities	10,258	121
Proceeds from maturities of held-to-maturity securities	518	141
Purchases of available-for-sale securities	(26,155)	(42,426)
Loan originations, net of principal repayments	(40,535)	(23,343)
Purchases of premises and equipment	(2,236)	(483)
Net cash used by investing activities	(50,050)	(45,985)
Cash flows from financing activities:		
Net increase in deposits	57,077	20,112
Net increase in securities sold under agreement to repurchase	12,376	18,457
Proceeds from Federal Home Loan Bank advances	70,000	38,000
Repayments of Federal Home Loan Bank advances	(70,000)	(38,000)
Dividends paid on common stock	(1,846)	(1,550)
Excess tax benefits from the exercise of stock options	560	0
Proceeds from stock options exercised	840	457
Tax benefits from the exercise of stock options	527	304
Net cash from Trust Preferred	155	10,000

Net cash provided by financing activities		69,689		47,780
Net increase in cash and cash equivalents		18,989		4,068
Cash and cash equivalents, beginning of period		26,556		19,241
Cash and cash equivalents, end of period	$	45,545	$	23,309
Supplemental disclosures:				
Cash paid during the period for:				
Income taxes	$	2,936	$	2,582
Interest		10,851		4,979

See accompanying notes to condensed consolidated financial statements.

6

Table of Contents

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements

1. Consolidation and Basis of Presentation

The unaudited condensed consolidated financial statements include the accounts of Bank of Commerce Holdings (the Holding Company) and its subsidiaries Redding Bank of Commerce, Roseville Bank of Commerce and Sutter Bank of Commerce (RBC or the Bank) and Bank of Commerce Mortgage (collectively the Company). All significant inter-company balances and transactions have been eliminated. The financial information contained in this report reflects all adjustments that in the opinion of management are necessary for a fair presentation of the results of the interim periods. All such adjustments are of a normal recurring nature. Certain reclassifications have been made to the prior period condensed consolidated financial statements to conform to the current financial statement presentation.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and general practices within the banking industry. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts for prior periods have been reclassified to conform to the current financial statement presentation.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in Bank of Commerce Holdings 2005 Annual Report on Form 10-K. The results of operations and cash flows for the 2006 interim periods shown in this report are not necessarily indicative of the results for any future interim period or the entire fiscal year.

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and repurchase agreements. Generally, federal funds are sold for a one-day period and securities purchased under agreements to resell are for no more than a 90-day period.

Recent Accounting pronouncements

On July 13, 2006, the FASB issued the Summary of Interpretation No. 48, *Accounting for Uncertainty in Income Taxes (FIN 48).* This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for income taxes(FAS 109).* FIN 48 applies to all tax positions related to income taxes subject to Financial Accounting Standards Board Statement No. 109, *Accounting for Income Taxes, (*FAS 109). This includes tax positions considered to be routine as well as those with a high degree of uncertainty. The guidance contained in FIN 48 also applies to pass-through entities, nontaxable entities, and entities whose tax liability is subject to 100% credit for dividends paid (i.e., real estate investment companies and registered investment companies).

FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e., the position is more-likely-than-not to be sustained). Under step two, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis that is more-likely-than-not to be realized upon ultimate settlement. FIN 48 s use of the term more-likely-than-not in steps one and two is consistent with how that term is used in FAS 109 (i.e., a likelihood of occurrence greater than 50%).

Those tax positions failing to qualify for initial recognition are recognized in the first subsequent interim period they meet the more-likely-than-not standard, or are resolved through negotiation or litigation with the taxing authority, or upon expiration of the statute of limitations. Derecognition of a tax position that was previously recognized would occur when a company subsequently determines that a tax position no longer meets the more-likely-than-not threshold of being sustained. FIN 48 specifically prohibits the use of a valuation allowance as a substitute for derecognition of tax positions.

Table of Contents

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Notes to Unaudited Condensed Consolidated Financial Statements

FIN 48 is effective for fiscal years beginning after December 15, 2006. Management is currently evaluating the effect of the interpretation on the Company s results of operations and financial condition.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS No. 156). SFAS No. 156 requires all separately recognized servicing assets and liabilities to be initially measured at fair value. In addition, entities are permitted to choose to either subsequently measure servicing rights at fair value and report changes in fair value in earnings, or amortize servicing rights in proportion to and over the estimated net servicing income or loss, and assess the rights for impairment. Beginning with the fiscal year in which an entity adopts SFAS No. 156, it may elect to subsequently measure a class of servicing assets and liabilities at fair value. Post adoption, an entity may make this election as of the beginning of any fiscal year. An entity that elects to subsequently measure a class of servicing assets and liabilities at fair value should apply that election to all new and existing recognized servicing assets and liabilities within that class. The effect of re-measuring an existing class of servicing assets and liabilities at fair value is to be reported as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. SFAS No. 156 is effective as of the beginning of an entity s first fiscal year that begins after September 15, 2006. Management is currently evaluating the impact of the adoption of SFAS No. 156.

On February 16, 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, ***Accounting for Certain Hybrid Instruments*** (SFAS No. 155), which permits, but does not require, fair value accounting for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133. The statement also subjects beneficial interests issued by securitization vehicles to the requirements of SFAS 133. The statement is effective as of January 1, 2007, with earlier adoption permitted. Management is currently evaluating the effect of the statement on the Company s results of operations and financial condition.

3. Earnings per Share

Basic earnings per share exclude dilution and is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that subsequently shared in the earnings of the entity. The following table displays the computation of earnings per share for the three and nine months ended September 30, 2006 and 2005.

	Three Months Ended		Nine Months Ended	
(Amounts in thousands, except per share data)	Sept. 30, 2006	Sept. 30, 2005	Sept. 30, 2006	Sept. 30, 2005
Basic EPS Calculation:				
Numerator (net income)	$ 1,672	$ 1,560	$ 4,953	$ 4,407
Denominator (average common shares outstanding)	8,764	8,619	8,723	8,582
Basic earnings per Share	$ 0.19	$ 0.18	$ 0.57	$ 0.51
Diluted EPS Calculation:				
Numerator (net income)	$ 1,672	$ 1,560	$ 4,953	$ 4,407
Denominator:				
Average common shares outstanding	8,764	8,619	8,723	8,582
Options	173	255	222	329

	8,937	8,874	8,945	8,911
Diluted earnings per Share	$ 0.19	$ 0.18	$ 0.55	$ 0.50

8

Table of Contents

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

Stock Option Plan

The Company adopted Statement of Financial Accounting Standards No. 123R (FAS 123R), *Share-Based Payment,* on January 1, 2006. The scope of FAS 123R includes a wide range of stock-based compensation arrangements including stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee stock purchase plans. FAS 123R requires the Company to measure the cost of employee services received in exchange for an award of equity instruments. The cost is determined based on the fair value of the award on the grant date. That cost must be recognized in the income statement over the service period of the award. Under the modified prospective transition method, awards that are granted, modified or settled beginning at the date of adoption will be measured and accounted for in accordance with FAS 123R. In addition, expense must be recognized in the income statement for unvested awards that were granted prior to the date of adoption. Prior to the adoption of FAS 123R and as permitted by FAS 123 and FAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure* , the Company elected to follow APB 25 and related interpretations in accounting for our employee stock options. The Company adopted FAS 123R using the modified prospective method. Under this transition method, stock option expense for the first quarter of 2006 included the cost for all share-based payments granted prior to, but not yet vested, as of January 1, 2006, as well as any share-based payments granted subsequent to December 31, 2005. This compensation expense is measured on the date of grant using an option-pricing model. The option-pricing model is based on certain assumptions, and changes to those assumptions may result in different fair value estimates. Prior to January 1, 2006, under APB 25, the Company accounted for stock options using the intrinsic value method and no compensation expense was recognized, as the grant price was equal to the strike price. In accordance with SFAS 123R, the Company provides disclosures as if it had adopted the fair value-based method of measuring all outstanding employee stock options during 2005.

Through the third quarter of 2006, stock option compensation expense charged against income was $35,948 ($21,152 net of tax), or less than one cent per diluted share. At September 30, 2006, there was $137,382 of total unrecognized compensation costs related to non-vested share based payments which is expected to be recognized over a period of five years. One new option was granted through the third quarter of 2006.

The following table illustrates the effect on net income and earnings per common share had the fair value-based method been applied to all outstanding and unvested awards for the three months and nine months ended September 30, 2005.

		Three Months Ended September 30,2005		Nine Months Ended September 30,2005
Net income				
As reported	$	1,560	$	4,407
Deduct:				
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(37)		(147)
Pro forma net income	$	1,523	$	4,260
Earnings per share:				
Basic as reported	$	0.18	$	0.51
Basic pro forma	$	0.18	$	0.50

Diluted	as reported	$	0.18	$	0.50
Diluted	pro forma	$	0.17	$	0.48

In determining the pro forma disclosures in the previous table, the fair value of options granted was estimated on the date of grant using an option-pricing model and assumptions appropriate to each plan. The weighted average grant fair values of the options granted are based on the assumptions below.

Table of Contents

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

	December 31, 2005	September 19, 2006
Risk-free interest rate	3.92%	4.75%
Dividend Yield	2.49%	2.67%
Volatility	32.36%	32.98%
Expected lives (years)	7	7
Weighted average grant-date fair value per share of options granted	$ 3.35	$ 3.33

Description of stock-based compensation plan

On February 17, 1998, the Board of Directors adopted the 1998 Stock Option Plan (the Plan) which was approved by the Company s stockholders on April 21, 1998. The Plan provides for awards in the form of options, which may constitute incentive stock options (Incentive Options) under Section 422(a) of the Internal Revenue Code of 1986, as amended (the Code), or non-statutory stock options (NSOs) to key personnel of the Company, including directors. The Plan provides that Incentive Options under the Plan may not be granted at less than 100% of fair market value of the Company s common stock on the date of the grant. The strike price of NSOs may not be granted at less than 85% of the fair market value of the common stock on the date of the grant.

The Company s stock option plans provide for awards of incentive and nonqualified stock options. Incentive options must have an exercise price at or above fair market value of the stock at the date of the grant and a term of no more than 10 years. Options generally become exercisable over five years from the date of the grant. Nonqualified stock options must have an exercise price of no less than 85% of the fair market value of the stock at the date of the grant and for a term of no more than 10 years. Nonqualified stock options generally become exercisable over five years from the date of the grant. A total of 1,782,000 shares of the Company s common stock are reserved for grant under the Plan.

