Bank of Marin Bancorp
Form 10-Q
November 12, 2013

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from __________________ to __________________

Commission File Number 001-33572

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

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

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

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

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

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

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

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

As of October 31, 2013, there were 5,460,411 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

(in thousands, except share data; 2013 unaudited)	September 30, 2013	December 31, 2012
Assets		
Cash and due from banks	$99,358	$28,349
Investment securities		
Held-to-maturity, at amortized cost	130,085	139,452
Available-for-sale, at fair value (amortized cost $118,353 and $150,420 at September 30, 2013 and December 31, 2012, respectively)	119,340	153,962
Total investment securities	249,425	293,414
Loans, net of allowance for loan losses of $13,808 and $13,661 at September 30, 2013 and December 31, 2012, respectively	1,079,043	1,060,291
Bank premises and equipment, net	8,947	9,344
Interest receivable and other assets	46,830	43,351
Total assets	$1,483,603	$1,434,749
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest bearing	$537,104	$389,722
Interest bearing		
Transaction accounts	76,221	169,647
Savings accounts	102,898	93,404
Money market accounts	437,247	443,742
CDARS® time accounts	1,474	15,718
Other time accounts	137,532	141,056
Total deposits	1,292,476	1,253,289
Federal Home Loan Bank borrowings	15,000	15,000
Interest payable and other liabilities	14,416	14,668
Total liabilities	1,321,892	1,282,957
Stockholders' Equity		
Preferred stock, no par value Authorized - 5,000,000 shares, none issued	—	—
Common stock, no par value Authorized - 15,000,000 shares; Issued and outstanding - 5,462,061 and 5,389,210 at September 30, 2013 and December 31, 2012, respectively	60,982	58,573
Retained earnings	100,157	91,164
Accumulated other comprehensive income, net	572	2,055
Total stockholders' equity	161,711	151,792
Total liabilities and stockholders' equity	$1,483,603	$1,434,749

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, except per share amounts; unaudited)	Three months ended September 30, 2013	June 30, 2013	September 30, 2012	Nine months ended September 30, 2013	September 30, 2012
Interest income					
Interest and fees on loans	$13,049	$13,366	$14,117	$40,050	$44,769
Interest on investment securities					
Securities of U.S. government agencies	553	585	731	1,763	2,515
Obligations of state and political subdivisions	524	437	382	1,599	1,224
Corporate debt securities and other	311	339	326	974	812
Interest due from banks and other	34	3	42	45	148
Total interest income	14,471	14,730	15,598	44,431	49,468
Interest expense					
Interest on interest bearing transaction accounts	12	12	48	35	137
Interest on savings accounts	9	8	26	25	72
Interest on money market accounts	101	95	181	295	544
Interest on CDARS® time accounts	1	2	19	8	72
Interest on other time accounts	226	224	254	682	827
Interest on borrowed funds	80	84	153	243	417
Total interest expense	429	425	681	1,288	2,069
Net interest income	14,042	14,305	14,917	43,143	47,399
(Reversal of) provision for loan losses	(480)	1,100	2,100	390	2,200
Net interest income after (reversal of) provision for loan losses	14,522	13,205	12,817	42,753	45,199
Non-interest income					
Service charges on deposit accounts	509	515	528	1,545	1,601
Wealth Management and Trust Services	532	539	507	1,618	1,451
Debit card interchange fees	288	280	261	820	754
Merchant interchange fees	196	222	183	623	562
Earnings on Bank-owned life insurance	179	186	192	766	572
Loss on sale of securities	(35)	—	—	(35)	(34)
Other income	284	202	130	666	390
Total non-interest income	1,953	1,944	1,801	6,003	5,296
Non-interest expense					
Salaries and related benefits	5,389	5,430	5,211	16,117	16,129
Occupancy and equipment	1,040	1,052	1,089	3,165	3,132
Depreciation and amortization	343	353	339	1,032	1,021
Federal Deposit Insurance Corporation insurance	244	223	221	681	672
Data processing	612	696	596	1,857	1,862
Professional services	775	814	519	2,116	1,620
Other expense	1,704	1,851	1,617	5,253	4,676
Total non-interest expense	10,107	10,419	9,592	30,221	29,112
Income before provision for income taxes	6,368	4,730	5,026	18,535	21,383
Provision for income taxes	2,364	1,675	1,802	6,610	8,268
Net income	$4,004	$3,055	$3,224	$11,925	$13,115

Net income per common share:					
Basic	$0.74	$0.56	$0.60	$2.20	$2.46
Diluted	$0.72	$0.55	$0.59	$2.16	$2.41
Weighted average shares used to compute net income per common share:					
Basic	5,433	5,419	5,344	5,414	5,335
Diluted	5,538	5,509	5,455	5,511	5,433
Dividends declared per common share	$0.18	$0.18	$0.18	$0.54	$0.52
Comprehensive income:					
Net income	$4,004	$3,055	$3,224	$11,925	$13,115
Other comprehensive (loss) income					
Change in net unrealized gain on available-for-sale securities	(621)	(1,666)	747	(2,591)	736
Reclassification adjustment for loss on sale of securities included in net income	35	—	—	35	34
Net change in unrealized gain on available-for-sale securities, before tax	(586)	(1,666)	747	(2,556)	770
Deferred tax (benefit) expense	(246)	(700)	314	(1,073)	324
Other comprehensive (loss) income, net of tax	(340)	(966)	433	(1,483)	446
Comprehensive income	$3,664	$2,089	$3,657	$10,442	$13,561

