Bank of Marin Bancorp
Form 10-K
March 12, 2012

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

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

For the fiscal year ended: December 31, 2011
or

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

For the transition period from __________________ to __________________

Commission File number: 001-33572

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

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

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

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, and attached Share Purchase Rights	NASDAQ Capital Market
(Title of each class)	Name of each exchange on which registered)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes o No x

Note – checking the box above will not relieve any registrant required to file reports pursuant to section 13 or 15(d) of the Exchange Act from their obligations under these sections.

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K. x

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

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 June 30, 2011, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting and non-voting common equity held by non-affiliates, based upon the closing price per share of the registrant's common stock as reported by the NASDAQ, was approximately $182 million. For the purpose of this response, directors and officers of the Registrant are considered the affiliates at that date.

As of February 29, 2012 there were 5,345,732 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held on May 15, 2012 are incorporated by reference into Part III.

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PART I

Forward-Looking Statements

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

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

Forward-looking statements are based on Management's current expectations regarding economic, legislative, and regulatory issues that may impact our earnings in future periods. A number of factors - many of which are beyond Management's control - could cause future results to vary materially from current Management's expectations. Such factors include, but are not limited to, estimated fair values related to the assets acquired and liabilities assumed of the former Charter Oak Bank; general economic conditions, the current financial uncertainty in the United States and abroad, changes in interest rates, deposit flows, real estate values and competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation; and other economic, competitive, governmental, regulatory and technological factors affecting our operations, pricing, products and services. These and other important factors are detailed in Item 1A Risk Factors section of this report. Forward-looking statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.

ITEM 1. BUSINESS

Bank of Marin (the "Bank") was incorporated in August 1989, received its charter from the California Superintendent of Banks (now the California Department of Financial Institutions or "DFI") and commenced operations in January 1990. The Bank is an insured bank under the Federal Deposit Insurance Act ("FDIC"). On July 1, 2007 (the "Effective Date"), a bank holding company reorganization was completed whereby Bank of Marin Bancorp ("Bancorp") became the parent holding company for the Bank, the sole and wholly-owned subsidiary of Bancorp. On the Effective Date, each outstanding share of Bank of Marin common stock was converted into one share of Bank of Marin Bancorp common stock. Bancorp is listed at NASDAQ and assumed the ticker symbol BMRC, which was formerly used by the Bank. Prior to the Effective Date, the Bank filed reports and proxy statements with the FDIC pursuant to Sections 12 of the Securities Exchange Act of 1934 (the "1934 Act"). Upon formation of the holding company, Bancorp became subject to regulation under the Bank Holding Company Act of 1956, as amended, which subjects Bancorp to Federal Reserve Board ("FRB") reporting and examination requirements.

References in this report to "Bancorp" mean Bank of Marin Bancorp, parent holding company for the Bank. References to "we," "our," "us" mean the holding company and the Bank that are consolidated for financial reporting purposes.

Virtually all of our business is conducted through Bancorp's sole subsidiary, the Bank, which is headquartered in Novato, California. As of December 31, 2011, we operated through seventeen offices in San Francisco, Marin, Napa and Sonoma counties with a strong focus on supporting the local community. Our customer base is made up of business and personal banking relationships from the communities near the branch office locations. Our business

banking focus is on small to medium-sized businesses, professionals and not-for-profit organizations.

We offer a broad range of commercial and retail deposit and lending programs designed to meet the needs of our target markets. Our loan products include commercial real estate loans, commercial and industrial loans and lines of credit, construction financing, consumer loans, and home equity lines of credit. Merchant card services are available for our customers in retail businesses. Through a third party vendor, we offer a proprietary Visa® credit card product combined with a rewards program to our customers, as well as a Business Visa® program for business and professional customers. We also offer cash management sweep to business clients through a third party vendor.

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We offer a variety of personal and business checking and savings accounts, and a number of time deposit alternatives, including time certificates of deposit, Individual Retirement Accounts (“IRAs”), Health Savings Accounts, and Certificate of Deposit Account Registry Service (“CDARS®”). CDARS® is a network through which we offer full FDIC insurance coverage in excess of the regulatory maximum by placing deposits in multiple banks participating in the network. We also offer remote deposit capture, Automated Clearing House services (“ACH”), social security and pension checks, fraud prevention services including identity theft insurance and image lockbox services. A valet deposit pick-up service is available to our professional and business clients. Automatic teller machines (“ATM's”) are available at each branch location.

Our ATM network is linked to the PLUS, CIRRUS and NYCE networks. In January 2009, we began offering free access to a network of nation-wide surcharge-free ATM’s called MoneyPass. We also offer our depositors 24-hour access to their accounts by telephone and through our internet banking products available to personal and business account holders.

We offer Wealth Management and Trust Services (“WMTS”) which include customized investment portfolio management, financial planning, trust administration, estate settlement and custody services, and advice of charitable giving. We also offer 401(k) plan services to small and medium businesses through a third party vendor.

We offer branch-based Private Banking as a natural extension of our services. Our Private Banking includes deposit services and loans, as well as a full range of banking services.

We do not directly offer international banking services, but do make such services available to our customers through other financial institutions with whom we have correspondent banking relationships.

We hold no patents, licenses (other than licenses required by the appropriate banking regulatory agencies), franchises or concessions. The Bank has registered the service marks "The Spirit of Marin", the words “Bank of Marin”, the Bank of Marin logo, and the Bank of Marin tagline “Committed to your business and our community” with the United States Patent & Trademark Office. In addition, Bancorp has registered the service marks for the words “Bank of Marin Bancorp” and for the Bank of Marin Bancorp logo with the United States Patent & Trademark Office.

All service marks registered by Bancorp or the Bank are registered on the United States Patent & Trademark Office Principal Register, with the exception of the words "Bank of Marin Bancorp" which is registered on the United States Patent & Trademark Office Supplemental Register.

Acquisition

As discussed in Note 2 to the Consolidated Financial Statements in Item 8 of this report, in February 2011, we expanded our community banking footprint to Napa County through an FDIC-assisted acquisition of $107.8 million of assets and assumption of $107.7 million of liabilities of the former Charter Oak Bank (the “Acquisition”). No capital has been raised to complete this transaction, as Bancorp has grown capital through the retention of earnings in order to take advantage of such acquisition opportunities. The acquired operations of the former Charter Oak Bank contributed approximately $2.0 million to our results of operations for the period February 18 to December 31, 2011.

Market Area

Our primary market area consists of Marin, San Francisco, Napa and Sonoma Counties. Our customer base is primarily made up of business and personal banking relationships within these market areas.

We attract deposit relationships from individuals, merchants, small to medium-sized businesses, not-for-profit organizations and professionals who live and/or work in the communities comprising our market areas. As of December 31, 2011, approximately 74% of our deposits are in Marin and southern Sonoma counties, and approximately 60% of our deposits are from businesses and 40% are from individuals.

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Competition

The banking business in California generally, and in our market area specifically, is highly competitive with respect to attracting both loan and deposit relationships. The increasingly competitive environment is impacted by changes in regulation, interest rate environment, technology and product delivery systems, and the consolidation among financial service providers. The banking industry is seeing extreme competition for quality loans. Larger banks are seeking to expand lending to small businesses, which are traditionally community bank customers. The Marin County market area is dominated by two major nation-wide banks, each of which has more branch offices than us in the defined service area. Additionally, there are several thrifts, credit unions and other independent banks.

As of June 30, 2011, the latest data available shows 90 banking offices with $9.0 billion in total deposits served the Marin County market. As of that same date, there were approximately 5 thrift offices in Marin with $0.7 billion in total deposits. We have the largest business core deposit market share, representing 25.4% of business core deposits in Marin County1. A significant driver of our franchise value is the growth and stability of our checking and savings deposits, which are a low cost funding source for our loan portfolio. We have also gained overall deposit market share in our primary market area in 20111. The four financial institutions with the greatest deposit market share in Marin County are Wells Fargo Bank, Bank of America, Bank of Marin, and Westamerica Bank with deposit market shares of 28.0% and 17.9%, 10.0%, and 8.3%, respectively1.

In the southern Sonoma County area of Petaluma, there are approximately 26 banking and thrift offices with $1.4 billion in total deposits as of June 30, 2011. Compared with our share of 5.0%, the four banking institutions with the greatest overall market share, Wells Fargo Bank, Bank of America, Bank of the West, and Exchange Bank had deposit market shares in Petaluma of 28.3%, 15.6%, 10.0%, and 8.9%, respectively1.

We also compete for depositors' funds with money market mutual funds and with non-bank financial institutions such as brokerage firms and insurance companies. Among the competitive advantages held by some of these non-bank financial institutions is their ability to finance extensive advertising campaigns and to allocate investment assets to regions of California or other states with areas of highest demand and, therefore, often higher yield.

Nation-wide banks have the competitive advantages of national advertising campaigns and technology infrastructure to achieve economies of scale. Large commercial banks also have substantially greater lending limits and have the ability to offer certain services which are not offered directly by us.

In order to compete with the numerous, and often larger, financial institutions in our primary market area, we use, to the fullest extent possible, the flexibility and rapid response capabilities which are accorded by our independent status. Our competitive advantages also include an emphasis on personalized services, community involvement, philanthropic giving, local promotional activities and personal contacts. The commitment and dedication of our organizers, directors, officers and staff have also contributed greatly to our success in competing for business.

Employees

At December 31, 2011, we employed 232 full-time equivalent (“FTE”) staff. The actual number of employees, including part-time employees, at year-end 2011 included 4 executive officers, 88 other corporate officers and 155 staff. None of our employees are presently represented by a union or covered by a collective bargaining agreement. We believe that our employee relations are good. We have been recognized as one of the “Best Places to Work in the San Francisco Bay Area” by the San Francisco Business Times and the “Best Places to Work” by North Bay Business Journal.

SUPERVISION AND REGULATION

Bank holding companies and banks are extensively regulated under both federal and state law. The following discussion summarizes certain significant laws, rules and regulations affecting Bancorp and the Bank.

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1 Based on the latest available FDIC deposit market share data as of June 30, 2011.

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Bank Holding Company Regulation

Upon formation of the bank holding company on July 1, 2007, we became subject to regulation under the Bank Holding Company Act of 1956, as amended ("BHCA") which subjects Bancorp to FRB reporting and examination requirements. Under the FRB's regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks.

The BHCA regulates the activities of holding companies including acquisitions, mergers and consolidations and, together with the Gramm-Leach Bliley Act of 1999, the scope of allowable banking activities. Bancorp is also a bank holding company within the meaning of the California Financial Code. As such, Bancorp and its subsidiaries are subject to examination by, and may be required to file reports with, the DFI.

Bank Regulation

Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole. These regulations affect our lending practices, consumer protections, capital structure, investment practices and dividend policy.

As a state chartered bank, we are subject to regulation and examination by the DFI. We are also subject to regulation, supervision and periodic examination by the FDIC. If, as a result of an examination of the Bank, the FDIC or the DFI should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of our operations are unsatisfactory, or that we have violated any law or regulation, various remedies are available to those regulators including issuing a "cease and desist" order, restricting our growth or removing officers and directors.

The following discussion summarizes certain significant laws, rules and regulations affecting both Bancorp and the Bank. The Bank addresses the many state and federal regulations it is subject to through a comprehensive compliance program that addresses the various risks associated with these issues.

Dividends

The payment of cash dividends by the Bank to Bancorp is subject to restrictions set forth in the California Financial Code (the "Code"). Prior to any distribution from the Bank to Bancorp, a calculation is made to ensure compliance with the provisions of the Code and to ensure that the Bank remains within capital guidelines set forth by the DFI and the FDIC. Management anticipates that there will be sufficient earnings at the Bank level to provide dividends to Bancorp to meet its funding requirements for 2012. See also Note 9 to the Consolidated Financial Statements, under the heading "Dividends" in Item 8 of this report.

FDIC Insurance Assessments

Our deposits are insured by the FDIC to the maximum amount permitted by law, which is currently $250,000 per depositor. The 2010 enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") made the deposit insurance coverage permanent at the $250,000 level retroactive to January 1, 2008.
The Dodd-Frank act also provides depositors at all FDIC-insured institutions with unlimited deposit insurance coverage on traditional checking accounts that do not pay interest and Interest on Lawyers Trust Accounts beginning December 31, 2010 through the end of 2012.

During 2009 and 2010, we elected to participate in the Temporary Transaction Account Guarantee Program, which provided full deposit insurance coverage to non-interest bearing transaction accounts (including low-interest

negotiable order of withdrawal accounts and interest on lawyer trust accounts), by paying a 10 basis point surcharge on the non-interest bearing transaction accounts over $250,000 through December 31, 2009, and a 15 basis point surcharge through December 31, 2010, when the program ended.

On November 12, 2009, the FDIC finalized a Deposit Insurance Fund restoration plan that required banks to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. Under the plan, banks were assessed through 2010 according to the risk-based premium schedule adopted in April 2009.

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On February 7, 2011, as required by the Dodd-Frank Act, the FDIC approved a rule that changes the FDIC insurance assessment base from adjusted domestic deposits to a bank's average consolidated total assets minus average tangible equity, defined as Tier 1 capital. Since the new base is larger than the current base, the new rule lowers assessment rates to between 2.5 and 9 basis points on the broader base for banks in the lowest risk category, and 30 to 45 basis points for banks in the highest risk category. The change was effective beginning with the second quarter of 2011. Since we have a solid core deposit base and do not rely heavily on borrowings and brokered deposits, the benefit of the lower assessment rate (which has dropped by approximately half for us) significantly outweighed the effect of a wider assessment base.

Community Reinvestment Act

We are subject to the provisions of the Community Reinvestment Act ("CRA"), under which all banks and thrifts have a continuing and affirmative obligation, consistent with safe and sound operations, to help meet the credit needs of their entire communities, including low and moderate income neighborhoods. The act requires a depository institution's primary federal regulator, in connection with its examination of the institution, to assess the institution's record in meeting the requirements in CRA. The regulatory agency's assessment of the institution's record is made available to the public. The record is taken into consideration when the institution establishes a new branch that accepts deposits, relocates an office, applies to merge or consolidate, or expands into other activities. Our CRA performance is evaluated by the FDIC under the intermediate small bank requirements. The FDIC's last CRA performance examination was performed on us and completed on May 7, 2009 with a rating of "Satisfactory".

Anti Money–Laundering Regulations

A series of banking laws and regulations beginning with the Bank Secrecy Act in 1970 require banks to prevent, detect, and report illicit or illegal financial activities to the federal government to prevent money laundering, international drug trafficking, and terrorism. Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as enhanced due diligence and "know your customer" standards in their dealings with high risk customers, foreign financial institutions, and foreign individuals and entities. We have extensive controls in place to comply with these requirements.

Privacy and Data Security

The Gramm-Leach Bliley Act ("GLBA") of 1999 imposes requirements on financial institutions with respect to consumer privacy. The GLBA generally prohibits disclosure of consumer information to non-affiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to consumers annually. The GLBA also directs federal regulators, including the FDIC, to prescribe standards for the security of consumer information. We are subject to such standards, as well as standards for notifying consumers in the event of a security breach. We must disclose our privacy policy to consumers and permit consumers to "opt out" of having non-public customer information disclosed to third parties. We are required to have an information security program to safeguard the confidentiality and security of customer information and to ensure proper disposal of information that is no longer needed. Customers must be notified when unauthorized disclosure involves sensitive customer information that may be misused.

Consumer Protection Regulations

Our lending activities are subject to a variety of statutes and regulations designed to protect consumers, including the Fair Credit Reporting Act, Equal Credit Opportunity Act, the Fair Housing Act, and the Truth-in-Lending Act. Our

deposit operations are also subject to laws and regulations that protect consumer rights including Funds Availability, Truth in Savings, and Electronic Funds Transfers. Additional rules govern check writing ability on certain interest earning accounts and prescribe procedures for complying with administrative subpoenas of financial records. Additionally, a provision of the Federal Reserve Regulation E has been changed effective July 1, 2010 that puts restrictions on institutions assessing overdraft fees on consumer's accounts relating to debit card usage or other forms of electronic transfer. As a result, our overdraft fee income has been negatively impacted. See also analysis captioned "Non interest income" in Item 7 of this report.