Activity in stock-based compensation plan

The following table presents the changes in outstanding stock options for the periods indicated:

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Options outstanding, January 1, 2006	608,316	$ 5.20	
Granted	20,000	$ 10.40	$
Exercised	(268,946)	$ 3.12	$ 1,933,722
Forfeited	(1,425)	$ 10.60	$
Options outstanding, September 30, 2006	357,945	$ 5.24	$ 70,461
Exercisable at September 30, 2006	312,831	$ 6.01	$ 1,348,301

At September 30, 2006, 104,740 shares were available for future grants under the Plan. As of September 30, 2006, 312,831 shares were available to be exercised. The weighted average grant exercise price at September 30, 2006 was $6.01. The total intrinsic value (which is the amount by which the stock price exceeded the exercise price on the date of exercise) of options exercised during the nine months ended September 30, 2006 was $1,933,722.

Table of Contents

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

Additional information regarding options outstanding as of September 30, 2006 is as follows:

Exercise Price	Options Outstanding	Weighted Average Remaining Contractual life (Years)	Options Exercisable
$ 2.75	43,350	1.3	43,350
$ 3.23	42,160	1.3	42,160
$ 5.42	29,250	4.4	29,250
$ 6.67	59,500	4.6	59,500
$ 7.30	55,130	5.5	44,104
$ 6.75	13,500	6.0	8,100
$ 10.72	7,500	7.4	7,500
$ 10.60	72,075	7.5	72,075
$ 10.76	3,000	7.9	3,000
$ 9.11	6,480	7.3	2,592
$ 11.59	3,500	8.4	700
$ 10.20	2,500	8.4	500
$ 10.40	20,000	9.7	0
	357,945	6.2	312,831

During the nine months ended September 30, 2006 and 2005 the Company realized income tax benefits of $559,729 and $303,998 respectively, related to the exercise of nonqualified stock options. The income tax benefit is reflected in net cash used in operating activities in the consolidated statements of cash flow for the same period.

During the nine months ended September 30, 2006 and 2005 the Company received cash of $839,873 and $457,310 respectively, upon exercise of stock-based compensation arrangements.

5. Comprehensive Income

The Company s total comprehensive income was as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net Income as reported	$ 1,672	$ 1,560	$ 4,953	$ 4,407
Components of other comprehensive income:				
Unrealized gains arising during the period on derivative transactions	235	0	235	0
Unrealized (losses) gains arising during the period on investment securities available-for-sale	1,242	(327)	(4)	(661)
Less: Income tax benefit related to unrealized (losses) gains on comprehensive income	(676)	95	(106)	193
Reclassification adjustment for loss on available-for-sale securities	171	0	171	2
Total other comprehensive income	972	(232)	296	(466)

Total comprehensive income	$ 2,644	$ 1,328	$ 5,249	$ 3,941

11

Table of Contents

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

6. Junior Subordinated Debt Payable to Unconsolidated Subsidiary Grantor Trust

During the first quarter 2003, Bank of Commerce Holdings formed a wholly-owned Delaware statutory business trust, Bank of Commerce Holdings Trust (the grantor trust), which issued $5.0 million of guaranteed preferred beneficial interests in Bank of Commerce Holdings junior subordinated debentures (the trust notes) to the public and $155,000 common securities to the Company. These debentures qualify as Tier 1 capital under Federal Reserve Board guidelines. The proceeds from the issuance of the trust notes were transferred from the grantor trust to the Holding Company and from the Holding Company to the Bank as surplus capital. The trust notes accrue and pay distributions on a quarterly basis at 3 month London Interbank Offered Rate (LIBOR) plus 3.30%. The rate at September 30, 2006 was 8.81%. The rate increase is capped at 2.75% annually and the lifetime cap is 12.5%. The final maturity on the trust note is March 18, 2033, and the debt allows for prepayment after five years on the quarterly payment date.

On July 29, 2005, Bank of Commerce Holdings (the Company) participated in a private placement to an institutional investor of $10 million of fixed rate trust preferred securities (the Trust Preferred Securities); through a newly formed Delaware trust affiliate, Bank of Commerce Holdings Trust II (the Trust). The Trust Preferred Securities mature on September 15, 2035, and are redeemable at the Company s option on any March 15, June 15, September 15 or December 15 on or after September 15, 2010. In addition, the Trust Preferred Securities require quarterly distributions by the Trust to the holder of the Trust Preferred Securities at a rate of 6.12%, until September 10, 2010 after which the rate will reset quarterly to equal LIBOR plus 1.58%. The Trust simultaneously issued $310,000 of the Trust s common securities of beneficial interest to the Company.

The proceeds from the sale of the Trust Preferred Securities were used by the Trust to purchase from the Company the aggregate principal amount of $10,310,000 of the Company s floating rate junior subordinate notes (the Notes). The net proceeds to the Company from the sale of the Notes to the Trust will be used by the Company for general corporate purposes, including funding the growth of the Company s various financial services.

The Notes were issued pursuant to a Junior Subordinated Indenture (the Indenture), dated July 29, 2005, by and between the Company and J.P. Morgan Chase Bank, National Association, as trustee. Like the Trust Preferred Securities, the Notes bear interest at a floating rate, at 6.12% until September 10, 2010, after which the rate will reset on a quarterly basis to equal LIBOR plus 1.58%. The interest payments by the Company will be used to pay the quarterly distributions payable by the Trust to the holder of the Trust Preferred Securities. However, so long as no event of default, as described below, has occurred under the Notes, the Company may, at any time and from time to time, defer interest payments on the Notes (in which case the Trust will be entitled to defer distributions otherwise due on the Trust Preferred Securities) for up to twenty (20) consecutive quarters.

The Notes are subordinated to the prior payment of other indebtedness of the Company that, by its terms, is not similarly subordinated. Although the Notes will be recorded as a long term liability on the Company s balance sheet, for regulatory purposes, the Notes are expected to be treated as Tier 1 or Tier 2 capital under rulings of the Federal Reserve Board, the Company s primary federal regulatory agency.

The Notes mature on September 15, 2035, but may be redeemed at the Company s option at any time on or after September 15, 2010, or at any time upon certain events, such as a change in the regulatory capital treatment of the Notes, the Trust being deemed to be an investment company, or the occurrence of certain adverse tax events. In each case, the Company may redeem the Notes for their aggregate principal amount, plus accrued interest, if any.

Table of Contents

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)
7. Commitments and contingent liabilities
Lease Commitments The Company leases certain facilities at which it conducts its operations. Future minimum lease commitments under all non-cancelable operating leases as of September 30, 2006 are below:

(Dollars in thousands)	
2006	$ 110
2007	$ 475
2008	$ 500
2009	$ 448
2010	$ 400
Thereafter	$ 437
Total	$ 2,370
Minimum rental due in the future Under non-cancelable subleases	$ 28

Legal Proceedings The Company is involved in various pending and threatened legal actions arising in the ordinary course of business. The Company maintains reserves for losses from legal actions, which are both probable and estimable. In the opinion of management, the disposition of claims, currently pending will not have a material adverse affect on the Company s financial position or results of operations.
FHLB Advances Included in other borrowings are advances from the Federal Home Loan Bank of San Francisco (FHLB) totaling $55,000,000 as September 30, 2006 and $35,000,000 as of September 30, 2005. The FHLB advances bear fixed and floating rates of interest ranging from 5.22% to 5.47%. Interest is payable either monthly or quarterly. The following table illustrates borrowings outstanding at the end of the period:

Advance #	Amount	Interest Rate	Maturity
#059277	$10,000,000	5.43%	01/24/2008
#077115	$10,000,000	5.39%	11/27/2006
#080890	$10,000,000	5.47%	11/24/2011
#087416	$ 5,000,000	5.23%	04/28/2008
#087272	$ 5,000,000	5.22%	10/24/2006
#077383	$15,000,000	5.39%	11/30/2007
	$55,000,000		

These borrowings are secured by an investment in FHLB stock and certain real estate mortgage loans which have been specifically pledged to the FHLB pursuant to their collateral requirements. Based upon the level of FHLB advances, the Company was required to hold a minimum investment of $3,804,300 in FHLB stock and pledge collateral of $52,190,768 in real estate mortgage loans as of September 30, 2006. At September 30, 2006, the Bank had available borrowing lines at the FHLB of $85,068,750 and additional federal fund borrowing lines at two correspondent banks totaling $15,000,000.

BANK OF COMMERCE HOLDINGS & SUBSIDIARIES
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)
Off-Balance Sheet Financial Instruments - In the ordinary course of business, the Company enters various types of transactions, which involve financial instruments with off-balance sheet risk. These instruments include commitments to extend credit and standby letter of credits, which are not reflected in the accompanying consolidated balance sheets. These transactions may involve, to varying degrees, credit and interest rate risk more than the amount, if any recognized in the consolidated balance sheets. Commitments to extend credit are agreements to lend to customers. These commitments have specified interest rates and generally have fixed expiration dates but may be terminated by the Company if certain conditions of the contract are violated. Although currently subject to draw down, many of the commitments do not necessarily represent future cash requirements. Collateral held relating to these commitments varies, but generally includes real estate, securities and cash. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Credit risk arises in these transactions from the possibility that a customer may not be able to repay the Bank upon default of performance.
Collateral held for standby letters of credit is based on an individual evaluation of each customer s creditworthiness, but may include cash and securities. Commitments to extend credit and standby letters of credit bear similar credit risk characteristics as outstanding loans.
The Company s commitments to extend credit are illustrated below:

	September 30, 2006	September 30, 2005
Commitment lines of credit	$ 155,898,477	$ 125,925,924
Standby letters of credit	14,211,847	10,029,239
Guaranteed commitments outstanding	1,248,000	0
	$ 171,358,324	$ 135,955,163

Derivative Financial Instruments and Hedging Activities - As part of the overall risk management, the Company pursues various asset and liability management strategies, which may include obtaining derivative financial instruments to mitigate the impact of interest fluctuations on the Company s net interest margin. During the third quarter of 2006, the Company entered into an interest rate swap agreement for the purpose of minimizing interest rate fluctuations on its interest rate margin and equity.
Under the interest rate swap agreement, the company received a fixed rate and pays a variable rate based on the Prime Rate (Prime). The swap qualifies as a cash flow hedge under SFAS no. 133, *Accounting for Derivative Instruments and Hedging Activities* , as amended, and is designated as a hedge of the variability of cash flows the Company receives from certain variable-rate loans indexed to Prime. In accordance with SFAS No. 133, the swap agreement is measured at fair value and reported as an asset or liability on the consolidated balance sheet. The portion of the change in the fair value of the swap that is deemed effective in hedging the cash flows of the designated assets is recorded in other comprehensive income and reclassified into interest income when such cash flow occurs in the future. Any ineffectiveness resulting from the hedge is recorded as a gain or loss in the consolidated statement of income as part of noninterest income.
The hedge has a notional value of $100 million, matures in June 2009, and has a duration of approximately 36 months. As of September 30, 2006, the gain amounts in accumulated other comprehensive income associated with these cash flows totaled $138,342 (net of tax of $97,000).