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

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

(dollars in thousands; 2013 unaudited)	Common Stock		Retained Earnings	Accumulated Other Comprehensive Income, Net of Taxes	Total
	Shares	Amount			
Balance at December 31, 2011	5,336,927	$56,854	$77,098	$1,599	$135,551
Net income	—	—	17,817	—	17,817
Other comprehensive income	—	—	—	456	456
Stock options exercised	37,563	1,041	—	—	1,041
Excess tax benefit - stock-based compensation	—	42	—	—	42
Stock issued under employee stock purchase plan	700	25	—	—	25
Restricted stock granted	9,030	—	—	—	—
Restricted stock forfeited / cancelled	(380)	—	—	—	—
Stock-based compensation - stock options	—	206	—	—	206
Stock-based compensation - restricted stock	—	202	—	—	202
Cash dividends paid on common stock	—	—	(3,751)	—	(3,751)
Stock purchased by directors under director stock plan	100	4	—	—	4
Stock issued in payment of director fees	5,270	199	—	—	199
Balance at December 31, 2012	5,389,210	$58,573	$91,164	$2,055	$151,792
Net income	—	—	11,925	—	11,925
Other comprehensive loss	—	—	—	(1,483)	(1,483)
Stock options exercised	56,850	1,736	—	—	1,736
Excess tax benefit - stock-based compensation	—	108	—	—	108
Stock issued under employee stock purchase plan	720	28	—	—	28
Restricted stock granted	12,010	—	—	—	—
Restricted stock forfeited / cancelled	(2,508)	—	—	—	—
Stock-based compensation - stock options	—	139	—	—	139
Stock-based compensation - restricted stock	—	170	—	—	170
Cash dividends paid on common stock	—	—	(2,932)	—	(2,932)
Stock purchased by directors under director stock plan	160	6	—	—	6
Stock issued in payment of director fees	5,619	222	—	—	222
Balance at September 30, 2013	5,462,061	$60,982	$100,157	$572	$161,711

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

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

(in thousands, unaudited)	September 30, 2013	September 30, 2012
Cash Flows from Operating Activities:		
Net income	$11,925	$13,115
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	390	2,200
Compensation expense--common stock for director fees	166	155
Stock-based compensation expense	309	307
Excess tax benefits from exercised stock options	(86)	(40)
Amortization of investment security premiums, net of accretion of discounts	2,401	1,619
Accretion of discount on acquired loans	(1,137)	(1,965)
Decrease in deferred loan origination fees, net	(662)	(895)
Loss on sale of investment securities	35	34
Depreciation and amortization	1,032	1,021
Loss on disposal of premise and equipment	—	11
(Gain) loss on sale of repossessed assets	(43)	14
Earnings on bank owned life insurance policies	(766)	(572)
Net change in operating assets and liabilities:		
Interest receivable	408	(267)
Interest payable	(32)	(142)
Deferred rent and other rent-related expenses	50	257
Other assets	(2,276)	798
Other liabilities	2,926	(1,623)
Total adjustments	2,715	912
Net cash provided by operating activities	14,640	14,027
Cash Flows from Investing Activities:		
Purchase of securities held-to-maturity	—	(40,639)
Purchase of securities available-for-sale	—	(55,679)
Proceeds from sale of securities available-for-sale	2,220	2,186
Proceeds from paydowns/maturity of securities held-to-maturity	7,815	5,068
Proceeds from paydowns/maturity of securities available-for-sale	28,963	41,663
Loans originated and principal collected, net	(20,375)	17,301
Purchase of bank owned life insurance policies	—	(364)
Purchase of premises and equipment	(635)	(523)
Proceeds from sale of repossessed assets	270	41
Net cash provided by (used in) investing activities	18,258	(30,946)
Cash Flows from Financing Activities:		
Net increase in deposits	39,187	55,901
Proceeds from stock options exercised	1,736	433
Repayment of subordinated debenture	—	(5,000)
Repayment of Federal Home Loan Bank borrowings	—	(20,000)
Cash dividends paid on common stock	(2,932)	(2,784)
Stock issued under employee and director stock purchase plans	34	24
Excess tax benefits from exercised stock options	86	40
Net cash provided by financing activities	38,111	28,614

Net increase in cash and cash equivalents	71,009	11,695
Cash and cash equivalents at beginning of period	28,349	129,743
Cash and cash equivalents at end of period	$99,358	$141,438
Supplemental disclosure of cash flow information:		
Cash paid for interest	$1,320	$2,212
Cash paid for income taxes	$7,889	$8,541
Supplemental disclosure of non-cash investing and financing activities:		
Change in unrealized gain on available-for-sale securities	$(2,556)	$770
Loans transferred to repossessed assets	$—	$65
Stock issued in payment of director fees	$222	$199

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Introductory Explanation

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

Note 1: Basis of Presentation

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

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

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

	Three months ended			Nine months ended	
(in thousands; except per share data; unaudited)	September 30, 2013	June 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Weighted average basic shares outstanding	5,433	5,419	5,344	5,414	5,335
Add: Potential common shares related to stock options	46	39	55	43	48
Potential common shares related to unvested restricted stock	4	2	9	4	6
Potential common shares related to the warrant	55	49	47	50	44
Weighted average diluted shares outstanding	5,538	5,509	5,455	5,511	5,433
Net income	$4,004	$3,055	$3,224	$11,925	$13,115

Basic EPS	$0.74	$0.56	$0.60	$2.20	$2.46
Diluted EPS	$0.72	$0.55	$0.59	$2.16	$2.41
Weighted average anti-dilutive shares not included in the calculation of diluted EPS	51	60	41	48	33

Note 2: Recently Issued Accounting Standards

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

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

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

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

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

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

Note 3: Acquisition

On July 1, 2013, we entered into a definitive agreement to acquire NorCal Community Bancorp, parent company of Bank of Alameda. Bank of Alameda has four branch offices serving Alameda, Emeryville, and Oakland, and had assets of $271.5 million, total deposits of $237.2 million, and total loans of $177.3 million as of September 30, 2013. We have received all the necessary regulatory approvals. Additionally, NorCal shareholders gave their approval on October 17, 2013. The transaction is expected to close in the fourth quarter of 2013.

For more information concerning the transaction, please see the S-4 filed by Bancorp with the Securities and Exchange Commission ("SEC") on August 23, 2013, and the 8-K Reports filed with the SEC on July 1 and July 5, 2013. For other important factors regarding the NorCal acquisition, please see the Forward Looking Statements and Risk Factors sections of the Form 10-Q for the quarter ended June 30, 2013.