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Restriction on Transactions between Member Banks and their Affiliates

Transactions between Bancorp and the Bank are quantitatively and qualitatively restricted under Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W. Section 23A places restrictions on the Bank's "covered transactions" with Bancorp, including loans and other extensions of credit, investments in the securities of, and purchases of assets from Bancorp. Section 23B requires that certain transactions, including all covered transactions, be on market terms and conditions. Federal Reserve Regulation W combines statutory restrictions on transactions between the Bank and Bancorp with FRB interpretations in an effort to simplify compliance with Sections 23A and 23B.

Capital Requirements

The FRB and the FDIC have adopted risk-based capital guidelines for bank holding companies and banks. Bancorp's ratios exceed the required minimum ratios for capital adequacy purposes and the Bank meets the definition for well capitalized. Undercapitalized depository institutions may be subject to significant restrictions. Payment of interest and principal on subordinated debt of the Bank could be restricted or prohibited, with some exceptions, if the Bank were categorized as "critically undercapitalized" under applicable FDIC regulations. For further information on risk-based capital, see Note 16 to the Consolidated Financial Statements in Item 8 of this Form 10-K.

The current risk-based capital guidelines which apply to the Bank are based upon the 1988 capital accord of international Basel Committee referred to as "Basel I." In January 2009, the Basel Committee proposed to reconsider regulatory-capital standards, supervisory and risk-management requirements and additional disclosures to further strengthen the Basel framework in response to recent worldwide economic developments. The proposed changes, otherwise known as the "Basel III" standards, if adopted, could lead to significantly higher capital requirements, higher capital charges and more restrictive leverage and liquidity ratios. Federal banking regulators have recently issued proposed rules relating to the Basel III requirements. In the proposed rule it is anticipated that the Basel III requirements will be applicable to all U.S. bank holding companies with consolidated assets of $50 billion or more and any nonbank financial firms that may be designated as systemically important companies. Bancorp is uncertain as to what eventual effect this will have on a companies such as us, with less than $50 billion in consolidated assets. There is always the possibility that some of the Basel III requirements may be implemented by bank regulators for banks with less than $50 billion in consolidated assets as a "best practice."

Sarbanes-Oxley Act of 2002

We are subject to the requirements of the Sarbanes-Oxley Act of 2002 which implemented legislative reforms intended to address corporate and accounting improprieties and among other things:

- required executive certification of financial presentations;
- increased requirements for board audit committees and their members;
- enhanced disclosure of controls and procedures and internal control over financial reporting;
- enhanced controls over, and reporting of, insider trading; and
- increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

Emergency Economic Stabilization Act of 2009 (the "EESA")

In response to the financial crisis affecting the banking system and financial markets and going concern threats of investment banks and other financial institutions, on October 3, 2008, the EESA was signed into law, which gave the U.S. Treasury the authority to, among other things, inject $700 billion capital into the market to stabilize the financial industry. Pursuant to the EESA, the U.S. Treasury also purchased senior preferred shares from the largest nine

financial institutions in the nation and the other financial institutions in a program known as the Treasury Capital Purchase Program ("TCPP") that was carved out of the Troubled Asset Relief Program ("TARP"). As a result of our participation in the TCPP, we were subject to restrictions on executive compensation and limitations on dividends and stock repurchases from December 5, 2008 to March 31, 2009, the period that the preferred stock issued to the U.S. Treasury was outstanding. We also issued a warrant to the U.S. Treasury as part of the TCPP to acquire 154,908 shares of our common stock (as adjusted to date). The warrant was auctioned by the U.S. Treasury and purchased by two institutional investors during November 2011 and remains outstanding. See Note 9 to the Consolidated Financial Statements in Item 8 of this report for discussion regarding the warrant.

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The American Recovery and Reinvestment Act of 2009 (the “Recovery Act”)

The Recovery Act was signed into law on February 17, 2009 in an effort, among other things, to jumpstart the U.S. economy, prevent job losses, expand educational opportunities, and provide affordable health care and tax relief. Among the various measures in the Recovery Act, it imposes further restriction on executive compensation and corporate expenditure limits of recipients of the TCPP funds, while allowing them to repurchase the preferred stock at liquidation amount without regard to the original TCPP transaction terms. See Note 9 to the Consolidated Financial Statements in Item 8 of this report for discussion regarding our repurchase of preferred stock issued under the TCPP.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, a landmark financial reform bill comprised of massive volume of new rules and restrictions that will impact banks going forward. It includes key provisions aimed at preventing a repeat of the 2008 financial crisis and a new process for winding down failing, systemically important institutions in a manner as close to a controlled bankruptcy as possible. The Act includes other key provisions as follows:

(1) The Act establishes a new Financial Stability Oversight Council to monitor systemic financial risks. The FRB is given extensive new authorities to impose strict controls on large bank holding companies with total consolidated assets equal to or in excess of $50 billion and systemically significant nonbank financial companies to limit the risk they might pose for the economy and to other large interconnected companies. The FRB can also take direct control of troubled financial companies that are considered systemically significant.

The Act restricts the amount of trust preferred securities (“TPS”) that may be considered as Tier 1 Capital. For bank holding companies below $15 billion in total assets, TPS issued before May 19, 2010 will be grandfathered, so their status as Tier 1 capital does not change. Beginning January 1, 2013, bank holding companies above $15 billion in assets will have a three-year phase-in period to fill the capital gap caused by the disallowance of the TPS issued before May 19, 2010. However going forward, TPS will be disallowed as Tier 1 capital.

(2) The Act creates a new process to liquidate failed financial firms in an orderly manner, including giving the FDIC broader authority to operate or liquidate a failing financial company.

(3) The Act also establishes a new independent Federal regulatory body for consumer protection within the Federal Reserve System known as the Bureau of Consumer Financial Protection (the "Bureau"), which will assume responsibility for most consumer protection laws (except the Community Reinvestment Act). It will also be in charge of setting appropriate consumer banking fees and caps. The Office of Comptroller of the Currency will continue to have authority to preempt state banking and consumer protection laws if these laws "prevent or significantly" interfere with the business of banking.

(4) The Act effects changes in the FDIC assessment as discussed in section “FDIC Insurance Assessments” above.

(5) The Act places certain limitations on investment and other activities by depository institutions, holding companies and their affiliates, including comprehensive regulation of all over-the-counter derivatives.

(6) The Act states that the FRB is authorized to regulate interchange fees on debit cards and certain general-use prepaid card transactions paid to issuing banks with assets in excess of $10 billion to ensure that they are “reasonable and proportional” to the cost of processing individual transactions, and to prohibit debit and general-use prepaid payment card networks and issuers from requiring transactions to be processed on a single payment network. The FRB issued its final rule on June 29, 2011.

The impact of the Act on our banking operations is still uncertain due to the massive volume of new rules still subject to adoption and interpretation.

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Available Information

On our internet web site, www.bankofmarin.com, we post the following filings as soon as reasonably practicable after they are filed with or furnished to the SEC: Annual Report on Form 10-K, Proxy Statement for the Annual Meeting of Shareholders, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities and Exchange Act of 1934. The text of the Code of Ethical Conduct for Bancorp and the Bank is also included on the website. All such filings on our website are available free of charge. This website address is for information only and is not intended to be an active link, or to incorporate any website information into this document. In addition, copies of our filings are available by requesting them in writing or by phone from:

Corporate Secretary
Bank of Marin
504 Redwood Blvd., Suite 100
Novato, CA 94947
415-763-4523

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ITEM 1A. RISK FACTORS

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that Management believes may affect our business are described below. Before making an investment decision, investors should carefully consider the risks and uncertainties described below, together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing our business. Additional risks and uncertainties that Management is not aware of or focused on or that Management currently deems immaterial may also impair business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected.

Our Earnings are Significantly Influenced by General Business and Economic Conditions

We are operating in an uncertain economic environment. While there are signs of economic conditions improving, the persistent high unemployment rate, weak business and consumer spending, the U.S. budget deficit and uncertainty in European economies underline that the economy remains very fragile. Economic recovery is expected to be slow and long. The housing market is not expected to recover soon amid a bleak job market. Business activity across a wide range of industries and regions is greatly affected. Local and state governments are in difficulty due to the reduction in sales taxes resulting from the lack of consumer spending and property taxes resulting from declining property values. Financial institutions continue to be affected by the contraction of the real estate market, elevated foreclosure rates, long-term high unemployment and underemployment rates and a stricter regulatory environment. While our market areas have not experienced the same degree of challenge in unemployment as other areas2, the effects of these issues have trickled down to households and businesses in our markets. There can be no assurance that the recent economic improvement is sustainable and credit worthiness of our borrowers will not deteriorate.

Continued declines in real estate values and home sale volumes, financial stress on borrowers, including job losses, and customers' inability to pay debt could adversely affect our financial condition and results of operations in the following aspects:

- Demand for our products and services may decline
- Low cost or non-interest bearing deposits may decrease
- Collateral for our loans, especially real estate, may decline further in value
- Loan delinquencies, problem assets and foreclosures may increase.

Our deposit growth level has outpaced our loan growth recently, which leads to excess liquidity earning a less favorable yield. As the economy is still vulnerable, businesses are wary about capital expenditures or expansion of working capital and consumers are de-leveraging their debts. Hence, we have noticed a low level of loan demand due to an unfavorable economic climate and intensified competition for creditworthy borrowers, all of which could impact our ability to generate profitable loans.

Nonperforming Assets Take Significant Time To Resolve And Adversely Affect Our Results Of Operations And Financial Condition.

Our nonperforming assets have been maintained at a manageable level historically. As discussed in Note 2 to the Consolidated Financial Statements in Item 8 of this report, we acquired certain assets of the failed Charter Oak Bank on February 18, 2011. The Acquisition may expose us to credit issues of acquired assets, which may become nonperforming in the future.

2 Based on the latest available labor market information from Employment Development Department. Preliminary December 2011 results show that the unemployment rate in Marin County was the lowest in California at 6.5%. The unemployment rates in Sonoma and Napa County are 8.9% and 9.0%, compared to the state of California at 10.9%.

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Nonperforming assets may adversely affect our net income in various ways. Until economic and market conditions improve, we expect to continue to incur elevated losses relating to nonperforming assets. We do not record interest income on non-accrual loans, thereby adversely affecting our income and increasing our loan administration costs. When we take collateral in foreclosures and similar proceedings, we are required to mark the related loan to the then fair value of the collateral, which may result in a loss. While we have tried to reduce our problem assets through workouts, restructurings and otherwise, decreases in the value of these assets, or the underlying collateral, or in these borrowers' performance or financial conditions, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management, which can be detrimental to the performance of other responsibilities. There can be no assurance that we will not experience further increases in nonperforming loans in the future.

Purchased Loans from the Acquisition May Lose Value if the Estimated Fair Value is Inaccurate

Our determination regarding the fair value of loans purchased in the Acquisition could be inaccurate, which could materially and adversely affect our business, financial condition, results of operations and future prospects. Management makes various assumptions and judgments about the collectability of the acquired loans, including the creditworthiness of borrowers and the value of the real estate and other assets serving as collateral for the repayment of secured loans. The timing and amount of future expected cash flows is hence subject to a great degree of uncertainty. Increases in the amount of future losses in response to different economic conditions or adverse developments in the acquired loan portfolio may result in increased credit loss provisions and could have a negative impact on our operating results.

Recently Enacted Legislation and Other Measures Undertaken by the Government May not Help Stabilize the U.S. Financial System and The Impact of New Financial Reform Legislation is Yet to be Determined

As discussed in Item 1, Section captioned "Supervision and Regulation" above, in 2010, President Obama signed into law a landmark financial reform bill—the Dodd-Frank Act. The rules under the Dodd-Frank Act may change banking statutes and the operating environment of Bancorp and the Bank in substantial and unpredictable ways, and could increase the cost of doing business, decrease our revenues, limit or expand permissible activities or affect the competitive balance depending upon whether or how regulations are implemented. We may be forced to invest significant management attention and resources to make any necessary changes related to the Dodd-Frank Act and any regulations promulgated there under. The ultimate effect of the changes would have on the financial condition or results of operations of Bancorp or the Bank is uncertain at this time.

The actual impact of the recently enacted legislation and such related measures undertaken to alleviate the aftermaths of the credit crisis is unknown. The capital and credit markets have experienced volatility and disruption at an unprecedented level in the past few years. In some cases, the markets have produced downward pressure on credit availability for certain issuers without regard to those issuers' underlying financial strength. If the recent years' disruption and volatility return, there can be no assurance that we will not experience an adverse effect on our ability to access credit or capital.

In addition to changes resulting from the Dodd-Frank Act, recent rules published by the Basel Committee on Banking Supervision, could lead to significantly higher capital requirements, higher capital charges and more restrictive leverage and liquidity ratios. On September 28, 2011, the Basel Committee upheld its view to require an additional loss absorbency amount ranging from 1% to 2.5% on tier 1 capital for global systemically important banks ("G-SIBs"). While we are not a G-SIB, general expectations of key stakeholders are that the Basel rules will trickle down and affect smaller banks like us, and therefore increase our capital requirements, particularly the tier one common equity ratio, in the future. As a result, it may affect the results of our financial condition or business'

prospects in the future.

The Recent Repeal of Federal Prohibitions on Payment of Interest on Demand Deposits Could Increase Our Interest Expense

On July 21, 2011, the Dodd-Frank Act lifted the prohibitions on payment of interest on demand deposits. Financial institutions can start paying interest on demand deposits in an effort to compete for deposits. Although we do not currently pay interest on business demand deposits and the current low interest rate environment may delay any significant change in interest rates offered by our main competitors, we may experience increases to our interest expense and interest rate sensitivity and an overall decrease in the net interest margin if we are to offer interest on demand deposits to attract or retain customers in the future. As a result, it may affect the results of our financial condition, or business' prospects in the future, especially when interest rates begin to rise.

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We May Experience Unfavorable Outcomes with Growth

We seek to expand our franchise safely and consistently. A successful growth strategy requires us to manage multiple aspects of the business simultaneously, such as following adequate loan underwriting standards, balancing loan and deposit growth without increasing interest rate risk or compressing our net interest margin, maintaining sufficient capital, and recruiting, training and retaining qualified professionals. We have recently expanded into the Napa and the greater Sonoma markets, which may have characteristics unfamiliar to us. We may also experience a lag in profitability associated with the new branch openings.

Our growth strategy also includes merger and acquisition opportunities that either enhance our market presence or have potential for improved profitability through financial management, economies of scale or expanded services. As discussed in Note 2 to the Consolidated Financial Statement in Item 8 of this report, we acquired certain assets and certain liabilities of Napa-based Charter Oak Bank on February 18, 2011 through an FDIC-assisted transaction. While FDIC-assisted acquisitions provide attractive opportunities in part due to loans purchased at significant discounts, acquiring other banks or branches involves risks such as exposure to potential asset quality issues of the target company, potential disruption to our normal business activities and diversion of Management's time and attention due to integration and conversion efforts. If we pursue our growth strategy too aggressively and fail to execute integration properly, we may not be able to achieve expected synergies or other anticipated benefits.