Table of Contents

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

Forward Looking Statements and Risk Factors

This discussion and information in the accompanying financial statements contains certain forward-looking statements, which are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements are subject to risks and uncertainties that could cause actual results to differ materially from those stated. These risks and uncertainties include the Company s ability to maintain or expand its market share and net interest margins, or to implement its marketing and growth strategies. Further, actual results may be affected by the Company s ability to compete on price and other factors with other financial institutions; customer acceptance of new products and services; and general trends in the banking and the regulatory environment, as they relate to the Company s cost of funds and return on assets. The reader is advised that this list of risks is not exhaustive and should not be construed as any prediction by the Company as to which risks would cause actual results to differ materially from those indicated by the forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements.

For additional information concerning risks and uncertainties related to the Company and its operations please refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2005, under the heading Risk factors that may affect results . *Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to revise or publicly release the results of any revision to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.*

The following sections discuss significant changes and trends in financial condition, capital resources and liquidity of the Company from December 31, 2005 to September 30, 2006. Also discussed are significant trends and changes in the Company s results of operations for the three and nine months ended September 30, 2006, compared to the same period in 2005. The consolidated financial statements and related notes appearing elsewhere in this report are condensed and unaudited. The following discussion and analysis is intended to provide greater detail of the Company s financial condition and results.

Corporate Overview

Bank of Commerce Holdings (the Holding Company) is a financial holding company (FHC) registered under the Bank Holding Company Act of 1956, as amended, and was incorporated in California on January 21, 1982, (under the name Redding Bancorp), for the purpose of organizing, as a wholly owned subsidiary, Redding Bank of Commerce (the Bank). The Holding Company elected to change to a FHC in 2000. As a financial holding company, the Holding Company is subject to the Financial Holding Company Act and to supervision by the Board of Governors of the Federal Reserve System (FRB). The Holding Company s principal business is to serve as a holding company for Redding Bank of Commerce, Roseville Bank of Commerce, Sutter Bank of Commerce and Bank of Commerce Mortgage, a California corporation and for other banking or banking-related subsidiaries which the Holding Company may establish or acquire (collectively the Company). The Holding Company also has two unconsolidated subsidiaries, Bank of Commerce Holdings Trust I and II. During the first quarter 2003, Bank of Commerce Holdings formed a wholly-owned Delaware statutory business trust, Bank of Commerce Holdings Trust (the grantor trust), which issued $5.0 million of guaranteed preferred beneficial interests in Bank of Commerce Holdings junior subordinated debentures (the Trust Notes). These debentures qualify as Tier 1 capital under Federal Reserve Board guidelines. The proceeds from the issuance of the Trust Notes were transferred from the grantor trust to the Holding Company and from the Holding Company to the Bank as surplus capital. The Trust Notes accrue and pay distributions on a quarterly basis at 3 month London Interbank Offered Rate (LIBOR) plus 3.30%. The rate at September 30, 2006 was 8.81%. The rate increase is capped at 2.75% annually and the lifetime cap is 12.5%. The final maturity on the Trust Notes is March 18, 2033, and the debt allows for prepayment after five years on the quarterly payment date. During the third quarter 2005, Bank of Commerce Holdings formed a wholly-owned Delaware statutory business trust, Bank of Commerce Holdings Trust II (the grantor trust), which issued $10.0 million of guaranteed preferred beneficial interests in Bank of Commerce Holdings junior subordinated debentures (the Trust Notes).

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

$10 million of the issuance will qualify as Tier 1 or Tier II capital under Federal Reserve Board guidelines.

$10 million of the proceeds from the issuance of the Trust Notes were transferred from the grantor trust to the Holding Company and from the Holding Company to the Bank as surplus capital and $5 million of the issuance is retained at the Holding Company for investment purposes. The issuance is priced at a fixed rate for the first five years at 6.12%.

The Company will provide free of charge upon request, or through links to publicly available filings accessed through its Internet website, the Company s annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, if any, as soon as reasonably practical after such reports have been filed with the Securities and Exchange Commission. The Internet addresses of the Company are www.reddingbankofcommerce.com, www.rosevillebankofcommerce.com, www.sutterbankofcommerce.com and www.bankofcommercemortgage.com. Reports may also be obtained through the Securities and Exchange Commission s website at www.sec.gov.

The Bank was incorporated as a California banking corporation on November 25, 1981, and received its certificate of authority to begin banking operations on October 22, 1982. The Bank operates five full service branch facilities. The Bank established its first full service branch at 1177 Placer Street, Redding, California, and opened for business on October 22, 1982. On November 1, 1988, the Bank received a certificate of authority to establish and maintain a loan production office in Citrus Heights, California. On September 1, 1998, the Bank relocated the loan production office to 2400 Professional Drive in Roseville, California.

On March 1, 1994, the Bank received a certificate of authority to open a second full-service branch at 1951 Churn Creek Road in Redding, California. On June 30, 2000, the Bank received a certificate of authority to convert the loan production office in Roseville to a full service banking facility under the name Roseville Bank of Commerce, a division of Redding Banking of Commerce.

On June 15, 2001, the Bank acquired the deposit liabilities of First Plus Bank at Citrus Heights, California and renamed the facility Roseville Bank of Commerce at Sunrise, a division of Redding Bank of Commerce. On February 22, 2002, the Roseville Bank of Commerce at Eureka Road, a division of Redding Bank of Commerce, relocated to its permanent location at 1504 Eureka Road, Suite 100, Roseville, California.

On March 18, 2004, RBC Mortgage Services, an affiliate of Redding Bank of Commerce and a wholly-owned subsidiary of the Holding Company, changed its name to Bank of Commerce Mortgage (the Mortgage Company), an affiliate of Redding Bank of Commerce. The subsidiary has an affiliated business, BWC Mortgage Services. Under the terms of the agreement, BWC Mortgage Services underwrites or brokers mortgage products. Additionally, BWC Mortgage Services manages the independent contractors, supporting staff and broker relationships with various secondary market lenders. Bank of Commerce Mortgage in turn provides office space, equipment and marketing support for the mortgage brokerage services. Bank of Commerce Mortgage, through this agreement, offers a full array of single-family and multi-family residential real estate mortgages including equity lines. Bank of Commerce Mortgage pays ten percent of gross premiums earned to BWC Mortgage Services. On July 1, 2004, Bank of Commerce Mortgage relocated to its permanent location at 1024 Mistletoe Lane, Redding, California.

On May 18, 2004, by majority shareholder vote, the Holding Company (Redding Bancorp) amended the Articles of Incorporation to change the Company s name to Bank of Commerce Holdings. The new name proves to be more reflective of the multiple financial holdings of the Company as well as more geographically open to expansion opportunities.

On May 24, 2004, the Company was approved to list on the NASDAQ National Market under the trading symbol BOCH (Bank of Commerce Holdings). The listing became live on June 15, 2004. On July 21, 2004, the Board of Directors declared a three-for-one stock split on the Company s common stock. The decision to declare the stock split was intended to make it easier for our current and future investors to enjoy ownership in our Company.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

On August 26, 2005, the Company received approval from the Federal Deposit Insurance Corporation to open a branch in the Yuba City market. The branch is entitled Sutter Bank of Commerce, a division of Redding Bank of Commerce. A lease has been secured for 950 Tharp Road, Suite 800, Yuba City, California. The office opened for business on Monday, April 10, 2006.

The Company is building an Administrative and Information Technology center during 2006. Ground breaking on the project began in February 2006 and is expected to take ten months to completion. The building will be approximately 12,000 square feet and will be built on property already owned by the Company. The budget for the building is approximately $3.7 million.

On March 20, 2006, the Board of Directors declared a $0.07 cent per share quarterly dividend payable to shareholders of record as of March 31, 2006, payable on April 7, 2006. The annual shareholder meeting of the Company was held on May 16, 2006. The Company s Articles of Incorporation were amended to increase the number of shares authorized from 10,000,000 to 50,000,000. On June 20, 2006, the Board of Directors declared a $0.07 cent per share quarterly dividend payable to shareholders of record as of June 30, 2006, payable on July 7, 2006. On September 20, 2006, the Board of Directors declared a $0.07 cent per share quarterly dividend payable to shareholders of record as of September 29, 2006, payable on October 13, 2006. On September 25, 2006, the board of Directors announced a Stock Repurchase plan of up to 2.2% of the Company s outstanding shares.

The Holding Company s principal source of income is dividends from its subsidiaries. The Holding Company conducts its corporate business operations at the administrative office of the Bank located at 1951 Churn Creek Road, Redding, California 96002. The Company conducts its business operations in three geographic market areas, Redding, Roseville and Yuba City California. The Company considers Upstate California to be the major market area of the Bank.

The Bank is principally supervised and regulated by the California Department of Financial Institutions (DFI) and the Federal Deposit Insurance Corporation (FDIC), and conducts a general commercial banking business in the counties of El Dorado, Placer, Shasta, Sutter, Sacramento, and Yuba, California. Through the Bank and mortgage subsidiaries, the Company provides a wide range of financial services and products. The services offered by the Bank include those traditionally offered by commercial banks of similar size and character in California. Products such as checking, interest-bearing checking (NOW) and savings accounts, money market deposit accounts, commercial, construction, and term loans, travelers checks, safe deposit boxes, collection services and electronic banking activities.

The primary focus of the Bank is to provide services to the business and professional community of its major market area, including Small Business Administration loans, payroll accounting packages, benefit administration and billing services. The Bank currently does not offer trust services or international banking services. The services offered by the Mortgage Company include single and multi-family residential residence new financing, refinancing and equity lines of credit and equity term loans.

Most of the Bank s customers are small to medium sized businesses, professionals and other individuals with medium to high net worth, and most of the Bank s deposits are obtained from such customers. The Bank emphasizes servicing the needs of local businesses and professionals and individuals requiring specialized services. The primary business strategy of the Bank is to focus on its lending activities. The Bank s principal lines of lending are (i) commercial, (ii) real estate construction and (iii) commercial and residential real estate. The majority of the loans of the Bank are direct loans made to individuals and small businesses in the major market area of the Bank and are secured by real estate. See Risk Factors That May Affect Results-Dependence on Real Estate in the Company s 2005 Annual Report on Form 10-K. A relatively small portion of the loan portfolio of the Bank consists of loans to individuals for personal, family or household purposes. The Bank accepts real estate, listed and unlisted securities, savings and time deposits, automobiles, machinery and equipment and other general business assets such as accounts receivable and inventory as collateral for loans. The Company s goal is to be a premier provider of financial services to the business and professional community of its major market area including Small Business Administration (SBA) loans, commercial building financing, bank card services, payroll accounting packages, lock box and billing programs. The Company measures premier performance by monitoring key operating ratios to high performing peer information on a national level, and models strategies to meet or exceed such goals.