Note 4: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

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

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

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

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

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

(in thousands) Description of Financial Instruments	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
At September 30, 2013 (unaudited):				
Securities available-for-sale:				
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies	$85,108	$—	$85,108	$—
Debentures of government-sponsored agencies	$18,954	$—	$18,954	$—
Privately-issued collateralized mortgage obligations	$15,278	$—	$15,278	$—
Derivative financial assets (interest rate contracts)	$646	$—	$646	$—
Derivative financial liabilities (interest rate contracts)	$3,085	$—	$3,085	$—
At December 31, 2012:				
Securities available-for-sale:				
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government-sponsored agencies	$111,797	$—	$111,797	$—
Debentures of government-sponsored agencies	$20,589	$—	$20,589	$—
Privately-issued collateralized mortgage obligations	$21,576	$—	$21,576	$—
Derivative financial assets (interest rate contracts)	$1	$—	$1	$—
Derivative financial liabilities (interest rate contracts)	$5,240	$—	$5,240	$—

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

On a recurring basis, derivative financial instruments are recorded at fair value, which is based on the income approach using observable Level 2 market inputs, reflecting market expectations of future interest rates as of the measurement date. Standard valuation techniques are used to calculate the present value of the future expected cash flows assuming an orderly transaction. Valuation adjustments may be made to reflect both our own credit risk and the counterparties' credit quality in determining the fair value of the derivatives. Level 2 inputs for the valuations are limited to observable market prices for LIBOR cash rates (for the very short term), quoted prices for LIBOR futures contracts, observable market prices for LIBOR swap rates, and one-month and three-month LIBOR basis spreads at

commonly quoted intervals. Mid-market pricing of the inputs is used as a practical expedient in the fair value measurements. Key inputs for interest rate valuations are used to project spot rates at resets specified by each swap, as well as to discount those future cash flows to present value at the measurement date. When the value of any collateral placed with counterparties is less than the interest rate derivative liability, the interest rate liability position is further discounted to reflect our potential credit risk to counterparties. We have used the spread between the Standard & Poors BBB rated U.S. Bank

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

Certain financial assets may be measured at fair value on a non-recurring basis. These assets are subject to fair value adjustments that result from the application of the lower of cost or fair value accounting or write-downs of individual assets, such as other real estate owned. For example, when a loan is identified as impaired, it is reported at the lower of cost or fair value, measured based on the loan's observable market price (Level 1) or the current net realizable value of the underlying collateral securing the loan, if the loan is collateral dependent (Level 3). Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as type, leasing status and physical condition. When the appraisals are received, Management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by management on a case-by-case basis. There have been no significant changes in the valuation techniques during the periods ended September 30, 2013.

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

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

(in thousands) Description of Financial Instruments	Carrying Value[1]	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) [1]
At September 30, 2013 (unaudited):				
Impaired loans carried at fair value:				
Commercial real estate, investor	$2,786	$—	$—	$2,786
Construction	3,971	—	—	3,971
Home equity	45	—	—	45
Installment and other consumer	143	—	—	143
Total	$6,945	$—	$—	$6,945
At December 31, 2012:				
Impaired loans carried at fair value:				
Commercial and industrial	$51	$—	$—	$51
Commercial real estate, investor	2,941	—	—	2,941
Construction	1,722	—	—	1,722
Home equity	107	—	—	107

Other residential	594	—	—	594
Installment and other consumer	159	—	—	159
Total	$5,574	$—	$—	$5,574

[1] Represents collateral-dependent loan principal balances that had been generally written down to the values of the underlying collateral, net of specific valuation allowances of $1.5 million and $729 thousand at September 30, 2013 and December 31, 2012, respectively. The carrying value of loans fully charged-off, which includes unsecured lines of credit, overdrafts and all other loans, is zero.

Disclosures about Fair Value of Financial Instruments

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

	September 30, 2013			December 31, 2012		
(in thousands; 2013 unaudited)	Carrying Amounts	Fair Value	Fair Value Hierarchy	Carrying Amounts	Fair Value	Fair Value Hierarchy
Financial assets						
Cash and cash equivalents	$99,358	$99,358	Level 1	$28,349	$28,349	Level 1
Investment securities held-to-maturity	130,085	131,567	Level 2	139,452	142,231	Level 2
Loans, net	1,079,043	1,097,619	Level 3	1,060,291	1,111,355	Level 3
Interest receivable	4,665	4,665	Level 2	5,073	5,073	Level 2
Financial liabilities						
Deposits	1,292,476	1,293,741	Level 2	1,253,289	1,254,713	Level 2
Federal Home Loan Bank borrowings	15,000	15,715	Level 2	15,000	15,989	Level 2
Interest payable	193	193	Level 2	225	225	Level 2

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

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

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

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

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

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

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

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

Note 5: Investment Securities

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

	September 30, 2013				December 31, 2012			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
(in thousands; 2013 unaudited)	Cost	Value	Gains	(Losses)	Cost	Value	Gains	(Losses)
Held-to-maturity								
Obligations of state and political subdivisions	$87,867	$89,057	$1,935	$(745)	$96,922	$99,350	$2,855	$(427)
Corporate bonds	42,218	42,510	382	(90)	42,530	42,881	458	(107)
Total held-to-maturity	130,085	131,567	2,317	(835)	139,452	142,231	3,313	(534)
Available-for-sale								
Securities of U. S. government agencies:								
MBS pass-through securities issued by FNMA and FHLMC	46,553	46,763	725	(515)	52,042	53,713	1,711	(40)
CMOs issued by FNMA	1,342	1,416	74	—	4,447	4,550	105	(2)
CMOs issued by FHLMC	8,940	9,084	166	(22)	13,527	13,778	251	—
CMOs issued by GNMA	27,133	27,845	745	(33)	38,871	39,756	886	(1)
Debentures of government-sponsored agencies	19,365	18,954	130	(541)	20,462	20,589	228	(101)
Privately-issued CMOs	15,020	15,278	320	(62)	21,071	21,576	595	(90)
Total available-for-sale	118,353	119,340	2,160	(1,173)	150,420	153,962	3,776	(234)
Total investment securities	$248,438	$250,907	$4,477	$(2,008)	$289,872	$296,193	$7,089	$(768)

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

	September 30, 2013			
	Held-to-Maturity		Available-for-Sale	
(in thousands; unaudited)	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	$8,331	$8,340	$—	$—
After one year but within five years	92,671	93,521	27,536	27,791
After five years through ten years	26,094	26,779	18,132	17,528
After ten years	2,989	2,927	72,685	74,021
Total	$130,085	$131,567	$118,353	$119,340

We sold four available-for-sale securities in the first nine months of 2013 with proceeds of $2.2 million and a loss of $35 thousand. One available-for-sale security was sold in 2012 with proceeds of $2.2 million and a loss of $34 thousand.