Interchange Reimbursement Fees and Related Practices Have Been Receiving Significant Legal and Regulatory Scrutiny, and the Resulting Regulations Could Have a Significant Impact on Interchange Fees We Earn

The Dodd-Frank Act includes provisions that regulate the debit interchange rates and certain other network industry practices (the "Durbin Amendment"). In addition, the FRB now has the power to regulate network fees to the extent necessary to prevent evasion of the new rules on interchange rates. The FRB issued a rule to restrict interchange fees on debit cards to 21 cents per transaction and 5 basis points multiplied by the value of the transaction for institutions with $10 billion or more in assets. Interchange represents a transfer of value between the financial institutions participating in payment networks such as Visa and NYCE, in which we participate. In connection with transactions initiated with cards in a payments system, interchange reimbursement fees are typically paid to issuers, the financial institutions such as us that issue debit cards to cardholders. They are typically paid by network owners, the financial institutions that offer network connectivity and payment acceptance services to merchants.

Despite the statutory attempt to separate out smaller banks from the price controls embodied in the Durbin amendment, the marketplace may drive business to the lowest cost option. Merchants may switch to lower-cost cards and accounts of larger institutions, applying downward pressure on the fees paid to small institutions to compete. In January 2010, Visa announced that it will implement a two-tiered pricing system for debit interchange – one for banks with more than $10 billion in assets, and one for all those under the $10 billion threshold. There is no obligation for networks, such as Visa, to maintain their multiple-tier pricing structure. Community banks such as us may ultimately be harmed as a result. We may be forced to charge lower fees to customers, affecting our profitability. Owners of networks in which we do not participate could elect to charge higher discount rates to merchants, leading merchants not to accept cards for payment, or to steer Visa cardholders to alternate payment systems, hence reducing our transaction volumes.

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Negative Conditions Affecting Real Estate May Harm Our Business

Concentration of our lending activities in the California real estate sector could negatively impact our results of operations if the adverse changes in the real estate market in our lending area intensify. Although we do not offer traditional first mortgages, nor have sub-prime or Alt-A residential loans or significant amount of securities backed by such loans in the portfolio, we are not immune from the effect of the set-back of the real estate market. Approximately 85% of our loans were secured by real estate at December 31, 2011, of which 61% were secured by commercial real estate and the remaining 24% by residential real estate. Real estate valuations are impacted by demand, and demand is driven by factors such as employment; when unemployment rises, demand drops. The unemployment rate has stayed at an elevated level since 2009. Most of the properties that secure our loans are located within Marin, San Francisco and Sonoma Counties. While we have seen improvement in real estate sales volume, the selling prices continue to be at a distressed level3.

Loans secured by commercial real estate include those secured by small office buildings, owner-user office/warehouses, mixed-use residential/commercial properties and retail properties. In 2011, office vacancy rates in Marin County have fallen from 25.7% to 23.3%, while industrial vacancy rates have risen from 5.9% to 7.8% and retail rates have fallen slightly from 5.5% to 5.1%4. In Sonoma County, vacancy rates are generally higher than in Marin County: the rate of industrial, retail, and office vacancies changed from 13.9%, 8.5%, and 22.3% in 2010 to 13.7%, 6.6%, and 23.3% in 2011, respectively4. There can be no assurance that the companies or properties securing our loans will generate sufficient cash flows to allow the borrowers to make full and timely loan payments to us.

In late 2006, Federal banking regulators issued final guidance regarding commercial real estate lending to address a concern that rising commercial real estate lending concentrations may expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the investor commercial real estate market. This guidance suggests that institutions that are potentially exposed to significant commercial real estate concentration risk will be subject to increased regulatory scrutiny. Institutions that have experienced rapid growth in commercial real estate lending, have notable exposure to a specific type of commercial real estate lending, or are approaching or exceed certain supervisory criteria that measure an institution’s commercial real estate portfolio against its capital levels, may be subject to such increased regulatory scrutiny. Although regulators have not notified us of any concern, there is no assurance that we will not be subject to additional scrutiny in the future.

We are Subject to Interest Rate Risk

Our earnings and cash flows are largely dependent upon our net interest income. Net interest income is the difference between interest income earned on interest-earning assets, such as loans and securities, and interest expense paid on interest-bearing liabilities, such as deposits and borrowed funds. Interest rates are sensitive to many factors outside our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the FRB, which regulates the supply of money and credit in the United States. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and interest we pay on deposits and borrowings, but could also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, and (iii) the average duration of our mortgage-backed securities portfolio. Our portfolio of securities is subject to interest rate risk and will generally decline in value if market interest rates increase, and generally increase in value if market interest rates decline. Our mortgage-backed security portfolio is also subject to prepayment risk in a low interest rate environment.

In response to the recessionary state of the national economy, the gloomy housing market and the volatility of financial markets, the Federal Open Market Committee of the FRB (“FOMC”) started a series of decreases in Federal funds target rate with seven decreases in 2008, bringing the target rate to a historically low range of 0% to 0.25% through December 2011. In their statement after the first FOMC meeting in 2012, they expect the exceptionally low

interest rates to continue through 2014.

Interest rate changes can create fluctuations in the net interest margin due to an imbalance in the timing of repricing or maturity of assets or liabilities. We manage interest rate risk exposure with the goal of minimizing the impact of interest rate volatility on the net interest margin. Although we believe we have implemented effective asset and liability management strategies, any substantial, prolonged low interest rate environment could have an adverse effect on our financial condition and results of operations. See the sections captioned "Net Interest Income" in Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 and Quantitative and Qualitative Disclosures about Market Risk in Item 7A of this report for further discussion related to management of interest rate risk.

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3 Home sales were up 5.3% in Marin County and 9.6% in Sonoma County in 2011.

4 Based on the latest available real estate information from Keegan & Coppin Company, Inc.

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In the current environment of historically low interest rates, it is important for us to mitigate exposure to future increases in interest rates. If interest rates rise by more than 100 basis points, we anticipate that net interest income will rise assuming no additional deposit rate sensitivity. However, it may still take several upward market rate movements for variable rate loans at floors to move above their floor rates. Further, a rise in index rates leads to lower debt service coverage of variable rate loans if the borrower's operating cash flow doesn't also rise. This creates a leveraged paradox of an improving economy (leading to higher interest rates), but lower credit quality as short-term rates move up faster than the cash flow or income of the borrowers. Higher interest rates may also depress loan demand, making it more difficult for us to grow loans.

We are Subject to Significant Credit Risk and Loan Losses May Exceed Our Allowance for Loan Losses in the Future

We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents Management's best estimate of probable losses that may be incurred within the existing portfolio of loans. The level of the allowance reflects Management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality and present economic, political and regulatory conditions. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Further, we generally rely on appraisals of the collateral or comparable sales data to determine the level of specific reserve and/or the charge-off amount on certain collateral dependent loans. Inaccurate assumptions in the appraisals or an inappropriate choice of the valuation techniques may lead to an inadequate level of specific reserve or charge-offs.

Changes in economic conditions affecting borrowers, new information regarding existing loans and their collateral, identification of additional problem loans and other factors, may require an increase in our allowance for loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs. In addition, if charge-offs in future periods exceed the allowance for loan losses or the cashflows from the acquired loans do not perform as expected, we will need to record additional provision for loan losses. Any increases in the allowance for loan losses will result in an adverse impact on net income and capital.

We Face Intense Competition with Other Financial Institutions to Attract and Retain Banking Customers

We are facing significant competition for customers from other banks and financial institutions located in the markets we serve. We compete with commercial banks, saving banks, credit unions, non-bank financial services companies and other financial institutions operating within or near our serving areas. Many of our non-bank competitors are not subject to the same extensive regulations as we are, thus, they are able to offer greater flexibility in competing for business. We anticipate intense competition will be continued for the coming year due to the recent consolidation of many financial institutions and more changes in legislature, regulation and technology. Further, we expect loan demand to continue to be challenging due to the uncertain economic climate and the intensifying competition for creditworthy borrowers, both of which could lead to loan rate concession pressure and could impact our ability to generate profitable loans.

Going forward, we may see tighter competition in the industry as banks seek to take market share in the most profitable customer segments, particularly the small business segment and the mass-affluent segment, which offers a rich source of deposits as well as more profitable and less risky customer relationships. Further, with the rebound of the equity markets, our deposit customers may perceive alternative investment opportunities as providing superior expected returns. Technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments or other deposit accounts such as online virtual banks and non-bank service providers. The current low interest rate environment could increase such transfers of deposits to higher yielding deposits or other

investments. Efforts and initiatives we undertake to retain and increase deposits, including deposit pricing, can increase our costs. When our customers move money into higher yielding deposits or in favor of alternative investments, we can lose a relatively inexpensive source of funds, thus increasing our funding costs.

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We also compete with nation-wide and regional banks much larger than our size, which may be able to benefit from economies of scale through their wider branch network, national advertising campaigns and sophisticated technology infrastructure.

We intend to seek additional deposits by continuing to establish and strengthen our personal relationships with our existing customers and by offering deposit products that are competitive with those offered by other financial institutions in our markets. If these efforts are unsuccessful, we may need to fund our asset growth through borrowings, other non-core funding or public offerings of our common stock which could be leveraged. Increased debt would further increase our leverage, reduce our borrowing capacity and increase our reliance on non-core funds and counterparties' credit availability. A public offering may have a dilutive effect on earnings per share and share ownership.

Our Ability to Access Markets for Funding and Acquire and Retain Customers Could be Adversely Affected by the Deterioration of Other Financial Institutions or the Financial Service Industry's Reputation

Reputation risk is the risk to liquidity, earnings and capital arising from negative publicity regarding the financial services industry. The financial services industry continues to be featured in negative headlines about their roles in the past global and national credit crisis and the resulting stabilization legislation enacted by the U.S. federal government. These reports can be damaging to the industry's image and potentially erode consumer confidence in insured financial institutions. Bank failures in California, including in our own markets, have had a negative impact and additional failures are expected. In addition, our ability to engage in routine funding and other transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor and counterparty confidence and could lead to losses or defaults by us or by other institutions. We could experience increases in deposits and assets as a direct or indirect result of other banks' difficulties or failure, which would increase the capital we need to support such growth or we could experience severe and unexpected decreases in deposits which could adversely impact our liquidity and heighten regulatory concern.

Bancorp and the Bank are Subject to Extensive Government Regulation and Supervision

Bancorp and the Bank are subject to extensive federal and state governmental supervision, regulation and control. Holding company regulations affect the range of activities in which Bancorp is engaged. Banking regulations affect the Bank's lending practices, capital structure, investment practices and dividend policy among other controls. Future legislative changes or interpretations may also alter the structure and competitive relationship among financial institutions. Legislation is regularly introduced in the U.S Congress and the California Legislature which would impact our operating environment in perhaps substantial and unpredictable ways. The nature and extent of future legislative and regulatory changes affecting us is unpredictable at this time.

The historic disruptions in the financial marketplace over the past few years have prompted the Obama administration to reform the financial market regulation. This reform includes additional regulations over consumer financial products, bond rating agencies and the creation of a regime for regulating systemic risk across all types of financial service firms. In light of recent economic conditions as well as regulatory and congressional criticism, further restrictions on financial service companies may adversely impact our results of operations and financial condition, as well as increase our compliance risk.

Compliance risk is the current and prospective risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies, and procedures, or ethical

standards set forth by regulators. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of our clients may be ambiguous or untested. This risk exposes Bancorp and the Bank to potential fines, civil money penalties, payment of damages and the voiding of contracts. Compliance risk can lead to diminished reputation, reduced franchise value, limited business opportunities, reduced expansion potential and an inability to enforce contracts.

For further information on supervision and regulation, see the section captioned "Supervision and Regulation" in Item 1 above.

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Bancorp Relies on Dividends from the Bank to Pay Cash Dividends to Shareholders

Bancorp is a separate legal entity from its subsidiary, the Bank. Bancorp receives substantially all of its revenue from the Bank in the form of dividends, which is Bancorp's principal source of funds to pay cash dividends to Bancorp's common shareholders. Various federal and state laws and regulations limit the amount of dividends that the Bank may pay to Bancorp. In the event that the Bank is unable to pay dividends to Bancorp, Bancorp may not be able to pay dividends to its shareholders. As a result, it could have an adverse effect on Bancorp's stock price and investment value.

Under federal law, capital distributions from the Bank would become prohibited, with limited exceptions, if the Bank were categorized as "undercapitalized" under applicable FRB or FDIC regulations. In addition, as a California bank, the Bank is subject to state law restrictions on the payment of dividends. For further information on the distribution limit from the Bank to Bancorp, see the section captioned "Bank Regulation" in Item 1 above and "Dividends" in Note 9 to the Consolidated Financial Statements in Item 8 below.

The Trading Volume of Bancorp's Common Stock is Less than That of Other Larger Financial Services Companies

Our common stock is listed on the NASDAQ's Capital Market. Our trading volume is less than that of nationwide or regional financial institutions. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence of willing buyers and sellers of common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the lower trading volume of our common stock, significant trades of our stock in a given time, or the expectations of these trades, could cause the stock price to be more volatile.

Failure of Correspondent Banks and Counterparties May Affect our Liquidity

In the past few years, the financial services industry in general was materially and adversely affected by the credit crises. We have witnessed failure of banks in the industry in recent years and the trend is expected to continue. We rely on our correspondent banks for lines of credit. We also have two correspondent banks as counterparties in our derivative transactions (see Note 15 to the Consolidated Financial Statements). While we continually monitor the financial health of our correspondent banks and we have diverse sources of liquidity, should any one of our correspondent banks become financially impaired, our available credit may decline and/or they may be unable to honor their commitments.

Unexpected Early Termination of Our Interest Rate Swap Agreements May Impact Our Earnings

We have entered into interest-rate swap agreements, primarily as an asset/liability management strategy, in order to mitigate the changes in the fair value of specified long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans caused by changes in interest rates. These hedges allow us to offer long-term fixed rate loans to customers without assuming the interest rate risk of a long-term asset by swapping our fixed-rate interest stream for a floating-rate interest stream. In the event of default by the borrowers on our hedged loans, we may have to terminate these designated interest-rate swap agreements early, resulting in severe prepayment penalties charged by our counterparties. On the other hand, when these interest-rate swap agreements are in an asset position, we are subject to the credit risk of our counterparties, who may default on the interest-rate swap agreements, leaving us vulnerable to interest rate movements.

Securities May Lose Value due to Credit Quality of the Issuers

We hold securities issued and/or guaranteed by Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Corporation ("FHLMC"). In 2008, the U.S. Government placed both FNMA and FHLMC under conservatorship. Starting in December 2008, the U.S. Government also began purchasing mortgage-backed securities ("MBS") issued by FNMA. Further, in December 2009, the U.S. Treasury also announced unlimited capital support for FNMA and FHLMC for the next three years. As a result, the MBS issued by FNMA and FHLMC has experienced an increase in fair value and our available-for-sale security portfolio has benefitted from this government support. However, the Obama administration released its report to Congress on reforming the housing-finance market on February 11, 2011. The proposal would wind down FNMA and FHLMC and incrementally shrink the government's housing-finance footprint by, among other things, gradually increasing the firms' guarantee pricing, reducing their conforming loan limits, and phasing in a 10-percent down-payment requirement. When the U.S. Government starts selling the MBS securities issued by FNMA and FHLMC, when the government support is phased-out or completely withdrawn, or if either the FNMA or FHLMC comes under further financial stress or deteriorates in their credit worthiness, the fair value of our securities issued or guaranteed by these entities could be negatively affected.

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We also invest in obligations of state and political subdivisions, some of which are experiencing financial difficulties in part due to loss of property tax from falling home values and declines in sales tax revenues from a reduction in retail activities. The 2009 federal stimulus plan funds flowing out to state governments across the country are running down and are expected to continue to decline and be fully utilized by 2013. State and political subdivisions are expected to undergo further financial stress due to the reduced federal funding. While we seek to minimize our exposure by diversifying geographic location of our portfolio and investing in investment grade securities, there is no guarantee that the issuers will remain financially sound to be current with their payments on these debentures.