17

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Lending Risks Associated with Commercial Banking and Construction Activities

The business strategy of the Company is to focus on commercial, single family and multi-family real estate loans, construction loans and commercial business loans. Loans secured by commercial real estate are generally larger and involve a greater degree of credit and transaction risk than residential mortgage (one-to-four family) loans. Because payments on loans secured by commercial and multi-family real estate properties are often dependent on successful operation or management of the underlying properties, repayment of such loans may be subject to a greater extent to the then prevailing conditions in the real estate market or the economy. Moreover, real estate construction financing is generally considered to involve a greater degree of credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property s value at completion of construction or development compared to the estimated cost (including interest) of construction. If the estimate of value proves to be inaccurate, the Company may be confronted with a project which, when completed, has a value which is insufficient to assure full repayment of the construction loan. Although the Company manages lending risks through its underwriting and credit administration policies, no assurance can be given that such risks would not materialize, in which event the Company s financial condition, results of operations, cash flows and business prospects could be materially adversely affected.

Dependence on Real Estate

At September 30, 2006, approximately 70% of the loans of the Company were secured by real estate. The value of the Company s real estate collateral has been, or could be adversely affected by any future economic recession and any resulting adverse impact on the real estate market in California.

The Company s primary lending focus has historically been commercial real estate, commercial lending and, to a lesser extent, construction lending. At September 30, 2006, commercial real estate and construction loans comprised approximately 38% and 28%, respectively, of the total loans in the portfolio of the Company. At September 30, 2006, all of the Company s real estate mortgage, real estate construction loans, and commercial real estate loans, were secured fully or in part by deeds of trust on underlying real estate. The Company s dependence on real estate increases the risk of loss in the loan portfolio of the Company and its holdings of other real estate owned if economic conditions in California deteriorate in the future. Deterioration of the real estate market in California could have a material adverse effect on the Company s business, financial condition and results of operations.

Risks Specific to Operations in California

Our operations are located entirely in the State of California, which in recent years has experienced economic disruptions that are unique to the state. The fiscal and political uncertainty surrounding the state government s financial condition, for example may have a material adverse effect on our customer s businesses or on our business, financial condition and results of operations.

Interest Rate Risk

The income of the Company is highly dependent on interest rate differentials and the resulting net interest margins (i.e., the difference between the interest rates earned on the Bank s interest-earning assets such as loans and securities, and the interest rates paid on the Bank s interest-bearing liabilities such as deposits and borrowings). These rates are highly sensitive to many factors, which are beyond the Company s control, including general economic conditions, inflation, recession and the policies of various governmental and regulatory agencies, in particular, the FRB. As a result, the Company is generally adversely affected by declining interest rates. In addition, changes in monetary policy, including changes in interest rates, influence the origination of loans, the purchase of investments and the generation of deposits and affect the rates received on loans and securities and paid on deposits, which could have a material adverse effect on the Company s business, financial condition and results of operations. See Quantitative and Qualitative Disclosure about Market Risk.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Potential Volatility of Deposits

At September 30, 2006, time certificates of deposit in excess of $100,000 represented approximately 30.0% of the dollar value of the total deposits of the Company. As such, these deposits are considered volatile and could be subject to withdrawal. Withdrawal of a material amount of such deposits could adversely affect the liquidity of the Company, profitability, business prospects, results of operations and cash flows. The Company monitors activity of volatile liability deposits on a quarterly basis. Approximately $55.7 million of the $128.7 million in time certificates of deposit over $100,000 act as core deposits with over five years history of rollover with the Company.

Dividends

Because the Company conducts no other significant activity than the management of its investment in the Bank and Mortgage Company, the Company is dependent on these subsidiaries for income. The ability of the Bank and Mortgage Company to pay cash dividends in the future depends on the profitability, growth and capital needs of the Bank and Mortgage Company. In addition, the California Financial Code restricts the ability of the Bank to pay dividends. No assurance can be given that the Company or the Bank will pay any dividends in the future or, if paid, such dividends will not be discontinued.

Government Regulation and Legislation

The Company and the Bank are subject to extensive state and federal regulation, supervision and legislation, which govern almost all aspects of the operations of the Company and the Bank. The business of the Company is particularly susceptible to being affected by the enactment of federal and state legislation which may have the effect of increasing or decreasing the cost of doing business, modifying permissible activities or enhancing the competitive position of other financial institutions. Such laws are subject to change from time to time and are primarily intended for the protection of consumers, depositors and the deposit insurance funds and not for the protection of shareholders of the Company. The Company cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have on the business and prospects of the Company, but it could be material and adverse.

Economic Conditions and Geographic Concentration

The Company s operations are located and concentrated in California, particularly the counties of El Dorado, Placer, Sutter, Shasta, Sacramento and Sutter, and are likely to remain so for the foreseeable future. At September 30, 2006, approximately 70% of the Bank s loan portfolio consisted of real estate related loans, most of which were related to collateral located in California. A change in California economic and business conditions may adversely affect the performance of these loans. Deterioration in economic conditions could have a material adverse effect on the quality of the loan portfolio of the Bank and the demand for its products and services. In addition, during periods of economic slowdown or recession, the Bank may experience a decline in collateral values and an increase in delinquencies and defaults. A decline in collateral values and an increase in delinquencies and defaults increase the possibility and severity of losses. California real estate is also subject to certain natural disasters, such as earthquakes, floods and mudslides, which are typically not covered by the standard hazard insurance policies maintained by borrowers. Uninsured disasters may make it difficult or impossible for borrowers to repay loans made by the Company.

Reliance on Key Employees and Others

As of September 30, 2006, the Company employed 125 employees. The Company considers employee relations to be excellent. A collective bargaining group represents none of the employees of the Company or its subsidiaries. Failure of the Company to attract and retain qualified personnel could have an adverse effect on the Company s business, financial condition and results of operations. The Company does maintain life insurance with respect to five of its officers in conjunction with a salary continuation plan.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Adequacy of Allowance for Loan and Lease Losses (ALLL)

The Company s allowance for loan and lease losses was approximately $4.8 million, or 1.16% of total loans at September 30, 2006. Material future additions to the allowance for loan losses might be necessary if material adverse changes in economic conditions occur and the performance of the loan portfolio of the Company deteriorates. In addition, future additions to the Company s allowance for loan and lease losses on other real estate owned may also be required in order to reflect changes in the markets for real estate in which the Company s other real estate owned is located and other factors which may result in adjustments which are necessary to ensure that the Company s foreclosed assets are carried at the lower of cost or fair value, less estimated costs to dispose of the properties. Moreover, the FDIC and the DFI, as an integral part of their examination process, periodically review the Company s allowance for loan and lease losses and the carrying value of its assets. The Bank was most recently examined by the FDIC in this regard during the second quarter of 2006. Increases in the provisions for loan losses and foreclosed assets could adversely affect the Bank s financial condition and results of operations.

Certain Ownership Restrictions under California and Federal Law

Federal law prohibits a person or group of persons acting in concert from acquiring control of a financial holding company unless the FRB has been given 60 days prior written notice of such proposed acquisition and within that time period the FRB has not issued a notice disapproving the proposed acquisition or extending for up to another 30 days, the period during which such a disapproval may be issued. An acquisition may be made before the expiration of the disapproval period if the FRB issues written notice of its intent not to disapprove the action. Under a rebuttal presumption established by the FRB, the acquisition of more than 10% of a class of voting stock of a bank with a class of securities registered under Section 12 of the Exchange Act (such as the common stock), would, under the circumstances set forth in the presumption, constitute the acquisition of control. In addition, any company would be required to obtain the approval of the FRB under the BHCA, before acquiring 25% (5% in the case of an acquirer that is, or is deemed to be, a bank holding company) or more of the outstanding shares of the Company s common stock, or such lesser number of shares as constitute control. See Supervision and Regulation and Regulation and Supervision of Bank Holding Companies in the Company s 2005 Annual Report on Form 10-K.

Under the California Financial Code, no person shall, directly or indirectly, acquire control of a California licensed bank or a bank holding company unless the Commissioner has approved such acquisition of control. A person would be deemed to have acquired control of the Company and the Bank under this state law if such person, directly or indirectly, has the power (i) to vote 25% or more of the voting power of the Company or (ii) to direct or cause the direction of the management and policies of the Company. For purposes of this law, a person who directly or indirectly owns or controls 10% or more of the common stock would be presumed to direct or cause the direction of the management and policies of the Company and thereby control the Company.

Shares Eligible for Future Sale

As of September 30, 2006, the Company had 8,926,842 shares of Common Stock outstanding, of which 5,975,954 shares are eligible for sale in the public market without restriction and 2,950,888 shares are eligible for sale in the public market pursuant to Rule 144 under the Securities Act of 1933, as amended (the Securities Act). Future sales of substantial amounts of the Company s common stock, or the perception that such sales could occur, could have a material adverse effect on the market price of the common stock. In addition, options to acquire 357,945 shares of the issued and outstanding shares of common stock at exercise prices ranging from $2.75 to $11.59 have been issued to directors and certain employees of the Company under the Company s 1998 Stock Option Plan. No prediction can be made as to the effect, if any, that future sales of shares, or the availability of shares for future sale, will have on the market price of the Company s common stock.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Technology and Computer Systems

Advances and changes in technology can significantly affect the business and operations of the Company. The Company faces many challenges including the increased demand for providing computer access to bank accounts and the systems to perform banking transactions electronically. The Company s ability to compete depends on its ability to continue to adapt its technology on a timely and cost-effective basis to meet these requirements. In addition, the Company s business and operations are susceptible to negative impacts from computer system failures, communication and energy disruption and unethical individuals with the technological ability to cause disruptions or failures of the Company s data processing systems.

During 2006 the Company began construction on an Administrative and Information Technology center on property already owned adjacent to the Churn Creek office. Ground breaking began in February 2006 and the project is expected to be completed by January 1, 2007. The budget for this project is approximately $3.7 million.

Environmental Risks

The Company, in its ordinary course of business, acquires real property securing loans that are in default, and there is a risk that hazardous substance or waste, contaminants or pollutants could exist on such properties. The Company may be required to remove or remediate such substances from the affected properties at its expense, and the cost of such removal or remediation may substantially exceed the value of the affected properties or the loans secured by such properties. Furthermore, the Company may not have adequate remedies against the prior owners or other responsible parties to recover its costs. Finally, the Company may find it difficult or impossible to sell the affected properties either before or following any such removal. In addition, the Company may be considered liable for environmental liabilities concerning its borrowers properties, if, among other things, it participates in the management of its borrowers operations. The occurrence of such an event could have a material adverse effect on the Company s business, financial condition, results of operations and cash flows.

Dilution

The Company has issued options to purchase shares of the Company s common stock at prices equal to 85% to 100% of the fair market value of the Company s Common Stock on the date of grant. As of September 30, 2006, the Company had outstanding options to purchase an aggregate of 357,945 shares of Common Stock at exercise prices ranging from $2.75 to $11.59 per share, or a weighted average exercise price per share of $5.24. To the extent such options are exercised, stockholders of the Company will experience dilution.