Investment securities carried at $42.2 million and $47.7 million at September 30, 2013 and December 31, 2012, respectively, were pledged with the State of California: $41.5 million and $47.0 million to secure public deposits in compliance with the Local Agency Security Program at September 30, 2013 and December 31, 2012, respectively, and $729 thousand and $719 thousand to provide collateral for trust deposits at September 30, 2013 and December 31, 2012, respectively. In addition, investment securities carried at $1.1 million were pledged to collateralize an internal Wealth Management and Trust Services ("WMTS") checking account at both September 30, 2013 and December 31, 2012.

Other-Than-Temporarily Impaired Debt Securities

We have evaluated the credit ratings of our investment securities and their issuer and/or insurers. Based on our evaluation, Management has determined that no investment security in our investment portfolio is other-than-temporarily impaired. In October 2013, we sold five securities amounting to $5.2 million in amortized cost as part of a portfolio review. Some of the positions were temporarily impaired and others were not, and the sales resulted in a net gain of approximately $8 thousand. We do not have the intent, and it is more likely than not that we will not have to sell the remaining securities temporarily impaired at September 30, 2013 before recovery of the cost basis.

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

September 30, 2013	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
(In thousands; unaudited)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity						
Obligations of state & political subdivisions	$24,675	$(711)	2,551	(34)	$27,226	$(745)
Corporate bonds	10,002	(89)	1,434	(1)	11,436	(90)
Total held-to-maturity	34,677	(800)	3,985	(35)	38,662	(835)
Available-for-sale						
MBS pass-through securities issued by FNMA and FHLMC	16,612	(515)	—	—	16,612	(515)
CMOs issued by FHLMC	2,716	(22)	—	—	2,716	(22)
CMOs issued by GNMA	4,190	(33)	—	—	4,190	(33)
Debentures of government-sponsored agencies	14,459	(541)	—	—	14,459	(541)
Privately issued CMOs	5,615	(61)	167	(1)	5,782	(62)
Total available-for-sale	43,592	(1,172)	167	(1)	43,759	(1,173)
Total temporarily impaired securities	$78,269	$(1,972)	$4,152	$(36)	$82,421	$(2,008)

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

Forty-eight securities in our portfolio were in a temporary loss position for less than twelve months as of September 30, 2013. We determine that the strengths of GNMA and FNMA through guarantee or support from the U.S. Federal Government are sufficient to protect us from credit losses. The other temporarily impaired securities are deemed credit worthy after our periodic impairment analysis and are all rated as investment grade by at least one major rating agency. We also monitor the financial information of the issuers of obligations of U.S. states and political

subdivisions. As a result of this impairment analysis, we concluded that these securities were not other-than-temporarily impaired at September 30, 2013.

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

Securities Carried at Cost

As a member of the FHLB, we are required to maintain a minimum investment in the FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can also increase in the event we need to increase our borrowing capacity with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at its $100 per share par value. We held $6.5 million and $6.0 million of FHLB stock recorded at cost in other assets on the consolidated statements of condition at September 30, 2013, and December 31, 2012, respectively. On October 29, 2013, the FHLB declared a cash dividend for the third quarter of 2013 at an annualized dividend rate of 5.65%. Management does not believe that the FHLB stock is other-than-temporarily-impaired, as we expect to be able to redeem this stock at cost.

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock with a carrying value of zero, which is equal to our cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s covered litigation escrow account. As a result of the restriction, these shares are not considered available-for-sale and are not carried at fair value. Upon conversion of this Class B common stock at a conversion rate of 0.4206 to Class A common stock, the value would be $1.4 million and $1.1 million at September 30, 2013 and December 31, 2012, respectively. The conversion rate is subject to further reduction upon the final settlement of the covered litigation against Visa Inc. and its member banks. See Note 9 herein.

Note 6: Loans and Allowance for Loan Losses

Credit Quality of Loans

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

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

(dollars in thousands; 2013 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential [1]	Installment and other consumer	Total
September 30, 2013								
30-59 days past due	$5	$ —	$—	$1,720	$—	$—	$246	$1,971
60-89 days past due	—	—	—	—	240	—	2	242
Greater than 90 days past due (non-accrual) [2]	1,229	1,403	5,832	7,045	359	1,117	311	17,296
Total past due	1,234	1,403	5,832	8,765	599	1,117	559	19,509
Current	167,606	204,770	541,505	16,228	85,605	42,455	15,173	1,073,342
Total loans [3]	$168,840	$ 206,173	$547,337	$24,993	$86,204	$43,572	$15,732	$1,092,851
Non-accrual loans to total loans	0.7 %	0.7 %	1.1 %	28.2 %	0.4 %	2.6 %	2.0 %	1.6 %
December 31, 2012								
30-59 days past due	$29	$ —	$—	$—	$294	$167	$98	$588
60-89 days past due	—	—	—	—	—	—	—	—
Greater than 90 days past due (non-accrual) [2]	4,893	1,403	6,843	2,239	545	1,196	533	17,652
Total past due	4,922	1,403	6,843	2,239	839	1,363	631	18,240
Current	171,509	195,003	502,163	28,426	92,398	48,069	18,144	1,055,712
Total loans [3]	$176,431	$ 196,406	$509,006	$30,665	$93,237	$49,432	$18,775	$1,073,952
Non-accrual loans to total loans	2.8 %	0.7 %	1.3 %	7.3 %	0.6 %	2.4 %	2.8 %	1.6 %

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

[2] Amounts include $1.4 million and $1.6 million of Purchased Credit Impaired ("PCI") loans that have stopped accreting interest at September 30, 2013 and December 31, 2012, respectively, and exclude accreting PCI loans of $2.2 million and $3.0 million at September 30, 2013 and December 31, 2012, respectively, as their accretable yield interest recognition is independent from the underlying contractual loan delinquency status. There were no accruing

loans past due more than ninety days at September 30, 2013 or December 31, 2012.