Deterioration of Credit Quality or Insolvency of Insurance Companies May Impede our Ability to Recover Losses

The recent financial crisis has led certain major insurance companies to the verge of bankruptcy. We have property, casualty and financial institution risk coverage underwritten by several insurance companies, who may not avoid the insolvency risk permeating the insurance industry. In addition, some of our investment in obligations of state and political subdivisions is insured by several insurance companies. While we closely monitor credit ratings of our insurers and insurers of our municipality securities, and we are poised to make quick changes if needed, we cannot predict an unexpected inability to honor commitments. We also invest in bank-owned life insurance policies on certain members of senior management, which may lose value in the event of the carriers' insolvency. In the event that our bank-owned life insurance policy carriers' credit ratings fall below investment grade, we may exchange policies underwritten by them to another carrier at a cost charged by the original carrier, or we may terminate the policies which may result in adverse tax consequences.

Our loan portfolio is also primarily secured by properties located in earthquake or fire-prone zones. In the event of a disaster that causes pervasive damage to the region in which we operate, not only the Bank, but also the loan collateral may suffer losses not recovered by insurance.

We Rely on Technology and Continually Encounter Technological Change

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology will enable efficiency and meeting customer's changing needs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to retain and compete for customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact of the long-term aspect our business and, in turn, our financial condition and results of operations.

We May Experience a Breach in Cyber-security

Our business requires the secure handling of sensitive client information. We also rely heavily on communications and information systems to conduct our business. Cyber incidents include intentional attacks or unintentional events that can include gaining unauthorized access to digital systems to disrupt operations, corrupting data, stealing sensitive information or causing denial-of-service on our Web sites. We store, process and transmit account information in connection with lending and deposit relationships, including funds transfer and online banking. A breach of cyber-security systems of the Bank, our vendors or customers, or widely publicized breaches of other financial institutions could significantly harm our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability. While we have systems and procedures designed to prevent security breaches, we cannot be certain that advances in criminal capabilities, physical system or network break-ins or inappropriate access will not compromise or breach the technology protecting our

networks or proprietary client information.

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We Rely on Third-Party Vendors for Important Aspects of Our Operation

We depend on the accuracy and completeness of information provided by certain key vendors, including but not limited to data processing, payroll processing, technology support, investment security safekeeping and accounting. Our ability to operate, as well as our financial condition and results of operations, could be negatively affected in the event of an interruption of an information system, an undetected error, or in the event of a natural disaster whereby certain vendors are unable to maintain business continuity.

We May Not Be Able To Attract and Retain Key Employees

Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people in most activities engaged by us can be intense and we may not be able to hire skilled people or retain them. We do not currently have non-competitive agreements with any of our senior officers. The unexpected loss of services of key personnel could have a material adverse impact on our business because of the skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Severe Weather, Natural Disasters or Other Climate Change Related Matters Could Significantly Impact Our Business

Our primary market is located in an earthquake-prone zone in northern California. Other severe weather or disasters, such as severe rainstorms, wildfire or flood, could interrupt our business operations unexpectedly. Climate-related physical changes and hazards could also pose credit risks for us. For example, our borrowers may have collateral properties located in coastal areas at risk to rise in sea level. The properties pledged as collateral on our loan portfolio could also be damaged by tsunamis, floods, earthquake or wildfires and thereby the recoverability of our loan could be impaired. A number of factors affect our credit losses, including the extent of damage to the collateral, the extent of damage not covered by insurance, the extent to which unemployment and other economic conditions caused by the natural disaster adversely affect the ability of borrowers to repay their loans, and the cost of collection and foreclosure to us. Lastly, there could be increased insurance premiums and deductibles, or a decrease in the availability of coverage, due to severe weather-related losses. The ultimate impact on our business of a natural disaster, whether or not caused by climate change, is difficult to predict.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

We lease our corporate headquarters building, which houses our primary loan production, operations, and administrative offices, in Novato, California. We also lease other branch or office facilities within our primary market areas in the cities of Corte Madera, San Rafael, Novato, Sausalito, Mill Valley, Greenbrae, Petaluma, Santa Rosa, Sonoma, Napa and San Francisco, California. We consider our properties to be suitable and adequate for our needs. For additional information on properties, see Notes 5 and 13 to the Consolidated Financial Statements included in Item 8 of this Form 10-K.

ITEM 3. LEGAL PROCEEDINGS

There are no pending, or to Management's knowledge any threatened, material legal proceedings to which we are a party, or to which any of our properties are subject. There are no material legal proceedings to which any director, any nominee for election as a director, any executive officer, or any associate of any such director, nominee or officer is a party adverse to us.

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

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Bancorp common stock trades on the NASDAQ Capital Market under the symbol BMRC. At February 29, 2012, 5,345,732 shares of Bancorp's common stock, no par value, were outstanding and held by approximately 1,900 holders of record. The following table sets forth, for the periods indicated, the range of high and low intraday sales prices of Bancorp's common stock.

Calendar Quarter	2011 High	2011 Low	2010 High	2010 Low
1st Quarter	$ 37.72	$ 31.80	$ 33.60	$ 29.19
2nd Quarter	$ 39.39	$ 34.04	$ 36.14	$ 30.80
3rd Quarter	$ 39.85	$ 32.34	$ 35.50	$ 30.08
4th Quarter	$ 38.63	$ 32.10	$ 36.00	$ 31.69

The table below shows cash dividends paid to common shareholders on a quarterly basis in the last two fiscal years.

Calendar Quarter	2011 Per Share	2011 Dollars	2010 Per Share	2010 Dollars
1st Quarter	$ 0.16	$ 848,000	$ 0.15	$ 785,000
2nd Quarter	$ 0.16	$ 851,000	$ 0.15	$ 787,000
3rd Quarter	$ 0.16	$ 852,000	$ 0.15	$ 789,000
4th Quarter	$ 0.17	$ 906,000	$ 0.16	$ 844,000

For additional information regarding our ability to pay dividends, see discussion in Note 9 to the Consolidated Financial Statement, under the heading "Dividends," in Item 8 of this report.

There were no purchases made by or on behalf of Bancorp or any "affiliated purchaser" (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of the Bancorp's common stock during the fourth quarter of 2011.

On July 2, 2007, Bancorp executed a shareholder rights agreement ("Rights Agreement") designed to discourage takeovers that involve abusive tactics or do not provide fair value to shareholders. Refer to Exhibit 4.1 to Registration Statement on Form 8-A12B filed with the Securities and Exchange Commission on July 2, 2007.

Securities Authorized for Issuance under Equity Compensation Plans

The following table summarizes information as of December 31, 2011, with respect to equity compensation plans. All plans have been approved by the shareholders.

	(A) Shares to be issued upon exercise of outstanding options		(B) Weighted average exercise price of outstanding options	(C) Shares available for future issuance (Excluding shares in column A)	
Equity compensation plans approved by shareholders	299,806	1	$ 30.71	471,519	2

1 Represents shares of common stock issuable upon exercise of outstanding options under the Bank of Marin 1990 Stock Option Plan, the Bank of Marin 1999 Stock Option Plan and the Bank of Marin Bancorp 2007 Equity Plan.

2 Represents shares of common stock available for future grants under the 2007 Equity Plan and the 2010 Director Stock Plan.

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Stock Price Performance Graph

The following graph, provided by Keefe, Bruyette, & Woods, Inc., shows a comparison of cumulative total shareholder return on our common stock during the five fiscal years ended December 31, 2011 compared to Russell 2000 Stock index and peer group index of other financial institutions. We have been part of the Russell 2000 index since July 2009. The comparison assumes $100 was invested on December 31, 2006 in our common stock and all of the dividends were reinvested. The performance graph represents past performance and should not be considered to be an indication of future performance. Ticker symbol BMRC represents the common stock of Bank of Marin Bancorp subsequent to its formation July 1, 2007 and represents the common stock of Bank of Marin for periods prior to the formation of the bank holding company.

	2006	2007	2008	2009	2010	2011
BMRC	100	81	67	90	97	104
Peer Group1	100	66	31	18	20	19
Russell 2000	100	98	65	83	105	101

1BMRC Peer Group represents public California banks with assets between $500 million to $2 billion as of December 31, 2011: FMCB, FCAL, EXSR, BSRR, PFBC, HTBK, AMBZ, BBNK, RCBC, PMBC, HEOP, PPBI, BOCH, NOVB, CVCY, CUNB, FNRN, FNBG, UBFO, CWBC, SWBCD, OVLY, AMRB, PBCA, SAEB, FENB, PFCF, PVLY. The peer group composite index is weighted by market capitalization and reinvests dividends on the ex-date and adjusts for stock splits, if applicable.

Source: Company Reports, FactSet, and SNL

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ITEM 6. SELECTED FINANCIAL DATA

As of For the Year Ended December 31, (dollars in thousands, except per share data)	2011	2010	2009	2008	2007	2010/2011 % change
At December 31						
Total assets	$1,393,263	$1,208,150	$1,121,672	$1,049,557	$933,901	15.3 %
Total loans	1,031,154	941,400	917,748	890,544	724,878	9.5 %
Total deposits	1,202,972	1,015,739	944,061	852,290	834,642	18.4 %
Total stockholders' equity	135,551	121,920	109,051	125,546	87,774	11.2 %
Equity-to-asset ratio	9.7 %	10.1 %	9.7 %	12.0 %	9.4 %	-3.6 %
For year ended December 31						
Net interest income	$63,819	$54,909	$52,567	$48,359	$42,742	16.2 %
Provision for loan losses	7,050	5,350	5,510	5,010	685	31.8 %
Non-interest income	6,269	5,521	5,182	5,356	5,718	13.5 %
Non-interest expense	38,283	33,357	31,696	28,677	27,673	14.8 %
Net income	15,564	13,552	12,765	12,150	12,324	14.8 %
Net income per share (diluted)	2.89	2.55	2.19	2.31	2.31	13.3 %
Tax-equivalent net interest margin	5.13 %	4.95 %	5.17 %	5.41 %	5.07 %	3.6 %
Cash dividend payout ratio on common stock 1	22.1 %	23.6 %	25.8 %	23.9 %	21.4 %	-6.3 %

1Calculated as dividends on common share divided by basic net income per common share.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of financial condition as of December 31, 2011 and 2010 and results of operations for each of the years in the three-year period ended December 31, 2011 should be read in conjunction with our consolidated financial statements and related notes thereto, included in Part II Item 8 of this report. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

Forward-Looking Statements

The disclosures set forth in this item are qualified by important factors detailed in Part I captioned Forward-Looking Statements and Item 1A captioned Risk Factors of this report and other cautionary statements set forth elsewhere in the report.

Executive Summary

We reported record annual earnings of $15.6 million in 2011, an increase of $2.0 million, or 14.8% from $13.6 million a year ago. 2011 earnings include the impact of the FDIC assisted acquisition of certain assets and the assumption of certain liabilities of the former Charter Oak Bank on February 18, 2011 partially offset by the $924 thousand

pre-payment penalty on the early pay-off of a $20 million fixed-rate FHLB advance. Diluted earnings per share for the year ended December 31, 2011 totaled $2.89, up $0.34 from $2.55 in the prior year.

The acquired operations of the former Charter Oak Bank contributed approximately $3.2 million to Bancorp's pre-tax 2011 income, including, among other things, $2.9 million of accretion on purchased non-credit impaired loans, $2.3 million in loan loss provision, $1.9 million of gains recognized in interest income on pay-offs of purchased credit-impaired loans ("PCI") loans, $1.0 million in Acquisition related third party costs, $683 thousand impairment write-off of the core deposit intangible asset and $146 thousand in pre-tax bargain purchase gain. The income amounts discussed above exclude allocated overhead and allocated cost of funds. The accretion on purchased non-credit impaired loans is expected to decline significantly over the next year.

In addition to our entry into the Napa market through the Acquisition, in 2011 we have expanded our community banking footprint in Sonoma County. In October 2011, the Bank opened a branch in downtown Sonoma and expanded our Santa Rosa loan production office into a full service branch. We have experienced an increase in non-interest expenses and may experience a short-term lag in profitability associated with the new branch openings. We expect that these strategic initiatives will contribute to our profitability in the long term.

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We are committed to building strong lending relationships in new and core markets. Total loans reached $1.0 billion at December 31, 2011, representing an increase of $89.8 million, or 9.5%. The increase reflects the loans in the Napa market totaling $56.3 million at December 31, 2011, primarily the remaining loans purchased in the Acquisition as well as growth in the Bank's commercial real estate, commercial and industrial and home equity portfolios, partially offset by a decreased emphasis on certain product lines, including construction and other residential lending.

Non-accrual loans totaled $12.0 million, or 1.16% of Bancorp's loan portfolio at December 31, 2011, compared to $12.9 million or 1.37% a year ago.

The provision for loan losses totaled $7.1 million and $5.4 million in 2011 and 2010, respectively. The increase in the provision for loan losses is primarily driven by $2.3 million of loan loss provision related to the acquired loans, where credit quality has deteriorated since the Acquisition. The allowance for loan losses of $14.6 million totaled 1.42% of loans at December 31, 2011 compared to $12.4 million or 1.32% at December 31, 2010. The increase in the allowance for loan losses as a percentage of loans reflects a higher level of impaired loans and the related specific reserves. Net charge-offs in 2011 totaled $4.8 million compared to $3.6 million in the prior year. The increase in net loan charge-offs primarily relates to $1.5 million of charge-offs related to the acquired loans.

Our continued focus on responsible community banking fundamentals and our strong customer relationships has led to higher deposits, a core funding source for our loan portfolio. Total deposits grew $187.2 million, or 18.4%, from a year ago to $1.2 billion at December 31, 2011. The higher level of deposits reflects growth in most categories, except CDARS® time deposits, which decreased $20.6 million. Non-interest bearing deposits grew $77.4 million or 27.4% to $359.6 million and comprised 29.9% of total deposits at December 31, 2011, compared to 27.8% a year ago. The increase in total deposits includes deposits in the Napa market, primarily assumed in the Acquisition, totaling $57.9 million at December 31, 2011.

The tax-equivalent net interest margin was 5.13% in 2011 compared to 4.95% in 2010. Tax-equivalent net interest income for 2011 totaled $64.9 million, representing an increase of $9.1 million, or 16.3% compared to 2010. The increase primarily reflects the acquisition of loans from the former Charter Oak Bank and a reduction in the cost of deposits, partially offset by the $924 thousand pre-payment penalty on the Federal Home Loan Bank of San Francisco ("FHLB") advance in the third quarter of 2011.

In the current environment of historically low interest rates, the largest factors likely to affect our net interest margin in 2012 will be our ability to reduce low-yielding excess liquidity by generating profitable loans to creditworthy borrowers, as well as our responsiveness to competitive pricing on loans and deposits in our market. The Acquisition, especially the accretion on acquired non-PCI loans (expected to decline significantly over the next year) and gains on payoffs of PCI loans, favorably impacted our 2011 net interest margin. We will need to grow loans significantly to maintain the elevated level of net interest margin. Further, as fixed rate loans mature, we expect loan production to continue to be challenging due to the uncertain economic climate and the intensifying competition for creditworthy borrowers, both of which could lead to loan rate concession pressure and could impact our ability to generate profitable loans. Lastly, approximately 13% of our loans are variable rate loans, whose repricing intervals lag between one to five years after their applicable rate indices change. The downward repricing on these variable loans will put pressure on our net interest margin. Refer to Table 10, Loan Portfolio Maturity Distribution and Interest Rate Sensitivity for further information. It is imperative for us to manage customer and product profitability, especially when the interest rate environment remains stable.

If interest rates increase, we anticipate that net interest income will rise. The increase in interest income from asset repricing may be partially offset by deposit rate sensitivity. Additionally, it may take several upward market rate movements for variable rate loans at floors to move above the floor rates.