UNRESOLVED STAFF COMMENTS

No comments to report.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Executive Overview

Our Company was established to make a profitable return while serving the financial needs of the business and professional communities of our markets. We are in the financial services business, and no line of financial services is beyond our charter as long as it serves the needs of businesses, professionals and consumers in our communities. The mission of our Company is to provide its stockholders with a safe, profitable return on their investment, over the long term. Management will attempt to minimize risk to our stockholders by making prudent business decisions, will maintain adequate levels of capital and reserves, and will maintain effective communications with stockholders.

Our Company s most valuable asset is its customers. We will consider their needs first when we design our products. High-quality customer service is an important mission of our Company, and how well we accomplish this mission will have a direct influence on our profitability.

Our vision is to embrace changes in the industry and develop profitable business strategies that allow us to maintain our customer relationships and build new ones. Our competitors are no longer just banks. We must compete with financial powerhouses that want our core business. The flexibility provided by the Financial Holding Company Act is becoming increasingly important. We have developed strategic plans that evaluate additional financial services and products that can be delivered to our customers efficiently and profitably. Producing quality returns is, as always, a top priority.

The Company s long term success rests on the shoulders of the leadership team to effectively work to enhance the performance of the Company. As a financial services company, we are in the business of taking risk. Whether we are successful depends largely upon whether we take the right risks and get paid appropriately for the risks we take. Our governance structure enables us to manage all major aspects of the Company s business effectively through an integrated process that includes financial, strategic, risk and leadership planning.

We define risks to include not only credit, market and liquidity risk the traditional concerns for financial institutions but also operational risks, including risks related to systems, processes or external events, as well as legal, regulatory and reputation risks.

Our management processes, structures and policies help to ensure compliance with laws and regulations and provide clear lines for decision-making and accountability. Results are important, but equally important is how we achieve those results. Our core values and commitment to high ethical standards is material to sustaining public trust and confidence in our Company. For additional information concerning risks and uncertainties related to the Company and its operations please refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2005 under the heading of Risk Management.

Sources of Income

The Company derives its income from two principal sources: (i) net interest income, which is the difference between the interest income it receives on interest-earning assets and the interest expense it pays on interest-bearing liabilities, and (ii) fee income, which includes fees earned on deposit services, income from SBA lending, electronic-based cash management services, mortgage brokerage fee income and merchant credit card processing services. The profitability of the Bank depends to a great extent on net interest income. Interest rate factors are highly sensitive to many factors, which are beyond the Company s control, including general economic conditions, inflation, recession, and the policies of various governmental and regulatory agencies, in particular, the Federal Reserve Board. Because of the Bank s predisposition to variable rate pricing and non-interest bearing demand deposit accounts, the Bank is considered asset sensitive. As a result, the Company is adversely affected by declining interest rates.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Financial Highlights Results of Operations

Net income for the third quarter of 2006 totaled $1,672,000 an increase of 7.2% from the $1,560,000 reported for the same quarterly period of 2005. On the same basis, diluted earnings per common share for the third quarter of 2006 were $0.19, compared to $0.18 for the same period of 2005, a 5.6% increase. Return on average assets (ROA) and return on average equity (ROE) for the third quarter of 2006 were 1.17% and 15.11%, respectively, compared with 1.31% and 17.75%, respectively, for the third quarter of 2005.

Net income for the nine-month period ended September 30, 2006 totaled $4,953,000, an increase of 12.4% over net income of $4,407,000 reported for the same nine-month period ended September 30, 2005. On the same basis, diluted earnings per common share for the nine-months ended September 30, 2006 was $0.55, compared to $0.50 for the same nine-month period in 2005, a 10.0% increase. ROA was 1.22% and ROE was 15.28% for the first nine-months of 2006 compared with 1.28% and 18.50%, respectively, for the same nine-month period of 2005.

Net Interest Income and Net Interest Margin

Net interest income is the primary source of the Company s income. Net interest income represents the excess of interest and fees earned on interest-earning assets (loans, securities and Federal Funds sold) over the interest paid on deposits and borrowed funds. Net interest margin is net interest income expressed as a percentage of average earning assets. Net interest income for the quarter ended September 30, 2006 was $5.5 million compared with $5.1 million for the same period in 2005, an increase of 7.9%. Net interest income for the nine-months ended September 30, 2006 was $16.6 million compared with $14.8 million for the same nine-month period in 2005, an increase of 12.2%.

Average earning assets for the nine-months ended September 30, 2006 increased $79.0 million or 18.3% compared with the same period in the prior year. Average loans, the largest component of average earning assets, increased $56.4 million or 17.0% on average compared with the prior year period. Average securities including federal funds sold increased $22.6 million or 23.0% over the prior period. Overall, the yield on earning assets increased to 7.23% for the nine-month period ended September 30, 2006 compared to 6.19% for the same period in the prior year. The increase is primarily due to new loan production priced at higher rates, additional available funds being invested into the security portfolio while current loan yields continue to rise with the prime rate.

Average interest-bearing liabilities for the nine-months ended September 30, 2006 increased $77.5 million or 22.6% compared with the prior year period. Average non-interest bearing deposits decreased by $1.2 million or 1.5% over the prior year nine-month period. Average borrowings increased $49.9 million compared with the prior year period, partially related to an increase in repurchase agreements and the second issuance of trust preferred securities. Borrowings are repaid as core deposit growth increases.

The overall cost of interest-bearing liabilities for the first nine-months 2006 was 3.51% compared with 2.02% for the first nine-months of 2005. The increase was primarily a result of increases in the interest paid on interest-bearing liabilities and longer-term fixed rate borrowings. The net effect of the changes discussed above resulted in an increase of $1.8 million or 12.0% in net interest income for the nine-month period ended September 30, 2006 from the same period in 2005. Net interest margin decreased twenty five basis points to 4.33% from 4.58% for the same period a year ago.

Liquidity

The objective of liquidity management is to ensure that the Company can efficiently meet the borrowing needs of our customers, withdrawals of our depositors and other cash commitments under both normal operating conditions and under unforeseen and unpredictable circumstances of industry or market stress.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The Asset Liability Management Committee (ALCO) establishes and monitors liquidity guidelines that require sufficient asset-based liquidity to cover potential funding requirements and to avoid over-dependence on volatile, less reliable funding markets. In addition to the immediately liquid resources of cash and due from banks and federal funds sold, asset liquidity is supported by debt securities in the available for sale security portfolio and wholesale lines of credit with the Federal Home Loan Bank and borrowing lines with other financial institutions. Customer core deposits have historically provided the Company with a source of relatively stable and low-cost funds.

The Company s consolidated liquidity position remains adequate to meet short-term and long-term future contingencies. At September 30, 2006, the Company had overnight investments of $45.5 million and available lines of credit of at the Federal Home Loan bank of approximately $85.1 million, and two federal funds borrowing line with correspondent banks of $15.0 million.

Capital Management

The Company uses capital to fund organic growth, pay dividends and repurchase its shares. The objective of effective capital management is to produce above market long-term returns by using capital when returns are perceived to be high and issuing capital when costs are perceived to be low. The Company s potential sources of capital include retained earnings, common and preferred stock issuance and issuance of subordinated debt and trust preferred securities.

Total stockholders equity increased from December 31, 2005 by $4.8 million to $43.9 million at September 30, 2006. The increase was a result of earnings of $5.0 million, $1.4 million from exercises of stock options, including tax benefits. The increase is partially offset dividends paid to shareholders of $1.8 million.

September 30, 2006	Capital	Actual Ratio	Well Capitalized Requirement	Minimum Capital Requirement
The Company				
Leverage	$ 54,942,252	9.99%	n/a	4.0%
Tier 1 Risk-Based	54,942,252	11.64%	n/a	4.0%
Total Risk-Based	60,092,573	12.73%	n/a	8.0%
Redding Bank of Commerce				
Leverage	$ 53,132,814	9.28%	5.0%	4.0%
Tier 1 Risk-Based	53,132,814	11.25%	6.0%	4.0%
Total Risk-Based	58,283,135	12.34%	10.00%	8.0%

Short and Long Term Borrowings

The Company actively uses Federal Home Loan Bank (FHLB) advances as a source of wholesale funding to support growth strategies as well as to provide liquidity. At September 30, 2006, the Company s FHLB advances were a combination of fixed term and variable borrowings without call or put option features.

At September 30, 2006, the Bank had $55 million in FHLB term advances outstanding at an average rate of 5.14% compared to $35 million at an average rate of 3.25% at September 30, 2005.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Provision for Loan and Lease Losses

The Company s most significant management accounting estimate is the appropriate level for the allowance for loan and lease losses. The Company follows a methodology for calculating the appropriate level for the allowance for loan and lease losses as discussed under Asset Quality and Allowance for Loan and Lease Losses (ALLL) in this document.

Provision for loan losses were $226,000 for the nine-months ended September 30, 2006 compared with $442,000 for the same period of 2005. Redding Bank of Commerce s allowance for loan losses was 1.16% of total loans at September 30, 2006 and 1.23% at September 30, 2005, while its ratio of non-performing assets to total assets was 0.00% at September 30, 2006, compared to 0.44% at September 30, 2005. Year-to-date net recoveries of $210,765 compare favorably to net charge-offs of $57,000 for the same period last year.

Factors that may affect future results

As a financial services company, our earnings are significantly affected by general business and economic conditions. These conditions include short-term and long-term interest rates, inflation, monetary supply, fluctuations in both debt and equity capital markets, and the strength of the United States economy and local economies in which we operate. For example, an economic downturn, increase in unemployment, or other events that negatively impact household and/or corporate incomes could decrease the demand for the Company s loan and non-loan products and services and increase the number of customers who fail to pay interest or principal on their loans. Geopolitical conditions can also affect our earnings. Acts or threats of terrorism, actions taken by the United States or other governments in response to acts or threats of terrorism and our military conflicts including the aftermath of the war with Iraq, could impact business conditions in the United States.

The Board of Governors of the Federal Reserve System regulates the supply of money and credit in the United States. Its policies determine in large part our cost of funds for lending and investing and the return we earn on those loans and investments, both of which impact our net interest margin, and can materially affect the value of financial instruments we hold. Its policies can also affect our borrowers, potentially increasing the risk of failure to repay their loans. Changes in Federal Reserve Board policies are beyond our control and hard to predict or anticipate.

We operate in a highly competitive industry that could become even more competitive because of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can now merge creating a financial holding company that can offer virtually any type of financial service, including banking, securities underwriting, insurance (agency and underwriting) and merchant banking. Technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of our competitors have fewer regulatory constraints and some have lower cost structures.