[3] Amounts were net of deferred loan fees of $107 thousand and $769 thousand at September 30, 2013 and December 31, 2012, respectively. Amounts were also net of unaccreted purchase discounts on non-PCI loans of $1.5 million and $2.1 million at September 30, 2013 and December 31, 2012, respectively.

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

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

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

Consumer loans primarily consist of home equity lines of credit, other residential (tenancy-in-common, or “TIC”) loans, and other personal loans. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, mitigates risk. Additionally, trend reports are reviewed by Management on a regular basis. Underwriting standards for home equity lines of credit include, but are not limited to, a conservative loan-to-value ratio, the number of such loans a borrower can have at one time, and documentation requirements. Our underwriting of the other residential loans, mostly secured by TIC units in San Francisco, is cautious compared to traditional residential mortgages due to the unique ownership structure. However, these borrowers tend to have more equity in their properties, which mitigates risk. Personal loans are nearly evenly split between mobile home loans and floating home loans along with a small number of installment loans.

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

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

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

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

Doubtful - Critical weaknesses that make collection or liquidation in full improbable. There may be specific pending events that work to strengthen the asset, however, the amount or timing of the loss may not be determinable. Pending

events generally occur within one year of the asset being classified as Doubtful. Examples include: merger, acquisition, or liquidation; capital injection; guarantee; perfecting liens on additional collateral; and refinancing. Such loans are placed on non-accrual status and usually are collateral-dependent.

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

- Generally, commercial borrowers with lines of credit are required to submit financial information with reporting intervals ranging from monthly to annually depending on credit size, risk and complexity.

- Investor commercial real estate borrowers with loans greater than $750 thousand are required to submit rent rolls or property income statements at least annually.
- Construction loans are monitored monthly, and assessed on an ongoing basis.
- Home equity and other consumer loans are assessed based on delinquency.
- Loans graded "Watch" or more severe, regardless of loan type, are assessed no less than quarterly.

The following table represents our analysis of loans by internally assigned grades, including the PCI loans, at September 30, 2013 and December 31, 2012:

(in thousands; 2013 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Purchased credit-impaired	Total
Credit Risk Profile by Internally Assigned Grade:									
September 30, 2013									
Pass	$ 148,974	$ 183,754	$ 529,573	$ 16,669	$ 81,629	$ 40,082	$ 14,965	$ 1,328	$ 1,016,974
Special Mention	14,613	16,626	8,575	1,278	2,082	1,052	—	737	44,963
Substandard	4,970	3,246	8,452	7,046	2,493	2,438	767	1,502	30,914
Total loans	$ 168,557	$ 203,626	$ 546,600	$ 24,993	$ 86,204	$ 43,572	$ 15,732	$ 3,567	$ 1,092,851
December 31, 2012									
Pass	$ 148,771	$ 170,553	$ 489,978	$ 26,287	$ 86,957	$ 45,634	$ 17,809	$ 1,862	$ 987,851
Special Mention	13,267	20,346	8,671	1,970	2,931	1,067	—	933	49,185
Substandard	13,753	2,992	8,963	2,408	3,349	2,731	966	1,754	36,916
Total loans	$ 175,791	$ 193,891	$ 507,612	$ 30,665	$ 93,237	$ 49,432	$ 18,775	$ 4,549	$ 1,073,952

Troubled Debt Restructuring

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

When a loan is modified, Management evaluates any possible impairment based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan agreement, except when the sole remaining source of repayment for the loan is the operation or liquidation of the collateral. In these cases Management uses the current fair value of the collateral, less selling costs, instead of discounted cash flows. If Management determines that the value of the modified loan is less than the recorded investment in the loan (net of previous charge-offs and unamortized premium or discount), impairment is recognized through a specific allowance or a charge-off of the loan.

The table below summarizes outstanding TDR loans by loan class as of September 30, 2013 and December 31, 2012. The summary includes those TDRs that are on non-accrual status and those that continue to accrue interest.

(in thousands; 2013 unaudited)	As of	
Recorded investment in Troubled Debt Restructurings [1]	September 30, 2013	December 31, 2012
Commercial and industrial	$6,139	$9,470
Commercial real estate, owner-occupied	4,354	1,403
Commercial real estate, investor	536	—
Construction	5,798	1,929
Home equity	513	908
Other residential	2,085	2,831
Installment and other consumer	1,708	1,743
Total	$21,133	$18,284

[1] Includes $12.6 million and $10.8 million of TDR loans that were accruing interest as of September 30, 2013 and December 31, 2012, respectively.

The tables below present the following information for TDRs modified during the periods presented: number of contracts modified, the recorded investment in the loans prior to modification, and the recorded investment in the loans after the loans were restructured. The tables below exclude fully paid-off or fully charged-off TDR loans.

(dollars in thousands; unaudited)	Number of Contracts Modified	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment at period end
Troubled Debt Restructurings during the three months ended September 30, 2013:				
Commercial and industrial	3	$ 587	$ 560	$558
Commercial real estate, owner occupied	1	2,961	2,956	2,951
Commercial real estate, investor	1	539	538	536
Installment and other consumer	2	11	9	9
Total	7	$ 4,098	$ 4,063	$4,054
Troubled Debt Restructurings during the three months ended June 30, 2013:				
Construction	1	$ 4,745	$ 4,766	$4,806
Troubled Debt Restructurings during the three months ended September 30, 2012:				
Commercial and industrial	1	$ 135	$ 134	$133
Other residential	1	682	682	680
Installment and other consumer	1	26	26	26
Total	3	$ 843	$ 842	$839

(dollars in thousands; unaudited)	Number of Contracts Modified	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment at period end
Troubled Debt Restructurings during the nine months ended September 30, 2013:				
Commercial and industrial [1]	5	$1,086	1,057	$991
Commercial real estate, owner occupied	1	2,961	2,956	2,951
Commercial real estate, investor	1	539	538	536
Construction	1	4,745	4,766	4,806
Installment and other consumer	2	11	9	9
Total	10	$9,342	9,326	$9,293
Troubled Debt Restructurings during the nine months ended September 30, 2012:				
Commercial and industrial	10	$9,456	$ 9,375	$6,766
Construction	6	11,324	11,324	6,564
Home Equity	2	472	474	471
Other residential	1	682	682	680
Installment and other consumer	1	26	26	26
Total	20	$21,960	$ 21,881	$14,507

[1] Excludes two contracts modified during the three months ended March 31, 2013, which were subsequently paid off during the three months ended June 30, 2013. The pre-modification and post-modification outstanding recorded investment balances were both $218 thousand.