Critical Accounting Policies

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

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

Allowance for Loan Losses

Allowance for loan losses is based upon estimates of loan losses and is maintained at a level considered adequate to provide for probable losses inherent in the outstanding loan portfolio. The allowance is increased by provisions charged to expense and reduced by charge-offs, net of recoveries. In periodic evaluations of the adequacy of the allowance balance, Management considers our past loan loss experience by type of credit, 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, current economic conditions and other factors. We formally assess the adequacy of the allowance for loan losses on a quarterly basis. These assessments include the periodic re-grading of loans based on changes in their individual credit characteristics including delinquency, seasoning, recent financial performance of the borrower, economic factors, changes in the interest rate environment, and other factors as warranted. Loans are initially graded when originated. They are reviewed as they are renewed, when there is a new loan to the same borrower and/or when identified facts demonstrate heightened risk of default. Confirmation of the quality of our grading process is obtained by independent reviews conducted by outside consultants specifically hired for this purpose and by periodic examination by various bank regulatory agencies. Management monitors delinquent loans continuously and identifies problem loans to be evaluated individually for impairment testing. For loans that are determined impaired, formal impairment measurement is performed at least quarterly on a loan-by-loan basis.

Our method for assessing the appropriateness of the allowance includes specific allowances for identified problem loans, an allowance factor for categories of credits, and allowances for changing environmental factors (e.g., portfolio trends, concentration of credit, growth, economic factors). Allowances for identified problem loans are based on specific analysis of individual credits. Loss estimation factors for loan categories are based on analysis of local economic factors applicable to each loan category, including consideration of our historical charge-off history. Allowances for changing environmental factors are Management's best estimate of the probable impact these changes have had on the loan portfolio as a whole.

For our methodology on estimating the allowance for loan losses on acquired loans, refer to the section Acquired Loans below.

Acquired Loans

Acquired loans are recorded at their estimated fair values at acquisition date in accordance with ASC 805 Business Combinations, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses is not carried over or recorded for acquired loans as of the acquisition date.

The process of estimating fair values of the acquired loans, including the estimate of losses that are expected to be incurred over the estimated remaining lives of the loans at acquisition date and the ongoing updates to Management's expectation of future cash flows, requires significant subjective judgments and assumptions, particularly considering the current economic environment. The economic environment and the lack of market liquidity and transparency are

factors that have influenced, and may continue to affect, these assumptions and estimates.

We estimated the fair value of acquired loans at the acquisition date based on a discounted cash flow methodology that considered factors including the type of loan and related collateral, risk classification, fixed or variable interest rate, term of loan and whether or not the loan was amortizing, and current discount rates. Loans were grouped together according to similar characteristics and were treated in the aggregate when applying various valuation techniques. The estimate of expected cash flows incorporates our best estimate of current key assumptions, such as property values, default rates, loss severity and prepayment speeds. The discount rates used for loans were based on current market rates for new originations of comparable loans, where available, and include adjustments for liquidity concerns. To the extent comparable market rates are not readily available, a discount rate was derived based on the assumptions of market participants' cost of funds, servicing costs and return requirements for comparable risk assets. In either case, the discount rate does not include a factor for credit losses, as that has been considered in estimating the cash flows. The initial estimate of cash flows to be collected was derived from assumptions such as default rates, loss severities and prepayment speeds.

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In conjunction with the Acquisition, we purchased certain loans with evidence of credit quality deterioration subsequent to their origination and for which it was probable, at acquisition, that we would be unable to collect all contractually required payments. Management has applied significant subjective judgment in determining which loans are PCI loans. Evidence of credit quality deterioration as of the purchase date may include statistics such as past due and nonaccrual status, risk grades and recent loan-to-value percentages. Revolving credit agreements (e.g. home equity lines of credit and revolving commercial loans), where the borrower had revolving privileges at acquisition date, are not considered PCI loans because the timing and amount of cash flows cannot be reasonably estimated.

The accounting guidance for PCI loans provides that the excess of the cash flows initially expected to be collected over the fair value of the loans at the acquisition date (i.e., the accretable yield) should be accreted into interest income at a level rate of return over the remaining term of the loan, provided that the timing and amount of future cash flows is reasonably estimable. The difference between the contractually required payments and the cash flows expected to be collected at acquisition, considering the impact of prepayments, is referred to as the nonaccretable difference and is not recorded.

The initial estimate of cash flows expected to be collected is updated each quarter and requires the continued usage of key assumptions and estimates similar to the initial estimate of fair value. Given the current economic environment, we must apply judgment to develop our estimate of cash flows for PCI loans given the impact of real estate value changes, changing loss severities and prepayment speeds.

For purposes of accounting for the PCI loans purchased in the Acquisition, we elected not to apply the pooling method but to account for these loans individually. Disposals of loans, which may include sales of loans to third parties, receipt of payments in full by the borrower, foreclosure of the collateral or troubled debt restructurings, result in removal of the loan from the PCI loan portfolio at its carrying amount.

If we have probable and significant increases in cash flows expected to be collected on PCI loans, we first reverse any previously established allowance for loan loss and then increase interest income as a prospective yield adjustment over the remaining life of the loans. The impact of changes in variable interest rates is recognized prospectively as adjustments to interest income. All PCI loans that were classified as nonperforming loans prior to Acquisition were no longer classified as nonperforming because, at Acquisition, we believed that we would fully collect the new carrying value of these loans. Subsequent to Acquisition, specific allowances are allocated to PCI loans that have experienced credit deterioration through an increase to the allowance for loan losses. The amount of cash flows expected to be collected and, accordingly, the adequacy of the allowance for loan losses are particularly sensitive to changes in loan credit quality. When there is doubt as to the timing and amount of future cash flows to be collected, PCI are classified as non-accrual loans. It is important to note that judgment is required to classify PCI loans as performing or non-accrual, and is dependent on having a reasonable expectation about the timing and amount of cash flows expected to be collected.

For acquired loans not considered PCI loans, we elect to recognize the entire fair value discount accretion based on the acquired loan’s contractual cash flows using an effective interest rate method for term loans, and on a straight line basis to interest income for revolving lines, as the timing and amount of cash flows under revolving lines are not predictable. Subsequent to Acquisition, if the probable and estimable losses for non-PCI loans exceed the amount of the remaining unaccreted discount, the excess is established as an allowance for loan losses.

For further information regarding our acquired loans, see Note 2 and Note 4 to our Consolidated Financial Statements in this Form 10-K.

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Other-than-temporary Impairment of Investment Securities

At each financial statement date, we assess whether declines in the fair value of held-to-maturity and available-for-sale securities below their costs are deemed to be other than temporary. We consider, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) our intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair value. Evidence evaluated includes, but is not limited to, the remaining payment terms of the instrument and economic factors that are relevant to the collectability of the instrument, such as: current prepayment speeds, the current financial condition of the issuer(s), industry analyst reports, credit ratings, credit default rates, interest rate trends and the value of any underlying collateral. Credit-related other-than-temporary impairment results in a charge to earnings and the corresponding establishment of a new cost basis for the security. Non-credit-related other-than-temporary impairment results in a charge to other comprehensive income, net of applicable taxes, and the corresponding establishment of a new cost basis for the security. The other-than-temporary impairment recognized in other comprehensive income for debt securities classified as held-to-maturity is accreted from other comprehensive income to the amortized cost of the debt security over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows.

Accounting for Income Taxes

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

We recognize the financial statement effect of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. For tax positions that meet the more-likely-than-not threshold, we may recognize only the largest amount of tax benefit that is greater than fifty percent likely of being realized upon ultimate settlement with the taxing authority. Management believes that all of our tax positions taken meet the more-likely-than-not recognition threshold. To the extent tax authorities disagree with these tax positions, our effective tax rates could be materially affected in the period of settlement with the taxing authorities.

Fair Value Measurements

We use fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. We base our fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Securities available for sale, derivatives, and loans held for sale, if any, are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record certain assets at fair value on a non-recurring basis, such as purchased loans recorded at acquisition date, certain impaired loans held for investment and securities held to maturity that are

other-than-temporarily impaired. These non-recurring fair value adjustments typically involve write-downs of individual assets due to application of lower-of-cost or market accounting.

We have established and documented a process for determining fair value. We maximize the use of observable inputs when developing fair value measurements. Whenever there is no readily available market data, Management uses its best estimate and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these financial statements. For detailed information on our use of fair value measurements and our related valuation methodologies, see Note 10 to the Consolidated Financial Statements in Item 8 of this Form 10-K.

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RESULTS OF OPERATIONS

Overview

Highlights of the financial results are presented in the following table:

(dollars in thousands, except per share data)	As of and for the years ended December 31, 2011	2010	2009
For the period:			
Net income	$ 15,564	$ 13,552	$ 12,765
Net income per share			
Basic	$ 2.94	$ 2.59	$ 2.21
Diluted	$ 2.89	$ 2.55	$ 2.19
Return on average equity	12.01 %	11.67 %	11.46 %
Return on average assets	1.16 %	1.14 %	1.16 %
Common stock dividend payout ratio	22.11 %	23.55 %	25.79 %
Efficiency ratio	54.62 %	55.20 %	54.89 %
At period end:			
Book value per common share	$ 25.40	$ 23.05	$ 20.85
Total assets	$ 1,393,263	$ 1,208,150	$ 1,121,672
Total loans	$ 1,031,154	$ 941,400	$ 917,748
Total deposits	$ 1,202,972	$ 1,015,739	$ 944,061
Loan-to-deposit ratio	85.72 %	92.68 %	97.21 %

Summary of Quarterly Results of Operations

Table 1 sets forth the quarterly results of operations for 2011 and 2010:

Table 1Summarized Statement of Income

(dollars in thousands, unaudited)	2011 Quarters Ended Dec. 31	Sept. 30	Jun. 30	Mar. 31	2010 Quarters Ended Dec. 31	Sept. 30	Jun. 30	Mar. 31
Interest income	$ 16,666	$ 17,225	$ 18,137	$ 17,086	$ 15,364	$ 15,601	$ 15,505	$ 14,887
Interest expense	948	2,005	1,134	1,208	1,305	1,636	1,748	1,759
Net interest income	15,718	15,220	17,003	15,878	14,059	13,965	13,757	13,128
Provision for loan losses	2,500	500	3,000	1,050	1,050	1,400	1,350	1,550
Net interest income after provision for loan losses	13,218	14,720	14,003	14,828	13,009	12,565	12,407	11,578
Non-interest income	1,524	1,565	1,581	1,599	1,360	1,307	1,505	1,349
Non-interest expense	9,734	9,421	9,998	9,130	8,037	8,507	8,591	8,222
	5,008	6,864	5,586	7,297	6,332	5,365	5,321	4,705

Income before provision for income taxes								
Provision for income taxes	1,625	2,631	2,147	2,788	2,424	2,006	1,983	1,758
Net income	$ 3,383	$ 4,233	$ 3,439	$ 4,509	$ 3,908	$ 3,359	$ 3,338	$ 2,947
Net income available to common stockholders	$ 3,383	$ 4,233	$ 3,439	$ 4,509	$ 3,908	$ 3,359	$ 3,338	$ 2,947
Net income per common share								
Basic	$ 0.64	$ 0.80	$ 0.65	$ 0.85	$ 0.74	$ 0.64	$ 0.64	$ 0.56
Diluted	$ 0.63	$ 0.79	$ 0.64	$ 0.84	$ 0.73	$ 0.63	$ 0.63	$ 0.56

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Net Interest Income

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

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

Table 2, Distribution of Average Statements of Condition and Analysis of Net Interest Income, compares interest income and average interest-earning assets with interest expense and average interest-bearing liabilities for the three years ended December 31, 2011, 2010 and 2009. The table also indicates net interest income, net interest margin and net interest rate spread for each period presented.

Table 2 Distribution of Average Statements of Condition and Analysis of Net Interest Income

	2011			2010			2009		
(dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Assets									
Interest-bearing due from banks (1)	$87,365	$222	0.25%	$43,028	$143	0.33%	$164	$1	0.60%
Federal funds sold	---	---	---	3,049	2	0.07	1,752	4	0.23
Investment securities									
U.S. Government agencies (2)	120,118	3,478	2.90	91,869	3,234	3.52	70,268	3,304	4.70
Corporate CMOs and other (2)	17,249	636	3.69	13,675	593	4.34	7,397	506	6.84
Obligations of state and political subdivisions (3)	38,204	1,935	5.06	30,893	1,741	5.64	29,221	1,677	5.74
Loans and banker's acceptances (1) (3) (4)	984,211	63,914	6.40	929,755	56,542	6.00	910,456	55,071	5.97
Total interest-earning assets (1)	1,247,147	70,185	5.55	1,112,269	62,255	5.52	1,019,258	60,563	5.86
Cash and non-interest-bearing due from banks	46,673			34,383			46,954		
	9,136			8,259			8,140		

Bank premises and equipment, net									
Interest receivable and other assets, net	34,183			31,262			26,041		
Total assets	$1,337,139			$1,186,173			$1,100,393		
Liabilities and Stockholders' Equity									
Interest-bearing transaction accounts	$125,316	$151	0.12%	$98,168	$110	0.11%	$90,159	$115	0.13%
Savings accounts	69,792	98	0.14	51,738	104	0.20	45,944	94	0.20
Money market accounts	405,726	1,286	0.32	390,575	2,467	0.63	391,571	3,235	0.83
CDARS® time accounts	39,514	237	0.60	71,432	842	1.18	51,248	721	1.41
Other time accounts	151,866	1,314	0.87	124,631	1,495	1.20	97,924	1,541	1.57
Overnight borrowings (1)	---	---	---	2	---	0.29	10,659	28	0.26
FHLB fixed-rate borrowings	49,722	2,062	4.15	55,000	1,281	2.33	53,794	1,253	2.33
Subordinated debenture (1)	5,000	147	2.90	5,000	149	2.94	5,000	180	3.55
Total interest-bearing liabilities	846,936	5,295	0.63	796,546	6,448	0.81	746,299	7,167	0.96
Demand accounts	347,682			263,742			232,502		
Interest payable and other liabilities	12,983			9,791			9,873		
Stockholders' equity	129,538			116,094			111,359		
Total liabilities & stockholders' equity	$1,337,139			$1,186,173			$1,100,033		
Tax-equivalent net interest income/margin (1)		$64,890	5.13%		$55,807	4.95%		$53,396	5.17%
Reported net interest income/margin		$63,819	5.05%		$54,909	4.87%		$52,567	5.09%
Tax-equivalent net interest rate spread			4.92%			4.71%			4.90%

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

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2011 Compared with 2010:

Tax equivalent net interest income totaled $64.9 million and $55.8 million for the years ended December 31, 2011 and 2010, respectively. The $9.1 million or 16.3% increase was due to an increase in volume of interest-earning assets and the increase in loan yield, offset by the effect of lower yields on investment securities.

The tax-equivalent net interest margin increased to 5.13% in 2011, up eighteen basis points from 2010. The increase in the tax-equivalent net interest margin primarily reflects the acquisition of loans from the former Charter Oak Bank and a reduction in the cost of deposits, partially offset by the $924 thousand pre-payment penalty on the FHLB advance in the third quarter of 2011, as well as lower yields on investment securities and originated loans and a higher concentration of low yielding due from banks. In 2011, PCI loans paid off early where the payoff amounts exceeded the recorded investment by $1.9 million which favorably impacted our net interest margin by fifteen basis points. Accretion on the acquired non-PCI loans of $2.9 million contributed twenty-three basis points to the net interest margin. The net interest spread increased twenty-one basis points from the same period last year for the same reasons.

Average interest-earning assets increased $134.9 million, or 12.1%, in 2011 compared to 2010. This included increases in average interest-earning due from banks of $44.3 million, average investment securities of $39.1 million and average loan growth of $54.5 million (mainly due to the Acquisition on February 18, 2011).

Market interest rates are in part based on the target Federal funds interest rate (the interest rate banks charge each other for short-term borrowings) implemented by the FOMC. In December of 2008, the target interest rate was brought to a historic low with a range of 0% to 0.25% where it remains as of December 31, 2011.