The holding company, subsidiary bank and non-bank subsidiary are heavily regulated at the federal and state levels. This regulation is to protect depositors, federal deposit insurance funds and the banking system as a whole, not investors. Congress and state legislatures and federal and state regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies including changes in interpretation and implementation could affect us in substantial and unpredictable ways including limiting the types of financial services and products we may offer. Our failure to comply with the laws, regulations or policies could result in sanctions by regulatory agencies and damage our reputation. For more information, refer to the Supervision and Regulation section in the Company s 2005 Annual Report on Form 10-K. Our success depends, in part, on our ability to adapt our products and services to evolving industry standards. There is increasing pressure on financial services companies to provide products and services at lower prices. This can reduce our net interest margin and revenues from fee-based products and services.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

In addition, the widespread adoption of new technologies, including internet-based services, could require us to make substantial expenditures to modify or adapt our existing products and services. Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people can be intense.

The holding company is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenues from dividends from its subsidiaries. These dividends are the principal source of funds to pay dividends on the holding company s common stock and interest and principal on its debt. Various federal and state laws and regulations limit the amount of dividends that our bank may pay to the holding company. For more information, refer to Dividends and Other Distributions in the Company s 2005 Annual Report on Form 10-K.

Critical Accounting Policies

The Securities and Exchange Commission (SEC) issued disclosure guidance for critical accounting policies . The SEC defines critical accounting policies as those that require application of 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 and may change in future periods.

Our accounting policies are integral to understanding the results reported. Accounting policies are described in detail in Note 2 of the NOTES TO CONSOLIDATED FINANCIAL STATEMENTS in the Company s 2005 Annual report on Form 10-K. Not all of significant accounting policies presented in Note 2 to the Consolidated Financial Statements contained in the Company s 2005 Annual Report on Form 10-K require management to make difficult, subjective or complex judgments or estimates.

Preparation of financial statements

The preparation of these financial statements requires management to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. On an ongoing basis, management evaluates the estimates used. Estimates are based upon historical experience, current economic conditions and other factors that management considers reasonable under the circumstances.

Use of estimates

These estimates result in judgments regarding the carrying values of assets and liabilities when these values are not readily available from other sources, as well as assessing and identifying the accounting treatments of contingencies and commitments. Actual results may differ from these estimates under different assumptions or conditions.

Generally Accepted Accounting Principles in the United States of America

The Company s financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The Company s significant accounting policies are presented in Note 2 to the Consolidated Financial Statements contained in the Company s 2005 Annual Report on Form 10-K. The Company follows accounting policies typical to the community commercial banking industry and in compliance with various regulations and guidelines as established by the Financial Accounting Standards Board (FASB) and the Bank s primary federal regulator, the Federal Deposit Insurance Corporation (FDIC). The following is a brief description of our current accounting policies involving significant management judgments. Accounting principles generally accepted in the United States of America (GAAP), itself may change over time, having impact over the reporting of the Company s financial activity.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Although the economic substance of the Company s transactions would not change, alterations in GAAP could affect the timing or manner of accounting or reporting.

Allowance for Loan and Lease Losses (ALLL)

The allowance for loan and lease losses is management s best estimate of the probable losses that may be sustained in our loan portfolio. The allowance is based on two basic principles of accounting. (1) SFAS No.5 which requires that losses be accrued when they are probable of occurring and estimable and (2) SFAS No. 114, which requires that losses be accrued based on the differences between that value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. The Company performs periodic and systematic detailed evaluations of its lending portfolio to identify and estimate the inherent risks and assess the overall collectibility. These evaluations include general conditions such as the portfolio composition, size and maturities of various segmented portions of the portfolio such as secured, unsecured, construction, and Small Business Administration (SBA).

Additional factors include concentrations of borrowers, industries, geographical sectors, loan product, loan classes, size and collateral types; volume and trends of loan delinquencies and non-accrual; criticized and classified assets and trends in the aggregate in significant credits identified as watch list items. There are several components to the determination of the adequacy of the ALLL. Each of these components is determined based upon estimates that can and do change when the actual events occur. The Company estimates the SFAS No. 5 portion of the ALLL based on the segmentation of its portfolio. For those segments that require an ALLL, the Company estimates loan losses on a monthly basis based upon its ongoing loan review process and analysis of loan performance. The Company follows a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation. One method of estimating loan losses for groups of loans is through the application of loss rates to the groups aggregate loan balances. Such rates typically reflect historical loss experience for each group of loans, adjusted for relevant economic factors over a defined period of time. The Company evaluates and modifies its loss estimation model as needed to ensure that the resulting loss estimate is consistent with GAAP.

For individually impaired loans, SFAS No. 114 provides guidance on the acceptable methods to measure impairment. Specifically, SFAS No. 114 states that when a loan is impaired, the Company should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan s effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan s observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of future cash flows for a loan, the Company considers all available information reflecting past events and current conditions, including the effect of existing environmental factors.

Revenue recognition

The Company s primary sources of revenue are interest income. Interest income is recorded on an accrual basis. Note 2 to the Consolidated Financial Statements contained in the Company s 2005 Annual Report on Form 10-K offers an explanation of the process for determining when the accrual of interest income is discontinued on an impaired loan.

Stock-based Compensation

Statement of Financial Accounting Standards No. 123 (revised 2004); ***Accounting for Stock Based Compensation*** was adopted by the Company as of January 1, 2006, using the modified prospective transition method. Under the modified prospective transition method, compensation cost is recognized on or after the required effective date for the portion of outstanding awards, for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated under Statement No. 123 for either recognition or pro forma disclosures.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The amount of the reduction for the fiscal years 2003 through 2005 is disclosed in Note 13 to the Consolidated Financial Statements contained in the Company s 2005 Annual Report on Form 10-K, based upon the assumptions listed therein. Accounting principles generally accepted in the United States of America (GAAP), itself may change over time, having impact over the reporting of the Company s financial activity. Although the economic substance of the Company s transactions would not change, alterations in GAAP could affect the timing or manner of accounting or reporting.

Income Taxes

The Company accounts for income taxes under the asset liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using currently enacted tax rates applied to such taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. If future income should prove non-existent or less than the amount of deferred tax assets within the tax years to which they may be applied, the asset may not be realized and our net income will be reduced. Our deferred tax assets are described further in Note 12 of the NOTES TO CONSOLIDATED FINANCIAL STATEMENTS in the Company s 2005 Annual Report on Form 10-K.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following table presents the Company s daily average balance sheet information together with interest income and yields earned on average interest-bearing assets and interest expense and rates paid on average interest-bearing liabilities. Average balances are average daily balances.

Table 1.

Average Balances, Interest Income/Expense and Yields/Rates Paid (Unaudited, Dollars in thousands)

	Nine Months Ended September 30, 2006			Nine Months Ended September 30, 2005		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Earning Assets						
Portfolio Loans	$ 388,886	$ 23,881	8.19%	$ 332,476	$ 17,393	6.98%
Tax-exempt Securities	18,059	494	3.65%	9,235	230	3.32%
US Government Securities	83,440	2,575	4.11%	73,162	2,026	3.69%
Federal Funds Sold	17,335	658	5.06%	16,818	385	3.05%
Other Securities	3,437	113	4.38%	488	16	4.37%
Average Earning Assets	$ 511,157	$ 27,721	7.23%	$ 432,179	$ 20,050	6.19%
Cash & Due From Banks	$ 14,161			$ 15,211		
Bank Premises	6,500			5,543		
Allowance for Loan and Lease Losses	(4,459)			(4,091)		
Other Assets	14,969			11,188		
Average Total Assets	$ 542,328			$ 460,030		
Interest Bearing Liabilities						
Demand Interest Bearing	$ 106,002	$ 968	1.22%	$ 112,259	$ 688	0.82%
Savings Deposits	25,095	209	1.11%	25,884	127	0.65%
Certificates of Deposit	182,478	5,844	4.27%	147,834	3,051	2.75%
Repurchase Agreements	28,010	794	3.78%	16,345	264	2.15%
FHLB Borrowings	64,597	2,492	5.14%	31,337	746	3.17%
Trust Preferred Borrowings	15,000	796	7.08%	10,000	332	4.43%
Average Interest Bearing Liabilities	421,182	$ 11,103	3.51%	343,659	$ 5,208	2.02%
Non interest Demand	78,388			79,612		
Other Liabilities	4,547			5,003		
Shareholder Equity	38,211			31,756		
	$ 542,328			$ 460,030		

Average Liabilities and Stockholders Equity				
Net Interest Income and Net Interest Margin	$ 16,618	4.33%	$ 14,842	4.58%

Interest income on loans includes fee income of approximately $381,000 and $443,000 for the period ended September 30, 2006 and 2005 respectively. The Company s average total assets increased to $542.3 million at September 30, 2006 compared to $460.0 million for the same period in 2005, a $82.3 million increase or 17.9%. The Company s practice is to place an asset on nonaccrual status when one of the following events occurs: (i) Any installment of principal or interest is 90 days or more past due, (ii) management determines the ultimate collection of principal or interest to be unlikely or (iii) the terms of the loan have been renegotiated due to a serious weakening of the borrower s financial condition. Interest income on loans does not reflect accruals on loans in a nonaccrual status. Accruals are resumed on loans only when they are brought fully current with respect to interest and principal and when the loan is estimated to be fully collectible.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following tables set forth changes in interest income and expense for each major category of earning assets and interest-bearing liabilities, and the amount of change attributable to volume and rate changes for the periods indicated. Changes attributable to rate/volume have been allocated to volume changes.

Table 2.

Analysis of Changes in Net Interest Income and Interest Expense (Unaudited)

(Dollars in thousands)	September 30, 2006 over September 30, 2005		
	Volume	Rate	Total
Increase(Decrease) In Interest Income			
Portfolio Loans	$ 4,472	$ 2,016	$ 6,488
Tax-exempt Securities	249	15	264
US Government Securities	394	155	549
Federal Funds Sold	104	169	273
Other Securities	97	0	97
Total Increase	$ 5,316	$ 2,355	$ 7,671
Increase(Decrease) In Interest Expense			
Interest Bearing Demand	$ 55	$ 225	$ 280
Savings Deposits	23	59	82
Certificates of Deposit	1,671	1,122	2,793
Repurchase Agreements	397	133	530
FHLB Borrowings	1,437	309	1,746
Trust Preferred Borrowings	332	132	464
Total Increase	$ 3,915	$ 1,980	$ 5,895
Net Increase	$ 1,401	$ 375	$ 1,776

Net interest income for the quarter ended September 30, 2006 was $5.5 million compared with $5.1 million for the same period in 2005, an increase of 7.9%. Net interest income for the nine-months ended September 30, 2006 was $16.6 million compared with $14.8 million for the same nine-month period in 2005, an increase of 12.2%.

Average earning assets for the nine-months ended September 30, 2006 increased $79.0 million or 18.3% compared with the same period in the prior year. Average loans, the largest component of earning assets, increased $56.4 million or 17.0% on average compared with the prior year period. Average securities including federal funds sold increased $22.6 million or 23.0% over the prior period. Overall, the yield on earning assets increased to 7.23% for the nine-month period compared to 6.19% for the same period in the prior year. The increase is primarily due to new loan production priced at higher rates, additional available funds being invested into the security portfolio while current loan yields continue to rise with the prime rate index.