Modifications during the nine months ended September 30, 2013 primarily involved maturity or payment extensions and interest rate concessions, while modifications in the nine months ended September 30, 2012 primarily involved payment extensions and forbearances. There was one construction loan modified as troubled debt restructuring with a recorded investment of $4.8 million that subsequently defaulted during the first nine months of 2013, where the default occurred within the first twelve months after modification into a TDR. There were three commercial loans, two commercial real estate loans, and one construction loan modified as troubled debt restructurings within the previous twelve months with recorded investments of $833 thousand that subsequently defaulted and were charged-off in the nine months ended September 30, 2012. We are reporting these defaulted TDRs based on a payment default definition of more than ninety days past due.

Allowance for Loan Losses

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

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

Management, changes are warranted.

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

The first component, specific allowances, result from the analyses of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. Through Management's ongoing loan grading and credit monitoring process, individual loans are identified that have conditions that indicate the borrower may be unable to pay all amounts due in accordance with the contractual terms. These loans are evaluated for impairment individually by Management. Management considers an originated loan to be impaired when it is probable we will be unable to

collect all amounts due according to the contractual terms of the loan agreement. For allowance established on acquired loans, refer to our Critical Accounting Policies section in this Form 10-Q. When the fair value of the impaired loan is less than the recorded investment in the loan, the difference is recorded as the impairment through the establishment of the specific allowance. For loans determined to be impaired, the extent of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate at origination (for originated loans), based on the loan's observable market price, or based on the fair value of the collateral, if the loan is collateral dependent or if foreclosure is imminent. Generally with problem credits that are collateral-dependent, we obtain appraisals of the collateral at least annually. We may obtain appraisals more frequently if we believe the collateral value is subject to market volatility, if a specific event has occurred to the collateral, or if we believe foreclosure is imminent.

The second component is an estimate of the probable inherent losses in each loan pool with similar characteristics. Beginning with the quarter-ended September 30, 2013, Management refined the methodology for estimating general allowances in order to provide a more comprehensive evaluation of the potential risk of loss in our loan portfolio. This analysis encompasses our entire loan portfolio and excludes acquired loans where the discount has not been fully accreted. For allowance established on acquired loans, refer to our Critical Accounting Policies section in this Form 10-Q. See below for how loans were pooled under the prior model. For additional information on our prior allowance for loan losses model, refer to Note 1: Summary of Significant Accounting Policies in our 2012 Annual Report on Form 10-K.

- Commercial real estate loans, owner occupied
- Commercial real estate loans, investor
- Construction loans
  - Land loans
- Residential real estate loans
  - Residential loans, fractional tenants-in-common
- Commercial loans
  - Commercial asset-based lines
  - Commercial quick qualifier loans
- Personal loans
  - Personal floating home loans
  - Personal mobile home loans
- Home equity loans
- Other loans

Under the new methodology, the loans are evaluated on a pool basis by loan segment which is further delineated by Federal regulatory reporting codes ("call codes"). Each segment is assigned an expected loss factor which is primarily based on a twelve quarter look-back at our historical losses for that particular segment, as well as a number of other factors. We believe this change in methodology will provide a more comprehensive evaluation of the potential risk in our portfolio because the additional delineation by call code establishes a stronger focus on areas of weakness and strength within the portfolio. Loans are pooled into the following segments under the new methodology:

- Loans secured by real estate:

- 1-4 family residential construction loans
- Other construction loans and all land development and other land loans
- Secured by farmland (including farm residential and other improvements)
- Revolving, open-end loans secured by 1-4 family residential properties and extended under lines of credit
- Closed-end loans secured by 1-4 family residential properties, secured by first liens
- Closed-end loans secured by 1-4 family residential properties, secured by junior liens

- Secured by multifamily (5 or more) residential properties
- Loans secured by owner-occupied non-farm nonresidential properties
- Loans secured by other non-farm nonresidential properties

• Loans to finance agricultural production and other loans to farmers
• Commercial and industrial loans
• Loans to individuals for household, family and other personal expenditures (i.e., consumer loans)
• Other loans

Management determines loan loss multipliers based on objective and subjective factors. Objective factors include a rolling historical loss rate using a twelve quarter look-back, changes in the volume and nature of the loan portfolio, changes in credit quality metrics (past due loans, non-accrual loans, net charge-offs), and the existence of credit concentrations. Subjective factors include changes in the overall economic environment, legal and regulatory conditions, lending management and other relevant staff, as well as the quality of our loan review system. The total amount allocated is determined by applying loss multipliers to outstanding loans by call code.