The yield on interest-earning assets increased three basis points in 2011 compared to 2010. The yield on the loan portfolio, which comprised 78.9% and 83.6% of average earning assets in 2011 and 2010, respectively, increased forty basis points. The accretion on the acquired non-PCI loans of $2.9 million represents twenty-nine basis points of the increase and the early payoff on PCI loans where the payoff amounts exceeded the recorded investment by $1.9 million represents nineteen basis points of the increase. This increase is partially offset by the decrease in yields on investment securities due to lower yields on recently purchased securities in this low interest rate environment and a higher concentration of low yielding due from banks. In addition, we have experienced downward repricing and rate concessions on the loan portfolio as well as the addition of new loans at lower current market rates. The current level of accretion on non-PCI loans is expected to continue to decline.

The average balance of interest-bearing liabilities increased $50.4 million, or 6.3%, in 2011 compared to 2010. Average deposits grew in most categories, except for CDARS® time deposits, which decreased $31.9 million. The increase in average deposits was offset by a decrease in average FHLB borrowings of $5.3 million due to the early pay-off of a $20 million FHLB fixed-rate advance at 2.54% on September 19, 2011.

The rate on interest-bearing liabilities decreased eighteen basis points in 2011 compared to 2010, primarily reflecting lower offering rates on money market accounts, as well as the downward re-pricing of time deposits as they mature. In 2011, the rate on other time deposits, CDARS®, and money market accounts decreased thirty-three basis points, fifty-eight basis points, and thirty-one basis points, respectively. The increase of 1.82% in the rate on FHLB borrowings is due to the $924 thousand pre-payment penalty on the early pay-off of the $20 million fixed-rate advance.

2010 Compared with 2009:

Tax equivalent net interest income totaled $55.8 million and $53.4 million for the years ended December 31, 2010 and 2009, respectively. The $2.4 million or 4.5% increase was due to an increase in volume of interest-earning assets, offset by the effect of lower yields on investment securities.

Average interest-earning assets increased $93.0 million, or 9.1%, in 2010 compared to 2009. This included increases in average interest-bearing due from banks of $42.9 million, average investment securities of $29.6 million and average loan growth of $19.3 million. In October 2010, we opened our Santa Rosa loan production office, to position the Bank for additional loan growth, particularly in commercial and industrial loans.

The tax-equivalent net interest margin decreased to 4.95% in 2010, down twenty-two basis points from 2009. The decrease in the tax-equivalent net interest margin was primarily due to lower yields on investment securities (as a result of increased prepayments and lower yields on recent additions) and a shift in the relative composition of interest-earning assets from higher-yielding loans to lower-yielding interest-bearing due from banks. The excess liquidity from deposit inflows has not yet been deployed into funding new loans, as the banking industry as a whole has been experiencing challenges with loan demand and the competition for qualified borrowers intensified. The net interest spread decreased nineteen basis points from 2009 for the same reasons.

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The yield on the loan portfolio, which comprised 83.6% and 89.3% of average earning assets in 2010 and 2009, respectively, increased three basis points in 2010 compared to 2009. This is mainly due to the shift in the mix of loans from construction and commercial loans to higher-yielding commercial real estate loans. Interest foregone on non-accrual loans represented a seven-basis point reduction to the net interest margin in both 2010 and 2009.

The lower yields on investment securities are a result of increased prepayments resulting in accelerated amortization of premiums, and lower yields on recently purchased securities. The yield on private-label CMOs, agency securities and municipal bonds decreased 250 basis points, 118 basis points and ten basis points, respectively, in 2010.

The average balance of interest-bearing liabilities increased $50.2 million, or 6.7%, in 2010 compared to 2009. The increases are pervasive in all categories of deposit accounts except money market accounts, with the most significant increase in time deposits (including CDARS®), which increased $46.9 million. These increases were partially offset by a decrease in overnight borrowings of $10.7 million. We have experienced a shift in the relative composition of interest-bearing deposits in 2010 compared to 2009 as the proportion of higher-costing time accounts has increased, while the proportion of money market deposit accounts has decreased.

The rate on interest-bearing liabilities decreased fifteen basis points in 2010 compared to 2009, primarily reflecting lower offering rates on money market accounts, as well as the downward re-pricing of time deposits as they mature. In 2010, the rate on other time deposits, CDARS®, and money market accounts decreased thirty-seven basis points, twenty-three basis points, and twenty basis points, respectively. The rate on the subordinated debenture dropped sixty-one basis points due to a decline in the three-month LIBOR rate, to which the debenture rate is indexed.

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Table 3, Analysis of Changes in Net Interest Income, separates the change in net interest income into two components: 1 Volume – change caused by increases or decreases in the average asset and liability balances outstanding, and 2 Yield/Rate – changes in average yields on earning assets and average rates for interest-bearing liabilities.

Table 3 Analysis of Changes in Net Interest Income

The table indicates that in 2011 and 2010, our net interest income was favorably affected by an increase in the volume of interest-earning assets and increase in loan yields (primarily due to accretion on acquired non-PCI loans and the impact of gains on early payoffs of loans acquired at a discount), partially offset by declines in yields on investment securities and market pricing pressures on loan yields. Further, net interest income in both 2011 and 2010 benefitted from lower rates on deposits, especially money market and time accounts.

	2011 compared to 2010			2010 compared to 2009		
(in thousands)	Volume	Yield/ Rate[1]	Total	Volume	Yield/ Rate[1]	Total
Assets						
Interest-bearing due from banks	$ 113	$ (34)	$ 79	$ 142	$ -	$ 142
Federal funds sold	(2)	-	(2)	1	(3)	(2)
Investment securities						
U. S. Government agencies	818	(574)	244	760	(830)	(70)
Obligations of state and political						
Municipal bonds[2]	370	(176)	194	272	(185)	87
Corporate CMO	132	(89)	43	94	(30)	64
Loans and bankers' acceptances[2]	3,536	3,836	7,372	1,174	297	1,471
Total interest-earning assets	4,967	2,963	7,930	2,443	(751)	1,692
Liabilities						
Interest-bearing transaction accounts	33	8	41	9	(14)	(5)
Savings accounts	25	(31)	(6)	12	(2)	10
Money market accounts	48	(1,229)	(1,181)	(6)	(762)	(768)
CDARS® time deposits	(191)	(414)	(605)	238	(117)	121
Other time accounts	236	(417)	(181)	320	(366)	(46)
Overnight borrowings	-	-	-	(31)	3	(28)
FHLB fixed-rate borrowings	(220)	1,001	781 [3]	28	-	28
Subordinated debenture	-	(2)	(2)	-	(31)	(31)
Total interest-bearing liabilities	(69)	(1,084)	(1,153)	570	(1,289)	(719)
Tax-equivalent net interest income	$ 5,036	$ 4,047	$ 9,083	$ 1,873	$ 538	$ 2,411

1 The changes for each category of interest income and expense are divided between the portion of change attributable to the variance in volume and the portion of change attributable to the variance in rate for that category. The unallocated change in rate or volume variance has been allocated between the rate and volume variances on a pro rata

basis.
2 Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the Federal statutory rate of 35 percent.
3 Amounts includes a $924 thousand prepayment penalty in 2011 discussed in Note 8 of the consolidated financial statements.

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Provision for Loan Losses

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

Our provision for loan losses totaled $7.1 million in 2011 compared to $5.4 million in 2010. The increase in the provision for loan losses is primarily driven by $2.3 million of loan loss provision related to the acquired loans in the later half of 2011, where credit quality has deteriorated since the Acquisition. The allowance for loan losses of $14.6 million totaled 1.42% of loans at December 31, 2011, compared to 1.32% at December 31, 2010, respectively. Net charge-offs in 2011 totaled $4.8 million compared to $3.6 million in the prior year. The increase in net charge-offs primarily relates to $1.5 million of charge-offs related to the acquired loans. See the section captioned "Allowance for Loan Losses" below for further analysis of the provision for loan losses.

Non-interest Income

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

Table 4 Significant Components of Non-interest Income

(in thousands)	Years Ended December 31, 2011	2010	2009	2011 compared to 2010 Amount Increase (Decrease)	2011 compared to 2010 Percent Increase (Decrease)	2010 compared to 2009 Amount Increase (Decrease)	2010 compared to 2009 Percent Increase (Decrease)
Service charges on deposit accounts	$ 1,836	$ 1,797	$ 1,782	$ 39	2.2 %	$ 15	0.8 %
Wealth Management and Trust Services	1,834	1,521	1,383	313	20.6	138	10.0
Other non-interest income							
Earnings on Bank-owned life insurance	752	690	696	62	9.0	(6)	(0.8)
Customer banking fees and other charges	108	120	98	(12)	(10.0)	22	22.4
Debit card interchange fees	845	486	368	359	73.9	118	32.1
Pre-tax bargain purchase gain	147	---	---	147	NM	---	---
Other income	747	907	855	(160)	(17.6)	52	6.1
Total other non-interest income	2,599	2,203	2,017	396	18.0	186	9.2
Total non-interest income	$ 6,269	$ 5,521	$ 5,182	$ 748	13.5 %	$ 339	6.5 %

NM - Not Meaningful

2011 Compared with 2010:

When comparing 2011 to 2010, service charge income on deposit accounts increased due to a higher number of deposit accounts (mainly from the Acquisition), partially offset by a decrease in overdraft and non-sufficient funds fee income, primarily due to the new regulatory restriction on overdraft fee assessments (Federal Reserve Regulation E), which was effective July 1, 2010.

The increase in Wealth Management and Trust Services (“WMTS”) income is due to higher estate settlement fees and higher rates charged on corporate trust-related services in 2011, as well as an increase in the number of accounts and customer relationships. This is partially offset by volatility in the equity and bond markets which impacts the market value of trust assets and the related investment fees. As of December 31, 2011 and 2010, assets under management totaled approximately $251.4 million and $254.0 million, respectively.

The increase in Bank-owned life insurance (“BOLI”) income in 2011 compared to 2010 is primarily due to additional income earned on $2.5 million in new policies purchased in late March 2011.

The decrease in customer banking fees and other charges is due to less ATM surcharge and higher remote capture fee income waived, partially offset by higher credit card referral fees and check order income, relating to an increase in the number of customer accounts.

The increase in debit card interchange fees is primarily attributable to a steady increase in volume of debit card usage, as well as new accounts from the Acquisition. In June 2011, the FRB finalized a new regulation to restrict interchange fees charged for debit card transactions by banks with more than $10 billion in assets. Although we are exempt under the new rule, market pricing of the interchange fees may drive these revenues down. The effect on market pricing, if any, may take time to realize. Therefore, we cannot quantify the ultimate impact of this rule on such interchange fees.

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2011 reflects the pre-tax bargain purchase gain of $147 thousand from the Acquisition.

Other income decreased due to lower merchant interchange income, partially offset by increases on the gain on disposal of repossessed assets, safe deposit box rental income and wire fee income.

2010 Compared with 2009:

When comparing 2010 to 2009, service charge income on deposit accounts remained relatively unchanged.

The increase in WMTS income was due to higher estate settlement and trust-services fees received in 2010, as well as the increase in assets under management. As of December 31, 2010 and 2009, assets under management totaled approximately $254.0 million and $252.5 million, respectively.

BOLI income remained relatively unchanged in 2010 compared to 2009.

The increase in customer banking fees and other charges was due to higher credit card referral fees, miscellaneous card fees, ATM surcharges and check order income, relating to an increase in the number of customer accounts, partially offset by higher remote capture fee income waived.

The increase in debit card interchange fees was primarily due to higher Visa® debit card fees, attributable to a higher volume of Visa® debit card usage, as well as a Bank-wide Visa® debit card promotion program.

The increase in other non-interest income was mainly due to an increase in merchant interchange due to a higher transaction volume from our merchant customers as well as one-time billing adjustments and an increase in the dividend received on FHLB stock, partially offset by a decrease in miscellaneous income.

Non-interest Expense

Table 5, Significant Components of Non-interest Expense, summarizes the amounts and changes in dollars and percentages. Our efficiency ratio (the ratio of non-interest expense divided by the sum of non-interest income and net interest income) totaled 54.62%, 55.20% and 54.89% in 2011, 2010 and 2009, respectively.

Table 5 Significant Components of Non-interest Expense

	Years Ended December 31,			2011 compared to 2010		2010 compared to 2009	
(dollars in thousands)	2011	2010	2009	Amount Increase (Decrease)	Percent Increase (Decrease)	Amount Increase (Decrease)	Percent Increase (Decrease)
Salaries and related benefits	$ 20,211	$ 18,240	$ 17,001	$ 1,971	10.8 %	$ 1,239	7.3 %
Occupancy and equipment	4,002	3,576	3,516	426	11.9 %	60	1.7 %
Depreciation and amortization	1,293	1,344	1,370	(51)	(3.8 %)	(26)	(1.9 %)
FDIC Insurance	1,000	1,506	1,800	(506)	(33.6 %)	(294)	(16.3 %)
Data processing costs	2,690	1,916	1,650	774	40.4 %	266	16.1 %
	2,499	1,917	1,727	582	30.4 %	190	11.0 %

Professional services							
Other non-interest expense							
Advertising	589	459	528	130	28.3 %	(69)	(13.1)%
Director expense	493	475	420	18	3.8 %	55	13.1 %
Impairment and amortization of core deposit intangible	725	---	---	725	NM	---	---
Other expense	4,781	3,924	3,684	857	21.8 %	240	6.5 %
Total other non-interest expense	6,588	4,858	4,632	1,730	35.6 %	226	4.9 %
Total non-interest expense	$ 38,283	$ 33,357	$ 31,696	$ 4,926	14.8 %	$ 1,661	5.2 %

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2011 Compared with 2010:

The increase in salaries and benefits is primarily due to higher personnel-related costs associated with branch expansion, as well as annual merit increases. The number of average FTE totaled 226 and 201 in 2011 and 2010, respectively.

The increases in occupancy and equipment expense are mainly due to an increase in expenses related to branch expansion, including Napa, Sonoma and a full year of rent for our Santa Rosa branch, partially offset by a full year of cost savings from the relocation of our Corte Madera branch and leases re-negotiated at lower rates.

Depreciation and amortization expense decreased as 2010 reflected the accelerated amortization of leasehold improvements of our old Corte Madera branch when it relocated in July 2010.

The decrease in 2011 FDIC insurance expenses compared to 2010 reflects the revision to the FDIC insurance assessment base. As discussed in the section captioned "FDIC Insurance Assessments" in Item 1 Business above, in February 2011, as required by the Dodd-Frank Act, the FDIC approved a rule that changes the FDIC insurance assessment base from adjusted domestic deposits to a bank's average consolidated total assets minus average tangible equity, defined as Tier 1 capital. While the new rule expanded the assessment base, it lowered assessment rate to between 2.5 and 9 basis points on the broader base for banks in the lowest risk category. The change was effective for the second quarter of 2011. Since we have a solid core deposit base and do not rely heavily on borrowings and brokered deposits, the benefits of the lower assessment rate significantly outweighed the effect of a wider assessment base. The decrease in FDIC insurance also reflects the expiration of the FDIC Transaction Account Guarantee Program ("TAGP") on December 31, 2010, which provided unlimited insurance coverage on non-interest-bearing transaction accounts. We paid a 15 basis point surcharge per $100 covered balances in excess of $250 thousand from January to December 2010.

The increase in data processing expense is due to $455 thousand acquisition-related expenses, an annual contractual rate increase, as well as additional ongoing fees relating to a higher number of accounts.

The increase in professional service expenses in 2011 when compared to 2010 primarily reflects expenses incurred related to the Acquisition, including investment banking consultants, legal, accounting and valuation services. Additionally, we incurred more legal fees related to loan workouts in 2011 than in 2010.

Advertising expenses increased, primarily due to the additional expenses related to franchise expansion.

Director fees increased slightly due to the director compensation rate increase.