The overall cost of interest-bearing liabilities for the first nine-months 2006 was 3.51% compared with 2.02% for the first nine-months of 2005. The increase was primarily a result of increases in the interest paid on interest-bearing liabilities and longer-term borrowings. The net effect of the changes discussed above resulted in an increase of

$1.8 million or 12.0% in net interest income for the nine-month period ended September 30, 2006 from the same period in 2005. Net interest margin decreased twenty five basis points to 4.33% from 4.58% for the same period a year ago.

Table of Contents

\

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Noninterest Income

The Company s non-interest income consists of service charges on deposit accounts, other fee income, processing fees for credit card payments and gains or losses on security sales. The following table sets forth a summary of noninterest income for the periods indicated.

(Dollars in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Noninterest income				
Service charges on deposit accounts	$ 81	$ 98	$ 255	$ 303
Payroll and benefit processing fees	89	81	287	264
Earnings on cash surrender value - Bank owned insurance	80	52	231	156
Net loss on sale of securities available-for-sale	(171)	0	(171)	(2)
Net gain on sale of loans	90	23	90	91
Merchant credit card service income, net	110	91	280	268
Mortgage brokerage fee income	32	85	84	242
Other Income	117	85	331	283
Total Noninterest income	$ 428	$ 515	$ 1,387	$ 1,605

Noninterest income decreased $87,000 or 16.9% for the quarter ended September 30, 2006 over September 30, 2005. The most significant portion of the decline is a loss on the sale of available-for-sale securities**.** The ALCO Roundtable restructured the Investment portfolio to improve yield and protect income on the rate downside by extending maturities in the municipal market. Management believes that the net loss after tax will be fully recovered through investment earnings before the end of this year. The second most significant drop in quarterly earnings is the reduction in mortgage brokerage fee income from $85,000 in 2005 to $32,000 in 2006 reflective of the slowdown in the single family residential real estate market.

Noninterest income decreased $218,000 or 13.6% for the nine-months ended September 30, 2006 over September 30, 2005. The decrease for the nine-month period is specifically related to the investment sale strategy and lower earnings on mortgage brokerage fee income for the period.

Noninterest Expense

(Dollars in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Noninterest Expense				
Salaries and related benefits	$ 1,996	$ 1,750	$ 5,870	$ 5,088
Occupancy and equipment expense	467	437	1,350	1,173
FDIC insurance premium	12	11	36	36

Data processing fees	53		71	169		209
Professional service fees	149		199	503		577
Payroll and Benefit fees	24		24	78		86
Deferred compensation expense	94		85	272		234
Stationery and Supplies	71		40	180		159
Postage	26		45	91		84
Directors expense	45		30	170		188
Other expenses	362		403	1,128		1,068
Total Noninterest expense	$ 3,299	$	3,095	$ 9,847	$	8,902

31

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Noninterest expense for the quarter ended September 30, 2006 was $3.3 million, an increase of $204,000 or 6.6% over the same period a year ago. Salaries and employee benefits increased $246,000 or 14.1% over the same period a year ago, representative of increases to staffing in support of the new Sutter Bank of Commerce and increases in the profit sharing component of the expense item.

Non-interest expense for the nine-months ended September 30, 2006 was $9.8 million compared to $8.9 million in the same period a year ago, an increase of $945,000 or 10.6% over the same nine-month period a year ago. Salaries and employee benefits increased $782,000 or 15.4% over the same nine-month period a year for the reasons mentioned above.

Income Taxes

The Company s effective tax rate varies with changes in the relative amounts of its non-taxable income and non-deductible expenses. The increase in the Company s tax provision is attributable to decreases in non-taxable income related to a reduction in the municipal security portfolio and reclassification of enterprise zone qualified credits.

The following table reflects the Company s tax provision and the related effective tax rate for the periods indicated.

(Dollars in thousands)	Three Months Ended		Nine Months Ended	
Income Taxes	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Tax provision	$ 915	$ 897	$ 2,979	$ 2,696
Effective tax rate	35.4%	36.5%	37.6%	38.0%

The Company s provision for income taxes includes both federal and state income taxes and reflects the application of federal and state statutory rates to the Company s net income before taxes. The principal difference between statutory tax rates and the Company s effective tax rate is the benefit derived from investing in tax-exempt securities and enterprise zone qualifying loans. Increases and decreases in the provision for taxes reflect changes in the Company s net income before tax.

Provision for income tax for the third quarter 2006 was $915,000 as compared to $897,000 for the third quarter period in 2005. The increase in tax expense is attributed to increased production and earnings for the period. Reductions in the effective tax rate are related to investments in tax deductible municipal securities and increases in holdings of Company key life products.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Asset Quality

The Company concentrates its lending activities primarily within in El Dorado, Placer, Sutter, Sacramento, Shasta and Yuba Counties, California, and the location of the Bank s five full service branches, specifically identified as Upstate California.

The Company manages its credit risk through diversification of its loan portfolio and the application of underwriting policies and procedures and credit monitoring practices. Although the Company has a diversified loan portfolio, a significant portion of its borrowers ability to repay the loans is dependent upon the professional services and commercial real estate development industry sectors. Generally, the loans are secured by real estate or other assets and are expected to be repaid from the cash flows of the borrower or proceeds from the sale of collateral.

The following table sets forth the amounts of loans outstanding by category as of the dates indicated:

(Dollars in thousands)	September 30, 2006	December 31, 2005
Portfolio Loans		
Commercial and financial loans	$ 123,904	$ 115,401
Real estate-construction loans	111,352	100,786
Real estate-commercial	153,020	133,510
Real estate-other	14,238	13,790
Real estate-mortgage	3,210	3,669
Installment	222	439
Other loans	2,841	446
Less:		
Net deferred loan fees	(377)	(420)
Allowance for loan losses	(4,753)	(4,316)
Total net loans	$ 403,657	$ 363,305

The Company s practice is to place an asset on nonaccrual status when one of the following events occur: (i) any installment of principal or interest is 90 days or more past due (unless in management s opinion the loan is well secured and in the process of collection). (ii) Management determines the ultimate collection of principal or interest to be unlikely or (iii) the terms of the loan have been renegotiated due to a serious weakening of the borrower s financial condition. Nonperforming loans are loans that are on nonaccrual, are 90 days past due and still accruing or have been restructured.

Net portfolio loans have increased to $403.7 million, up $40.4 million or 11.1% at September 30, 2006 compared to $363.3 million at December 31, 2005. The portfolio mix reflects increases in production in commercial and financial loans, real estate construction and real estate commercial. Installment and real estate mortgage loans have declined. The balance of the portfolio remains relatively consistent with the mix at December 31, 2005, with commercial and financial loans of approximately 31%, real estate construction of 28% and commercial real estate at 38%. Impaired loans are loans for which it is probable that the Bank will not be able to collect all amounts due and payable. The Bank had outstanding balances of $0 and $3.2 million in impaired loans that had impairment allowances of $0 and $291,723 as of September 30, 2006 and December 31, 2005, respectively.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following table sets forth a summary of the Company s nonperforming assets as of the dates indicated:

(Dollars in thousands)

Non performing assets	September 30, 2006	December 31, 2005
Nonaccrual loans	$ 5	$ 372
90 days past due and still accruing interest	0	0
Total nonaccrual loans	5	372
Other Real Estate Owned	0	0
Total non performing assets	$ 5	$ 372

Allowance for Loan and Lease Losses (ALLL)

The allowance for loan and lease losses is management s estimate of the amount of probable loan losses in the loan portfolio. The Company determines the allowance for loan losses based on an ongoing evaluation. The evaluation is inherently subjective because it requires material estimates, including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. The Company makes provisions to the ALLL on a regular basis through charges to operations that are reflected in the Company s statements of income as a provision for loan losses. When a loan is deemed uncollectible, it is charged against the allowance. Any recoveries of previously charged-off loans are credited back to the allowance. There is no precise method of predicting specific losses or amounts that ultimately may be charged-off on particular categories of the loan portfolio. The Company s allowance for loan and lease losses is the accumulation of various components that are calculated based upon independent methodologies. All components of the allowance for loan losses represent an estimation performed pursuant to SFAS No. 5, *Accounting for Contingencies* or SFAS No. 114, *Accounting by Creditors for Impairment of a Loan.* Management s estimate of each SFAS No. 5 *Accounting for Contingencies* component is based on certain observable data that management believes is the most reflective of the underlying loan losses being estimated. Changes in the amount of each component of the allowance for loan losses are directionally consistent with changes in the observable data, taking into account the interaction of the SFAS No. 5 components over time.

An essential element of the methodology for determining the allowance for loan and lease losses is the Company s loan risk evaluation process, which includes loan risk grading individual commercial, construction, commercial real estate and most consumer loans. Loans are assigned loan risk grades based on the Company s assessment of conditions that affect the borrower s ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrower s current financial information, historical payment experience, loan documentation, public information, and other information specific to each individual borrower. Loans are reviewed on an annual or rotational basis or as management become aware of information affecting the borrower s ability to fulfill its obligations. Loan risk grades carry a dollar weighted risk percentage.

The ALLL is a general reserve available against the total loan portfolio. It is maintained without any inter-allocation to the categories of the loan portfolio, and the entire allowance is available to cover loan losses. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of the examination process, periodically review the Company s ALLL. Such agencies may require the Company to provide additions to the allowance based on their judgment of information available to them at the time of their examination. Accordingly, it is not possible to predict the effect future economic trends may have on the level of the provision for loan losses in future periods. In addition to the ALLL, an allowance for unfunded loan commitments and letters of loan is determined using estimates of the probability of funding. This reserve is carried as a liability on the condensed

consolidated balance sheet.

The ALLL should not be interpreted as an indication that charge-offs in future periods will occur in the stated amounts or proportions.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following table summarizes the activity in the ALLL reserves for the periods indicated.

(Dollars in thousands)	Three Months Ended		Nine Months Ended	
Allowance for Loan Losses	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Beginning balance for Loan Losses	$ 4,502	$ 4,148	$ 4,316	$ 3,866
Provision for Loan Losses	72	88	226	442
Charge offs:				
Commercial	(0)	(3)	(269)	(80)
Real Estate	(0)	(0)	0	0
Other	(1)	(0)	(1)	0
Total Charge offs	(1)	(3)	(270)	(80)
Recoveries:				
Commercial	180	18	475	23
Real Estate	0	0	0	0
Other	0	0	6	0
Total Recoveries	180	18	481	23
Ending Balance	$ 4,753	$ 4,251	$ 4,753	$ 4,251
ALLL to total loans	1.16%	1.23%	1.16%	1.23%
Net Charge offs to average loans	0.00%	0.02%	0.01%	0.02%

Securities Portfolio

The securities portfolio is comprised of U.S. Treasury securities, U.S. Agency securities, mortgage-backed securities, and obligations of states and political subdivisions. Securities classified as available for sale are recorded at fair value, while securities classified as held to maturity are recorded at cost. Unrealized gains or losses on available for sale securities, net of the deferred tax effect, are reported as increases or decreases in stockholders equity. Portions of the securities portfolio are used for pledging requirements for deposits of state and local subdivisions, securities sold under repurchase agreements, and FHLB advances. The Company does not include federal funds sold as securities. These investments are included in cash and cash equivalents.