The following tables represent the effect on the current period provision of the change in methodology by loan class from that used in prior periods:

(in thousands; 2013 unaudited)	Three months ended September 30, 2013		
	Calculated Provision Based on New Methodology	Calculated Provision Based on Prior Methodology	Difference In ALLL
Commercial and industrial	$(965)	$(46)	$(919)
Commercial real estate, owner-occupied	427	57	370
Commercial real estate, investor	1,338	73	1,265
Construction	(210)	(128)	(82)
Home equity	(173)	(29)	(144)
Other residential	(124)	2	(126)
Installment and other consumer	(669)	(450)	(219)
Unallocated	(104)	41	(145)
Total reversal of provision for loan losses	$(480)	$(480)	$—

(in thousands; 2013 unaudited)	Nine months ended September 30, 2013		
	Calculated Provision Based on New Methodology	Calculated Provision Based on Prior Methodology	Difference in ALLL
Commercial and industrial	$(1,204)	$(285)	$(919)
Commercial real estate, owner-occupied	436	66	370
Commercial real estate, investor	1,308	43	1,265
Construction	916	998	(82)
Home equity	(159)	(15)	(144)
Other residential	(274)	(148)	(126)
Installment and other consumer	(506)	(287)	(219)
Unallocated	(127)	18	(145)
Total provision for loan losses	$390	$390	$—

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

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

(dollars in thousands; 2013 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
September 30, 2013								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 1,839	$ 1,403	$ 3,457	$ 2,239	$356	$2,303	$117	$11,714
With a specific allowance recorded	4,300	4,094	2,911	5,798	276	226	1,708	19,313
Total recorded investment in impaired loans	$ 6,139	$ 5,497	$ 6,368	$ 8,037	$632	$2,529	$1,825	$31,027
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	$ 1,839	$ 3,060	$ 5,449	$ 5,146	$842	$2,303	$159	$18,798
With a specific allowance recorded	4,535	5,119	2,911	5,798	402	226	1,708	20,699
Total unpaid principal balance of impaired loans	$ 6,374	$ 8,179	8,360	$ 10,944	$1,244	$2,529	$1,867	$39,497
Specific allowance	$ 859	$ 102	$ 125	$ 1,236	$74	$26	$381	$2,803
Average recorded investment in impaired loans during the quarter ended September 30, 2013	5,933	3,526	6,389	8,479	775	2,576	1,842	29,520
Interest income recognized on impaired loans during the quarter ended September 30, 2013	102	63	7	21	5	22	16	236
Average recorded investment in impaired loans during the quarter ended June 30, 2013	7,327	2,534	6,041	8,820	1,158	2,590	1,879	30,349
Interest income recognized on impaired loans during the quarter ended June 30, 2013	107	53	—	185	12	22	18	397

Average recorded investment in impaired loans during the nine months ended September 30, 2013	7,584	2,861	6,178	7,138	1,022	2,744	1,881	29,408
Interest income recognized on impaired loans during the nine months ended September 30, 2013	343	170	7	233	25	67	50	895

(dollars in thousands; 2013 unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
December 31, 2012								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 6,825	$ 1,403	$ 3,725	$ 2,328	$931	$2,598	$978	$18,788
With a specific allowance recorded	2,645	471	4,513	1,840	261	715	1,070	11,515
Total recorded investment in impaired loans	$ 9,470	$ 1,874	8,238	$ 4,168	$1,192	$3,313	$2,048	$30,303
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	$ 7,633	$ 3,060	$ 5,717	$ 2,514	$1,417	$2,598	$1,020	$23,959
With a specific allowance recorded	2,930	966	4,887	4,519	324	715	1,070	15,411
Total recorded investment in impaired loans	$ 10,563	$ 4,026	10,604	$ 7,033	$1,741	$3,313	$2,090	$39,370
Specific allowance	$ 1,131	$ 26	$ 374	$ 118	$154	$120	$431	$2,354
Average recorded investment in impaired loans during the quarter ended September 30, 2012	9,882	1,865	6,418	13,442	1,499	2,641	2,230	37,977
Interest income recognized on impaired loans during the quarter ended September 30, 2012	351	28	30	141	10	13	15	588
Average recorded investment in impaired loans during the nine months ended September 30, 2012	12,116	1,705	5,472	14,097	1,255	2,396	2,153	39,194
Interest income recognized on impaired loans during the nine months ended September 30, 2012	672	97	95	462	22	88	51	1,487

The gross interest income that would have been recorded had non-accrual loans been current totaled $291 thousand, $272 thousand and $387 thousand in the quarters ended September 30, 2013, June 30, 2013 and September 30, 2012, respectively, and totaled $827 thousand and $870 thousand for the nine months ended September 30, 2013 and September 30, 2012, respectively. PCI loans are excluded from the foregone interest data above as their accretable

yield interest recognition is independent from the underlying contractual loan delinquency status. See “Purchased Credit-Impaired Loans” below for further discussion.

Management monitors delinquent loans continuously and identifies problem loans, generally loans graded substandard or worse, to be evaluated individually for impairment testing. Generally, we charge off our estimated losses related to specifically-identified impaired loans when it is deemed uncollectible. The charged-off portion of impaired loans outstanding at September 30, 2013 totaled approximately $5.9 million. At September 30, 2013, there were $447 thousand outstanding commitments to extend credit on impaired loans, including loans to borrowers whose terms have been modified in troubled debt restructurings.

The following table discloses loans by major portfolio category and activity in the ALLL, as well as the related ALLL disaggregated by impairment evaluation method:

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
For the three months ended September 30, 2013									
Allowance for loan losses:									
Beginning balance	$ 3,799	$ 1,406	$ 4,368	$ 1,721	$ 1,153	$ 401	$ 1,313	$ 196	$ 14,357
Provision (reversal)	(965)	427	1,338	(210)	(173)	(124)	(669)	(104)	(480)
Charge-offs	(129)	—	—	(24)	—	—	(1)	—	(154)
Recoveries	75	—	9	—	—	—	1	—	85
Ending balance	$ 2,780	$ 1,833	$ 5,715	$ 1,487	$ 980	$ 277	$ 644	$ 92	$ 13,808
For the three months ended June 30, 2013									
Allowance for loan losses:									
Beginning balance	$ 4,032	$ 1,348	$ 4,020	$ 650	$ 1,216	$ 431	$ 1,366	$ 371	$ 13,434
Provision (reversal)	(189)	(26)	345	1,084	63	(30)	28	(175)	1,100
Charge-offs	(386)	—	—	(13)	(126)	—	(85)	—	(610)
Recoveries	342	84	3	—	—	—	4	—	433
Ending balance	$ 3,799	$ 1,406	$ 4,368	$ 1,721	$ 1,153	$ 401	$ 1,313	$ 196	$ 14,357
For the nine months ended September 30, 2013									
Allowance for loan losses:									
Beginning balance	$ 4,100	$ 1,313	$ 4,372	$ 611	$ 1,264	$ 551	$ 1,231	$ 219	$ 13,661
Provision (reversal)	(1,204)	436	1,308	916	(159)	(274)	(506)	(127)	390
Charge-offs	(586)	—	—	(41)	(133)	—	(87)	—	(847)
Recoveries	470	84	35	1	8	—	6	—	604
Ending balance	$ 2,780	$ 1,833	$ 5,715	$ 1,487	$ 980	$ 277	$ 644	$ 92	$ 13,808