We recorded a core deposit intangible asset of $725 thousand at Acquisition, of which $683 thousand was written-off in the fourth quarter of 2011 and $42 thousand was amortized during the year. The write-off was primarily due to higher than anticipated runoff of the acquired deposits and a significant decline in alternative funding costs since the Acquisition.

The increase in other non-interest expense from 2010 was primarily due to higher costs associated with an increase in the volume of debit card usage, write-offs of certain assets from the Acquisition, the implementation of a bank-wide customer service training program, higher travel expenses and higher telephone expenses.

2010 Compared with 2009:

The increase in salaries and benefits over 2009 was primarily due to higher personnel-related costs associated with branch expansion, as well as annual merit increases. The number of average FTE totaled 201 and 195 in 2010 and 2009, respectively. In addition, a rise in employee benefit rates contributed to the increase.

The increases in occupancy and equipment expense over 2009 were mainly due to an increase in rent for our Greenbrae branch in its first full-year of service in 2010, and also the new Santa Rosa loan production office, partially offset by cost savings from the relocation of our Corte Madera branch.

The decrease in 2010 FDIC insurance was due to the absence of a special assessment totaling $496 thousand in the second quarter of 2009, partially offset by a higher FDIC assessment rate and higher deposits. Further, we elected to participate in the FDIC Transaction Account Guarantee Program, which provided unlimited insurance coverage on non-interest-bearing transaction accounts defined by the FDIC, on which we paid a 10 basis point surcharge per $100 covered balances in excess of $250 thousand through 2009. The 10 basis point surcharge on non-interest-bearing transaction accounts over $250 thousand increased to 15 basis points from January to December 2010, at which time the program expired.

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The increase in data processing expense was due to process re-engineering costs, an annual contractual rate increase, as well as the outsourcing of certain trust operations.

The increase in professional service expenses in 2010 when compared to 2009 was mainly due to higher costs associated with strategic expansion initiatives and investment advisory fees.

Advertising expenses decreased in 2010, primarily due to a decrease in the usage of traditional print advertising channels as part of the marketing program.

Director fees increased due to the director compensation rate increase, partially offset by fewer directors.

The increase in other non-interest expense from 2009 was primarily due to a higher provision for losses on off-balance sheet commitments due to a higher commitment amount, operational losses, higher printing and stationery costs, charitable contributions and staff relation costs.

Provision for Income Taxes

We reported a provision for income taxes of $9.2 million, $8.2 million, and $7.8 million for the years ended December 31, 2011, 2010, and 2009, respectively. The effective tax rates were 37.1%, 37.6%, and 37.9% for those same periods. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities, BOLI and certain tax-exempt loans). Therefore, there are normal fluctuations in the effective rate from period to period based on the relationship of net permanent differences to income before tax. We have not been subject to an alternative minimum tax (“AMT”) during these periods.

Bancorp and the Bank have entered into a tax allocation agreement which provides that income taxes shall be allocated between the parties on a separate entity basis. The intent of this agreement is that each member of the consolidated group will incur no greater tax liability than it would have incurred on a stand-alone basis.

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FINANCIAL CONDITION

Short-term Investment

At December 31, 2011 and 2010, we had $2.0 million and $19.5 million held in money market accounts with our correspondent banks, respectively, which earned interest at rates between 0.15% to 0.50% during 2011 and 0.35% to 0.55% during 2010.

Investment Securities

We maintain an investment securities portfolio to provide liquidity and to generate earnings on funds that have not been loaned to customers. Management determines the maturities and the types of securities to be purchased based on the liquidity level and the desire to attain a reasonable investment yield balanced with risk exposure. Table 6 shows the makeup of the securities portfolio by expected maturity at December 31, 2011 and 2010. Expected maturities 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. We estimate and update expected maturity dates quarterly based on current prepayment speeds. Equity securities with a zero cost basis and a fair value of $732 thousand are excluded from the following table because they do not have a stated maturity.

Table 6 Investment Securities

(dollars in thousands)	December 31, 2011				December 31, 2010			
Type and Maturity Grouping	Principal Amount	Amortized Cost1	Fair Value	Weighted Average Yield2	Principal Amount	Amortized Cost1	Fair Value	Weighted Average Yield2
Held to maturity								
State and municipal								
Due within 1 year	$ 3,428	$ 3,343	$ 3,367	2.25 %	$ 1,624	$ 1,478	$ 1,500	5.81 %
Due after 1 but within 5 years	25,006	24,819	24,931	3.73	5,471	5,304	5,440	4.41
Due after 5 but within 10 years	22,574	22,145	24,240	5.37	20,905	20,589	20,784	5.11
Due after 10 years	4,444	4,431	4,688	6.03	7,561	7,546	7,366	6.01
Total	55,452	54,738	57,226	4.49	35,561	34,917	35,090	5.23
Corporate bonds								
Due after 1 but within 5 years	5,000	5,000	4,959	4.00	---	---	---	---
Total	5,000	5,000	4,959	4.00	---	---	---	---
Total held to maturity	60,452	59,738	62,185	4.45	35,561	34,917	35,090	5.23
Available for sale								
MBS/CMOs issued by U.S. government								

agencies								
Due within 1 year	6,810	6,710	6,846	5.15	5,946	5,839	5,873	5.16
Due after 1 but within 5 years	74,094	73,235	75,009	3.17	72,509	71,899	73,700	3.56
Due after 5 but within 10 years	18,227	18,169	18,901	3.55	15,518	15,483	15,685	4.10
Due after 10 years	7,822	7,814	8,101	3.84	---	---	---	---
Total	106,953	105,928	108,857	3.41	93,973	93,221	95,258	3.75
Debentures of government sponsored agencies								
Due after 1 but within 5 years	8,000	8,000	8,050	1.53	---	---	---	---
Total	8,000	8,000	8,050	1.53	---	---	---	---
Privately issued CMOs								
Due after 1 but within 5 years	10,953	10,905	10,770	3.81	15,869	15,849	15,870	4.27
Due after 5 but within 10 years	7,518	7,515	7,427	4.66	---	---	---	---
Total	18,471	18,420	18,197	4.15	15,869	15,849	15,870	4.27
Total available for sale	133,424	132,348	135,104	3.40	109,842	109,070	111,128	3.83
Total	$ 193,876	$ 192,086	$ 197,289	3.73 %	$ 145,403	$ 143,987	$ 146,218	4.17 %

1 Book value reflects cost, adjusted for accumulated amortization and accretion.
2 Yields on tax-exempt securities are presented on a tax-equivalent basis and weighted average calculation is based on amortized cost of securities.

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The carrying amount of our investment securities portfolio, consisting primarily of mortgage-backed securities ("MBS") issued or sponsored by the U.S. government agencies, state and municipal securities and privately-issued collateralized mortgage obligations ("CMOs"), increased $48.2 million or 32.9% at December 31, 2011 due to a conscious effort to utilize our excess liquidity from deposit inflows that has not been deployed to lending. U.S. government agency MBS or CMO securities, which make up 55.9% and 65.0% of the portfolio at December 31, 2011 and 2010 respectively, increased $13.6 million in 2011. State and municipal securities, which represented 28.1% and 23.8% of the portfolio at December 31, 2011 and 2010 respectively, increased $19.8 million. See discussion in section captioned "Securities May Lose Value due to Credit Quality of the Issuers" in Item 1A Risk Factors above. We also purchased $5.0 million of highly-rated corporate bonds in 2011. The weighted average maturity of the portfolio at December 31, 2011 was approximately four years.

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock at a zero cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s covered litigation escrow account pending the final resolution of the Visa Inc. covered litigation. The fair value of the Class B common stock we own was $732 thousand as of December 31, 2011 based on the Class A as-converted rate of 0.4254.

Mortgage-backed securities in the portfolio at December 31, 2011 totaled $125.6 million, which consisted of $27.5 million pass-through securities issued by FNMA and FHLMC, $81.4 million CMOs issued by FNMA, FHLMC, or Government National Mortgage Association ("GNMA"), and $16.7 million of privately issued CMOs. We generally invest in mortgage-backed securities with borrowers having strong credit scores and/or collateral compositions reflecting low loan-to-value ratios. Any investment securities in our portfolio that may be backed by sub-prime or Alt-A mortgages, which account for approximately 5.8% of our total security portfolio, relate to privately issued CMOs. See Note 3 to Consolidated Financial Statements and Item 1A, Risk Factors, for more information on investment securities.

Loans

Table 7 Loans Outstanding by Type at December 31

(dollars in thousands)	2011	2010	2009	2008	2007
Commercial loans	$175,790	$153,836	$164,643	$146,483	$124,336
Real estate					
Commercial owner-occupied	174,705	142,590	146,133	140,977	132,614
Commercial investor	446,425	383,553	332,752	326,193	257,127
Construction	51,957	77,619	91,289	121,981	97,153
Home equity	98,043	86,932	83,977	65,076	34,295
Other residential 1	61,502	69,991	69,369	55,600	44,565
Installment and other consumer loans	22,732	26,879	29,585	34,234	34,788
Total loans	1,031,154	941,400	917,748	890,544	724,878
Allowance for loan losses	(14,639)	(12,392)	(10,618)	(9,950)	(7,575)
Total net loans	$1,016,515	$929,008	$907,130	$880,594	$717,303

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 collateral compositions reflecting high loan-to-value ratios. However, substantially all of our residential loans are indexed to Treasury Constant Maturity Rates and have provisions to reset five years after their origination dates.

Commercial loans increased $22.0 million in 2011 and decreased $10.8 million in 2010. $14.5 million of the 2011 commercial loan growth represents the remaining balance of loans purchased from the Acquisition. The additional $7.5 million growth in 2011 was the result of our continued emphasis on commercial and industrial lending. The decrease in 2010 related to increased pay-downs as borrowers de-leveraged, successful resolution of problem loans, and reduced demand by qualified borrowers.

Commercial real estate loans increased $95.0 million in 2011 and $47.3 million in 2010. $32.4 million of the 2011 commercial real estate loan growth represents the remaining balances of loans purchased from the Acquisition. The remaining $62.6 million increase in 2011 reflects several large new relationships in our newer markets, primarily San Francisco and Santa Rosa. Of the commercial real estate loans at December 31, 2011, 72% are non-owner occupied and 28% are owner occupied. Our commercial real estate loan portfolio is weighted towards term loans for which the primary source of repayment is cash flow from net operating income of the real estate property. The following table summarizes our commercial real estate loan portfolio by the geographic location in which the property is located as of December 31, 2011 and 2010:

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Table 8 Commercial Real Estate Loans Outstanding by Geographic Location

(dollars in thousands)	December 31, 2011 Amount	% of		December 31, 2010 Amount	% of	
Marin	$245,107	39.5	%	$235,584	44.8	%
Sonoma	95,697	15.4		80,563	15.3	
San Francisco	102,486	16.5		78,307	14.9	
Alameda	35,886	5.8		36,083	6.8	
Contra Costa	8,054	1.3		7,855	1.5	
Napa	46,221	7.4		12,117	2.3	
Sacramento	10,446	1.7		11,057	2.1	
Other	77,233	12.4		64,577	12.3	
Total	$621,130	100.0	%	$526,143	100.0	%

Construction loans decreased $25.7 million and $13.7 million in 2011 and 2010, respectively, primarily due to a slow-down in construction activities, the successful completion and sell-through of construction development projects booked in prior years, as well as a conscious effort to reduce our concentration in construction loans. Table 9 below shows an analysis of construction loans by type and location.

Table 9 Construction Loans Outstanding by Type and Geographic Location

(dollars in thousands)	December 31, 2011			December 31, 2010		
Construction loans by type	Amount	% of		Amount	% of	
Single family non-owner-occupied	$9,949	19.1	%	$12,453	16.0	%
Single family owner-occupied	351	0.7		3,448	4.4	
Commercial non-owner-occupied	8,948	17.2		7,189	9.3	
Commercial owner-occupied	818	1.6		3,386	4.4	
Land non-owner-occupied	30,040	57.8		37,660	48.5	
Land owner-occupied	1,720	3.3		2,595	3.4	
Tenants-in-common and other	131	0.3		10,888	14.0	
Total	$51,957	100.0	%	$77,619	100.0	%
Construction loans by geographic location	Amount	% of		Amount	% of	
Marin	$11,048	21.3	%	$17,710	22.8	%
Sonoma	4,545	8.7		7,884	10.1	
San Francisco	29,281	56.4		44,310	57.1	
Alameda	1,056	2.0		1,748	2.3	
Contra Costa	265	0.5		265	0.3	
Napa	800	1.5		1,002	1.3	
Riverside	4,925	9.5		4,652	6.0	
Other	37	0.1		48	0.1	
Total	$51,957	100.0	%	$77,619	100.0	%

Home equity lines of credit increased $11.1 million to $98.0 million in 2011. $10.6 million of the 2011 home equity loan growth represents the remaining balance of loans purchased from the Acquisition. Other residential real estate loans decreased $8.5 million in 2011, primarily due to our de-emphasis on tenants-in-common residential lending, while the balance increased slightly by $622 thousand in 2010.

Approximately 85% and 86% of our outstanding loans are secured by real estate at both December 31, 2011 and 2010. At December 31, 2011, approximately 8% of our commercial real estate loans and 42% of our residential real estate loans contain an interest-only feature as part of the loan terms. Approximately 79% of the interest-only commercial real estate loans and 84% of the residential real estate loans are considered to have low credit risk (graded “Pass”) and are current with their payments. Also see Item 1A, Risk Factors, regarding our loan concentration risk. As of December 31, 2011, approximately $22.5 million of our loans have interest reserves, the majority of which are construction loans. When we determine a loan is impaired before the interest reserve has been depleted, the interest funded by the interest reserve is applied against loan principal. As of December 31, 2011, no construction loans having interest reserve balances were determined to be impaired.

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Variable rate loans at their established interest rate floors or ceilings are included as fixed rate loans in the following table. Table 10 shows a shift towards fixed rate loans within the portfolio in 2011 when compared to 2010 as variable rate loans continued to re-price down to their floor rates in a low-interest rate environment. The large majority of the variable rate loans are tied to independent indices (such as the Wall Street Journal prime rate or a Treasury Constant Maturity Rate). Most loans with an original term of more than five years have provisions for the fixed rates to reset, or convert to a variable rate, after one, three or five years.

Table 10 Loan Portfolio Maturity Distribution and Interest Rate Sensitivity

	December 31, 2011				December 31, 2010			
(dollars in thousands)	Fixed Rate	Variable Rate	Total	Percent	Fixed Rate	Variable Rate	Total	Percent
Due within 1 year	$ 126,443	$ 106,002	$ 232,445	22.5 %	$ 134,346	$ 118,860	$ 253,206	26.9 %
Due after 1 but within 5 years	213,560	32,650	246,210	23.9	214,467	52,236	266,703	28.3
Due after 5 years	552,499	---	552,499	53.6	421,491	---	421,491	44.8
Total	$ 892,502	$ 138,652	$ 1,031,154	100.0 %	$ 770,304	$ 171,096	$ 941,400	100.0 %
Percentage	86.55 %	13.45 %	100.00 %		81.83 %	18.17 %	100.00 %	

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Allowance for Loan Losses

Credit risk is inherent in the business of lending. As a result, we maintain an allowance for loan losses to absorb losses inherent in our loan portfolio through a provision for loan losses charged against earnings. All specifically identifiable and quantifiable losses are charged off against the allowance. The balance of our allowance for loan losses is Management's best estimate of the remaining losses inherent in the portfolio. The ultimate adequacy of the allowance is dependent upon a variety of factors beyond our control, including the real estate market, changes in interest rates and economic and political environments. Based on the current conditions of the loan portfolio, Management believes that the $14.6 million allowance for loan losses at December 31, 2011 is adequate to absorb losses inherent in our loan portfolio. No assurance can be given, however, that adverse economic conditions or other circumstances will not result in increased losses in the portfolio.