Total available-for-sale securities increased $3.6 million or 3.8% at September 30, 2006 compared to December 31, 2005, as maturities were reinvested. As of September 30, 2006, the Company has pledged $1.0 million of securities for treasury, tax and loan accounts, $14.5 million for deposits of public funds, approximately $32.5 million for collateralized repurchase agreements and $35.0 million towards Federal Home Loan Bank borrowings.

The following table summarizes the amortized cost and estimated fair value of the Company s available-for-sale securities held on the dates indicated.

(Dollars in thousands)	as of September 30, 2006			
	Amortized Costs	Unrealized Gains	Unrealized Losses	Estimated Fair Value
U.S. government & agencies	$ 35,954	$ 19	$ (785)	$ 35,188

Obligations of state and political subdivisions	20,026	129	(159)	19,996
Mortgage backed securities	41,558	124	(1,224)	40,458
Other securities	2,000	0	(28)	1,972
Total	$ 99,538	$ 272	$ (2,196)	$ 97,614

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

(Dollars in thousands)	as of September 30, 2005			
	Amortized Costs	Unrealized Gains	Unrealized Losses	Estimated Fair Value
U.S. government & agencies	$ 44,772	$ 1	$ (583)	$ 44,190
Obligations of state and political subdivisions	6,351	39	(123)	6,267
Mortgage backed securities	44,306	0	(689)	43,617
Corporate bonds	4,040	0	(7)	4,033
Total	$ 99,469	$ 40	$ (1,402)	$ 98,107

Economic factors may affect market pricing over the stated maturity of the security. The unrealized losses associated with securities are not considered to be other-than-temporary because their unrealized losses are related to changes in interest rates and do not affect the expected cash flows of the underlying collateral or issuer. Security income is accrued when earned and included in interest income. The Company requires a credit rating of A or higher on its initial acquisition of investments and maintains an average rating of AA on the overall securities portfolio. As of September 30, 2006, seventy-seven securities were in a loss position. Management has evaluated each security in an unrealized loss position to determine if the impairment is other-than-temporary. Management has determined that no security is other than temporarily impaired. The unrealized losses are due to interest rate changes and the Company has the ability and intent to hold all securities with identified impairments to the earlier of the forecasted recovery or the maturity of the underlying security.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Market risk is the risk that values of assets and liabilities or revenues will be adversely affected by changes in market conditions such as market movements. The risk is inherent in the financial instruments associated with our operations and activities including loans, deposits, securities, short-term borrowings, long-term debt and derivatives.
Market-sensitive assets and liabilities are generated through loans and deposits associated with our banking business, our Asset Liability Management (ALM) process, and credit risk mitigation activities. Traditional loan and deposit products are reported at amortized cost for assets or the amount owed for liabilities. These positions are subject to changes in economic value based on varying market conditions. Interest rate risk is the effect of changes in economic value of our loans and deposits, as well as our other interest rate sensitive instruments and is reflected in the levels of future income and expense produced by these positions versus levels that would be generated by current levels of interest rates. We seek to mitigate interest rate risk as part of the ALM process.
Interest rate risk represents the most significant market risk exposure to our financial instruments. Our overall goal is to manage interest rate sensitivity so that movements in interest rates do not adversely affect net interest income. Interest rates risk is measured as the potential volatility in our net interest income caused by changes in market interest rates. Lending and deposit taking create interest rate sensitive positions on our balance sheet. Interest rate risk from these activities as well as the impact of ever changing market conditions is mitigated using the ALM process. The Company does not operate a trading account and does not hold a position with exposure to foreign currency exchange or commodities. The Company faces market risk through interest rate volatility.
The Board of Directors has overall responsibility for the Company s interest rate risk management policies. The Company has an Asset/Liability Management Committee (ALCO) which establishes and monitors guidelines to control the sensitivity of earnings to changes in interest rates. The internal ALCO Roundtable group maintains a net interest income forecast using different rate scenarios utilizing a simulation model. This group updates the net interest income forecast for changing assumptions and differing outlooks based on economic and market conditions.
The simulation model used includes measures of the expected repricing characteristics of administered rate (NOW, savings and money market accounts) and non-related products (demand deposit accounts, other assets and other liabilities). These measures recognize the relative sensitivity of these accounts to changes in market interest rates, as demonstrated through current and historical experience, recognizing the timing differences of rate changes. In the simulation of net interest margin and net income the forecast balance sheet is processed against five rate scenarios. These five rate scenarios include a flat rate environment, which assumes interest rates are unchanged in the future and four additional rate ramp scenarios ranging for + 200 to 200 basis points in 100 basis point increments, unless the rate environment cannot move in these basis point increments before reaching zero.
The formal policies and practices adopted by the Company to monitor and manage interest rate risk exposure measure risk in two ways: (i) repricing opportunities for earning assets and interest-bearing liabilities and (ii) changes in net interest income for declining interest rate shocks of 100 to 200 basis points. Because of the Company s predisposition to variable rate pricing and noninterest bearing demand deposit accounts, the Company is asset sensitive. As a result, management anticipates that, in a declining interest rate environment, the Company s net interest income and margin would be expected to decline, and, in an increasing interest rate environment, the Company s net interest income and margin would be expected to increase. However, no assurance can be given that under such circumstances the Company would experience the described relationships to declining or increasing interest rates. Because the Company is asset sensitive, the Company is adversely affected by declining rates rather than rising rates.

Table of Contents

To estimate the effect of interest rate shocks on the Company s net interest income, management uses a model to prepare an analysis of interest rate risk exposure. Such analysis calculates the change in net interest income given a change in the federal funds rate of 100 or 200 basis points up or down. All changes are measured in dollars and are compared to projected net interest income. At September 30, 2006, the estimated annualized reduction in net interest income attributable to a 50 and 100 basis point decline in the federal funds rate was $579,968 and $1,091,488, respectively. At December 31, 2005, the estimated annualized reduction in net interest income attributable to a 100 and 200 basis point decline in the federal funds rate was $1,480,382 and $3,139,893, respectively, with a similar and opposite result attributable to a 100 and 200 basis point increase in the federal funds rate.

The ALCO has established a policy limitation to interest rate risk of -14% of net interest margin and -12% of the present value of equity.

The securities portfolio is integral to our asset liability management process. The decision to purchase or sell securities is based upon the current assessment of economic and financial conditions, including the interest rate environment, liquidity, regulatory requirements and the relative mix of our cash positions.

The Company s approach to managing interest rate risk may include the use of derivatives. This helps to minimize significant, unplanned fluctuations in earnings, fair values of assets and liabilities and cash flows caused by interest rate volatility. This approach involves modifying the repricing characteristics of certain assets and liabilities so that changes in interest rates do not have a significant adverse effect on the net interest margin and cash flows. As a result of interest rate fluctuations, hedged assets and liabilities will gain or lose market value. In a fair value hedging strategy, the effect of this unrealized gain or loss will generally be offset by income or loss on the derivatives linked to the hedged assets and liabilities. For a cash flow hedge, the change in the fair value of the derivative to the extent that it is effective is recorded through other comprehensive income.

We may use derivatives as part of our interest rate risk management, including interest rate swaps, caps and floors. At inception, the relationship between hedging instruments and hedged items is formally documented with our risk management objective, strategy and our evaluation of effectiveness of the hedge transactions. This includes linking all derivatives designated as fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific transactions. Periodically, as required, we formally assess whether the derivative we designated in the hedging relationship is expected to be and has been highly effective in offsetting changes in fair values or cash flows of the hedged item.

The Company s use of derivatives is monitored by the Directors ALCO committee. At the March 2006 Board of Directors meeting the Board of Directors approved a cash flow hedge up to a notional amount of $100 million. During the third quarter 2006, The ALCO Roundtable initiated a forward starting swap transaction with Morgan Keegan as the counterparty. Two transactions, $60 million and $40 million, aggregating $100 million were executed, both commencing on December 1, 2006 and maturing on June 1, 2009. Under the $60 million swap transaction, the Company will receive, on a monthly basis, a fixed rate of 7.90% and pay Morgan Keegan a floating rate payment tied to the Wall Street Prime Index commencing on January 1, 2007. Under the $40 million swap transaction the Company will receive, on a monthly basis, a fixed rate of 7.95% and pay Morgan Keegan a floating rate payment tied to the Wall Street Prime Index commencing on January 1, 2007. The $40 million swap has a Prime Indexed embedded floor of 6.5%. The purpose of this strategy is to protect or hedge net interest income in a declining rate environment. Annually, the Company will protect approximately $388,000 and $640,000 should the Prime Indexed rate decline by 100 to 200 basis points, respectively.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

As required by SEC rules the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s President and Chief Executive Officer and with the Company s Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures, pursuant to Exchange Act Rule 13a-14.

As part of the disclosure controls and procedures, management has formed the SEC Disclosure Committee. This committee reviews the quarterly filing to a disclosure checklist to ensure that all functional areas of the Company have participated in the disclosure review. In addition, operational and accounting audits are performed ongoing throughout the year by the Company s internal auditors to support the control structure.

Based upon that evaluation, the Company s President and Chief Executive Officer along with the Company s Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in this Form 10-Q.

There have been no significant changes in the Company s internal controls, or in other factors, which would significantly affect internal controls subsequent to the date the Company carried out its evaluation.

Table of Contents

PART II. Other Information

Item 1. Legal proceedings

The Company is involved in various pending and threatened legal actions arising in the ordinary course of business. The Company maintains reserves for losses from legal actions, which are both probable and estimable. In the opinion of management, the disposition of claims, currently pending will not have a material adverse affect on the Company s financial position or results of operations.

Item 1a. Risk Factors

There have been no material changes from the risk factors previously disclosed in the registrant s Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults upon Senior Securities

N/A.

Item 4. Submission of Matters to a vote of Security Holders

N/A

Item 5. Other Information

Item 6. Exhibits

(31.1) Certification of Chief Executive Officer pursuant to Sarbanes-Oxley Act of 2002

(31.2) Certification of Chief Financial Officer pursuant to Sarbanes-Oxley Act of 2002

(32.0) Certification of Chief Executive Officer and Chief Financial Officer pursuant to Sarbanes-Oxley Act of 2002

Table of Contents

SIGNATURES

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

BANK OF COMMERCE HOLDINGS
(Registrant)

Date: November 3, 2006

/s/ Linda J. Miles
Linda J. Miles
Executive Vice President &
Chief Financial Officer