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
As of September 30, 2013:									
Ending ALLL related to loans collectively	$1,921	$1,732	$5,590	$251	$906	$250	$263	$92	$11,005

evaluated for impairment									
Ending ALLL related to loans individually evaluated for impairment	$676	$43	$125	$1,236	$74	$27	$381	$—	$2,562
Ending ALLL related to purchased credit-impaired loans	$183	$58	$—	$—	$—	$—	$—	$—	$241
Loans outstanding:									
Collectively evaluated for impairment	$162,701	$200,676	$540,232	$16,956	$85,572	$41,044	$13,906	$—	$1,061,
Individually evaluated for impairment[1]	5,855	2,951	6,368	8,037	632	2,528	1,826	—	28,197
Purchased credit-impaired	284	2,546	737	—	—	—	—	—	3,567
Total	$168,840	$206,173	$547,337	$24,993	$86,204	$43,572	$15,732	$—	$1,092,
Ratio of allowance for loan losses to total loans	1.65 %	0.89 %	1.04 %	5.95 %	1.14 %	0.64 %	4.09 %	NM	1.26
Allowance for loan losses to non-accrual loans	226 %	131 %	98 %	21 %	273 %	25 %	207 %	NM	80

[1] Total excludes $2.8 million of PCI loans that have experienced post-acquisition declines in cash flows expected to be collected.These loans are included in the "purchased credit-impaired" amount in the next line below.

NM - Not Meaningful

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
As of December 31, 2012:									
Ending ALLL related to loans collectively evaluated for impairment	$2,969	$1,287	$3,998	$493	$1,110	$431	$800	$219	$11,30
Ending ALLL related to loans individually evaluated for impairment	$1,090	$—	$178	$118	$154	$120	$431	$—	$2,09
Ending ALLL related to purchased credit-impaired loans	$41	$26	$196	$—	$—	$—	$—	$—	$263
Loans outstanding:									
Collectively evaluated for impairment	$166,860	$193,891	$500,768	$26,497	$92,045	$46,119	$16,727	$—	$1,04
Individually evaluated for impairment[1]	8,931	—	6,844	4,168	1,192	3,313	2,048	—	26,49
Purchased credit-impaired	640	2,515	1,394	—	—	—	—	—	4,549
Total	$176,431	$196,406	$509,006	$30,665	$93,237	$49,432	$18,775	$—	$1,07
Ratio of allowance for loan losses to total loans	2.32 %	0.67 %	0.86 %	1.99 %	1.36 %	1.11 %	6.56 %	NM	1.27
Allowance for loan losses to non-accrual loans	84 %	94 %	64 %	27 %	232 %	46 %	231 %	NM	77

[1] Total excludes $3.8 million PCI loans that have experienced credit deterioration post-acquisition, which are included in the "purchased credit-impaired" amount in the next line below.

NM - Not Meaningful

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands; unaudited)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
For the three months ended September 30, 2012									
Allowance for loan losses:									
Beginning balance	$ 3,886	$ 1,148	$ 3,666	$ 985	$1,580	$ 562	$ 1,321	$ 287	$13,435
Provision (reversal)	259	119	2,160	(375)	2	(39)	35	(61)	2,100
Charge-offs	(15)	—	(2,236)	(15)	(149)	—	(60)	—	(2,475)
Recoveries	78	—	—	—	—	—	1	—	79
Ending balance	$ 4,208	$ 1,267	$ 3,590	$ 595	$1,433	$ 523	$ 1,297	$ 226	$13,139

For the nine months ended September 30, 2012									
Allowance for loan losses:									
Beginning balance	$ 4,334	$ 1,305	$ 3,710	$ 1,505	$ 1,444	$ 940	$ 1,182	$ 219	$ 14,639
Provision (reversal)	291	138	2,294	(723)	236	(221)	178	7	2,200
Charge-offs	(865)	(181)	(2,414)	(187)	(259)	(196)	(65)	—	(4,167)
Recoveries	448	5	—	—	12	—	2	—	467
Ending balance	$ 4,208	$ 1,267	$ 3,590	$ 595	$ 1,433	$ 523	$ 1,297	$ 226	$ 13,139

Purchased Credit-Impaired Loans

We evaluated loans purchased in accordance with accounting guidance in ASC 310-30 related to loans acquired with deteriorated credit quality. Acquired loans are considered credit-impaired if there is evidence of deterioration of credit quality since origination and it is probable, at the acquisition date, that we will be unable to collect all contractually required payments receivable. Management has determined certain loans purchased to be PCI loans based on credit indicators such as nonaccrual status, past due status, loan risk grade, etc. Revolving credit agreements (e.g. home

equity lines of credit and revolving commercial loans) are not considered PCI loans as cash flows cannot be reasonably estimated.

For acquired loans not considered credit-impaired, the difference between the contractual amounts due (principal amount) and the fair value is accounted for subsequently through accretion or amortization using an effective interest rate method for term loans and a straight line method for revolving lines. The accretion or amortization is recognized through the net interest margin.

The following table reflects the outstanding balance and related carrying value of PCI loans as of September 30, 2013 and December 31, 2012:

	September 30, 2013		December 31, 2012	
PCI Loans (dollars in thousands; 2013 unaudited)	Unpaid principal balance	Carrying value	Unpaid principal balance	Carrying value
Commercial and industrial	$519	$284	$2,163	$640
Commercial real estate	5,420	3,283	6,370	3,909
Total purchased credit-impaired loans	$5,939	$3,567	$8,533	$4,549

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

Accretable Yield	Three months ended			Nine months ended	
(dollars in thousands, unaudited)	September 30, 2013	June 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Balance at beginning of period	$3,277	$3,583	$5,386	$3,960	$5,405
Additions	—	—	—		