The Components of the Allowance for Loan Losses

As stated previously in "Critical Accounting Policies," and Note 1 to the Consolidated Financial Statements in this report, the overall allowance consists of a specific allowance for individually identified impaired loans, an allowance factor for categories of credits with similar characteristics and trends, and an allowance for changing economic factors (e.g., portfolio trends, concentration of credit, growth, economic factors, etc.).

The first component, the specific allowance, results from the analysis of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. Through Management's ongoing loan grading process and credit monitoring process, individual loans are identified that have conditions that indicate the borrower may be unable to pay all amounts due under the contractual terms. These loans are evaluated individually for impairment by Management and specific allowances for loan losses are established when the fair value of the impaired loan is less than the recorded investment in the loan. 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, based on the loan's observable market price, or based on the fair value of the collateral, if the loan is collateral dependent. Generally with problem credits that are collateral-dependent, we obtain appraisals/evaluations of the collateral at least annually. Impaired loan balances increased from $14.1 million at December 31, 2010 to $20.1 million at December 31, 2011. The increase in impaired loans is primarily the result of newly identified TDR loans upon the adoption of Accounting Standards Update No. 2011-02, as well as PCI loans that have experienced credit deterioration post-Acquisition. The specific allowance increased from $1.1 million at December 31, 2010 to $2.9 million at December 31, 2011. The increase in the specific allowance primarily relates to an increased number of impaired loans and deteriorating collateral values associated with those impaired loans. We are proactive in charging-off the uncollectible portion of impaired loans. The increase in specific reserves is also a function of higher levels of commercial, residential real estate, home equity and construction loans awaiting resolution of pending events before a determination can be made as to whether or not the loan should be charged-off.

The second component, the allowance factor, is an estimate of the probable inherent losses in each loan pool stratified by major segments or loans with similar characteristics in our loan portfolio. This analysis encompasses our entire loan portfolio, but excludes any loans that were analyzed individually for specific allowances as discussed above and excludes acquired loans where the discount has not been fully accreted. This analysis also includes loan types and economic and business conditions unique to each segment, including the Bank's own loss history. For loans graded "Substandard" and not already evaluated for impairment in the first component analysis above, they are also assigned an allowance factor. Confirmation of the quality of our grading process is obtained by independent reviews conducted by consultants specifically hired for this purpose and by various bank regulatory agencies. There are limitations to any credit risk grading process. The number of loans makes it impractical to review every loan at every reporting date. Therefore, it is possible that in the future some currently performing loans not recently graded will not be as strong as their last grading and an insufficient portion of the allowance will have been allocated to them. Grading and loan

review often must be done without knowing whether all relevant facts are at hand. Troubled borrowers may deliberately or inadvertently omit important information from reports or conversations with lending officers regarding their financial condition and the diminished strength of repayment sources.

The total amount allocated for the second component is determined by applying loss estimation factors to outstanding loan types. At December 31, 2011 and 2010, the allowance allocated by categories of credits totaled $8.5 million and $8.3 million, respectively. As disclosed in Note 4 to Consolidated Financial Statements in Item 8 below, loans graded "Substandard" totaled $63.2 million and $53.2 million as of December 31, 2011 and 2010, respectively. During 2011, Management evaluated the allowance factors used based on historical loss experience during this economic cycle, as well as expected loan loss trends inherent in the portfolio. The impact of this evaluation resulted in a net increase to the second component of $115 thousand.

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The third component of the allowance for loan losses is an economic component that is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by portfolio trends, concentration of credit, growth, and economic trends. This is Management's best estimate of the probable impact that economic changes may have on the loan portfolio as a whole. The general valuation allowance, including the economic component and unallocated allowance, increased from $3.0 million at December 31, 2010 to $3.2 million at December 31, 2011 due to loan growth. Management proactively evaluates economic and other qualitative loss factors used to determine the adequacy of the allowance for loan losses. After assessing the economic outlook, Management did not revise the economic loss factor in 2011 due to limited signs of economic change. Economic recovery has been limited and continued financial stress has been experienced by borrowers in our markets. The persistently high unemployment rate and restrained spending by consumers and businesses are expected to prevent rapid economic expansion and recovery of housing prices.

Table 11 shows the allocation of the allowance by loan type as well as the percentage of total loans in each of the same loan types.

Table 11 Allocation of Allowance for Loan Losses

	December 31, 2011		December 31, 2010		December 31, 2009		December 31, 2008		December 31, 2007	
(dollars in thousands)	Allowance balance allocation	Loans as percent of total loans	Allowance balance allocation	Loans as percent of total loans	Allowance balance allocation	Loans as percent of total loans	Allowance balance allocation	Loans as percent of total loans	Allowance balance allocation	Loans as percent of total loans
Commercial loans	$4,334	17.1 %	$3,114	16.3 %	$2,544	17.9 %	$2,306	16.5 %	$1,811	17.2 %
Real Estate										
Commercial, owner-occupied	1,305	16.9	1,037	15.2	1,006	15.9	978	15.8	799	18.3
Commercial, investor	3,710	43.3	4,134	40.7	3,000	36.3	2,933	36.7	2,067	35.5
Construction	1,505	5.0	1,694	8.3	1,832	9.9	2,118	13.6	1,659	13.4
Home Equity	1,444	9.5	643	9.2	586	9.2	453	7.3	205	4.7
Other residential	940	6.0	738	7.4	734	7.6	588	6.2	426	6.1
Installment and other consumer	1,182	2.2	835	2.9	662	3.2	563	3.9	430	4.8
Unallocated allowance	219	N/A	197	N/A	254	N/A	11	N/A	178	N/A
Total allowance for loan losses	$14,639		$12,392		$10,618		$9,950		$7,575	
Total percent		100.00%		100.00%		100.00%		100.00%		100.00%

The allowance for loan losses as a percentage of loans totaled 1.42% at December 31, 2011, compared to 1.32% at December 31, 2010. The increase in the allowance for loan losses as a percentage of loans reflects a higher level of specific reserves on impaired loans across most loan categories, most notably in our commercial and industrial portfolio, mainly related to the weak economic environment.

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Table 12 shows the activity in the allowance for loan losses for each of the years in the five-year period ended December 31, 2011. Net charge-offs totaled $4.8 million and $3.6 million in 2011 and 2010, respectively. The increase primarily relates to $1.5 million of charge-offs related to the acquired loans. Our 2011 commercial loan losses have stemmed primarily from unsecured commercial loans, as well as commercial loans secured by real estate where the property values have declined. Net charge-offs of construction loans in 2010 and 2009 have stemmed primarily from the land development and single-family residential construction projects in Oregon and Sonoma County, California, where property values have been affected more significantly than in our core market of Marin County. The percentage of net charge-offs to average loans was 0.49% in 2011, compared to 0.38% in 2010, reflecting the factors discussed above.

Table 12 Allowance for Loan Losses at December 31

(dollars in thousands)	2011	2010	2009	2008	2007
Beginning balance	$ 12,392	$ 10,618	$ 9,950	$ 7,575	$ 8,023
Cumulative-effect adjustment of election of fair value accounting on indirect auto portfolios 1	---	---	---	---	(1,048)
Provision for loan losses	7,050	5,350	5,510	5,010	685
Loans charged off					
Commercial	(3,306)	(643)	(1,552)	(1,100)	---
Real Estate					
Commercial	(113)	(47)	(9)	---	---
Construction	(473)	(2,628)	(3,046)	(1,508)	---
Home equity	(554)	(150)	(96)	---	---
Installment and other consumer	(456)	(318)	(659)	(72)	(115)
Total	(4,902)	(3,786)	(5,362)	(2,680)	(115)
Loan loss recoveries					
Commercial	57	95	52	24	---
Real Estate					
Commercial	4				
Construction	9	95	397	---	---
Home equity	13				
Installment and other consumer	16	20	71	21	30
Total	99	210	520	45	30
Net loans charged off	(4,803)	(3,576)	(4,842)	(2,635)	(85)
Ending balance	$ 14,639	$ 12,392	$ 10,618	$ 9,950	$ 7,575
Total loans outstanding at end of year, before deducting allowance for loan losses	$ 1,031,154	$ 941,400	$ 917,748	$ 890,544	$ 724,878
Average total loans outstanding during year	$ 984,211	$ 929,755	$ 910,456	$ 798,369	$ 703,087
Ratio of allowance for loan losses to total loans at end of year	1.42 %	1.32 %	1.16 %	1.12 %	1.05 %
Net charge-offs to average loans	0.49 %	0.38 %	0.53 %	0.33 %	0.01 %

Ratio of allowance for loan losses to net charge-offs	304.8	%	346.5	%	219.3	%	377.6	%	8,911.8	%

1 In conjunction with the election of accounting for the indirect auto loan portfolio at fair value in 2007, an unrealized loss of $3.5 million was recorded as a reduction of loans, and the allowance for loan losses was reduced by $1.0 million.

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Non-performing assets for each of the past five years are presented below. The increase in impaired loans from 2010 to 2011 is primarily due to newly identified TDR loans upon the adoption of Accounting Standards Update No. 2011-02, as well as PCI loans that have experienced credit deterioration post-Acquisition. The ratio of allowance for loan losses to non-accrual loans increased from 95.9% at December 31, 2010 to 122.3% at December 31, 2011. There were no other real estate owned at the end of the years presented.

Table 13 Non-performing Assets at December 31

(dollars in thousands)	2011	2010	2009	2008	2007
Non-accrual loans:					
Commercial	$2,955	$2,486	$910	$145	$---
Real Estate					
Commercial, owner-occupied	2,033	632	3,722	---	---
Commercial, investor	741	---	---	---	---
Construction	3,014	9,297	6,520	5,804	---
Home equity line of credit	766	---	100	288	144
Other residential	1,942	148	---	---	---
Installment and other consumer	519	362	313	455	---
Total non-accrual loans	11,970	12,925	11,565	6,692	144
Repossessed personal properties	25	135	96	---	---
Total non-performing assets	11,995	13,060	11,661	6,692	144
Accruing restructured loans:					
Commercial	2,741	---	49	---	---
Real Estate					
Construction	290	---	---	---	---
Home Equity	279	259	---	---	---
Other residential	1,464	---	---	---	---
Installment and other consumer	1,552	925	566	119	---
Total accruing restructured loans	6,326	1,184	615	119	---
Accreting impaired PCI loans[1]:					
Commercial real estate	1,710	---	---	---	---
Commercial	139	---	---	---	---
Total accreting impaired PCI loans	1,849	---	---	---	---
Total impaired loans	20,145	14,109	12,180	6,811	$144
Allowance for loan losses to non-accrual loans at period end	122.3 %	95.9 %	91.8 %	148.7 %	5260.4 %
Non-accrual loans to total loans	1.16 %	1.37 %	1.26 %	0.75 %	0.02 %

1 The expected cash flows on these PCI loans declined post-Acquisition, yet continue to accrete interest based on the revised expected cash flows.

Troubled debt restructured loans, whose contractual terms have been restructured in a manner which grants a concession to a borrower experiencing financial difficulties, totaled $10.7 million and $1.2 million as of December 31, 2011 and 2010, respectively. For more information, refer to Note 4 under “Troubled Debt Restructuring”.

Other Assets

As financial institutions continue to fail, the FDIC Deposit Insurance Fund depletes rapidly. Therefore, in December 2009, the FDIC required banks to prepay their regular insurance premiums for 2010 through 2012. Other assets included $2.2 million and $3.0 million of prepaid FDIC assessments at December 31, 2011 and 2010, respectively. Each quarter through 2012, the prepaid insurance asset balance will be reduced by the FDIC insurance expense that is applicable to that quarter.

BOLI totaled $21.6 million at December 31, 2011, compared to $18.3 million at December 30, 2010, and is recorded in other assets. Other assets also include net deferred tax assets of $7.0 million and $6.6 million at December 31, 2011 and 2010, respectively. These deferred tax assets consist primarily of tax benefits expected to be realized in future periods related to temporary differences of allowance for loan losses, depreciation, state tax, stock-based compensation and deferred compensation. Management believes these assets to be realizable due to our consistent record of earnings and the expectation that earnings will continue at a level adequate to realize such benefits.

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In addition, we held $5.4 million and $5.0 million of FHLB stock recorded at cost in other assets at December 31, 2011 and 2010, respectively. The FHLB paid $12 thousand and $16 thousand in cash dividends in 2011 and 2010, respectively. On February 22, 2012, FHLB declared a cash dividend for the fourth quarter of 2011 at an annualized dividend rate of 0.48%. Management does not believe that FHLB stock is other-than-temporarily-impaired as we expect to be able to redeem the stock at cost.

Deposits

Deposits, which are used to fund our interest earning assets, increased $187.2 million, or 18.4%, in 2011. Failures in a large number of banks have led to increased customer concern over safety and soundness rather than yield. We believe that we have successfully attracted new deposits due to our financial soundness, our personalized customer service, and our focus on relationship-building and cross-selling. The economic downturn also appears to have impacted the general public's investment behavior, as evidenced by a national trend of increasing household savings and movement away from higher-risk equity investments.

The increase in deposits reflects growth in most deposit categories, except for CDARS® time deposits, which decreased $20.6 million, primarily reflecting the movement by one client of balances from CDARS® to money market accounts within the Bank. We believe the increase in non-interest bearing deposits is due to customers seeking safety as all non-interest bearing transaction accounts are fully insured by the FDIC. No individual customer accounted for more than 5% of deposits.

Table 14 shows the relative composition of our average deposits for the years 2011, 2010 and 2009.

Table 14 Distribution of Average Deposits

	Years ended December 31,					
	2011		2010		2009	
(dollars in thousands)	Amount	Percent	Amount	Percent	Amount	Percent
Non-interest bearing	$347,682	30.5 %	$263,742	26.4 %	$232,502	25.6 %
Interest bearing transaction	125,316	11.0	98,168	9.8	90,159	9.9
Savings	69,792	6.1	51,738	5.2	45,944	5.0
Money market	405,726	35.6	390,575	39.0	391,571	43.1
CDARS®	39,514	3.5	71,432	7.1	51,248	5.6
Other Time deposits						
Less than $100,000	46,686	4.1	43,069	4.3	36,350	4.0
$100,000 or more	105,180	9.2	81,562	8.2	61,574	6.8
Total other time deposits	151,866	13.3	124,631	12.5	97,924	10.8
Total Average Deposits	$1,139,896	100.00 %	$1,000,286	100.00 %	$909,348	100.00 %

Table 15 below shows the maturity groupings for time deposits of $100,000 or more, including CDARS® deposits at December 31, 2011, 2010 and 2009.

Table 15 Maturities of Time Deposits of $100,000 or more at December 31

	December 31,		
(in thousands)	2011	2010	2009
Three months or less	$ 66,999	$ 77,173	$ 56,456
Over three months through six months	23,704	24,135	19,446
Over six months through twelve months	28,913	35,713	30,458

Over twelve months	31,982	18,699	5,830
Total	$ 151,598	$ 155,720	$ 112,190

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Borrowings

We currently have $261.2 million in secured lines of credit with FHLB, $41.2 million with Federal Reserve Bank of San Francisco ("FRBSF") and $77.0 million in unsecured lines with correspondent banks to cover any short or long-term borrowing needs. As of December 31, 2011, we had two FHLB fixed-rate advances outstanding totaling $35 million, leaving $226.2 million available borrowing capacity with FHLB. The FRBSF and correspondent bank lines were not utilized at December 31, 2011. For additional information, see Note 8 to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Deferred Compensation Obligations

We maintain a nonqualified, unfunded deferred compensation plan for certain key management personnel. Under this plan, participating employees may defer compensation, which will entitle them to receive certain payments upon retirement, death, or disability. The plan provides for payments for up to fifteen years commencing upon retirement and reduced benefits upon early retirement, disability, or termination of employment. The participating employee may elect to receive payments over periods not to exceed fifteen years. At December 31, 2011 and 2010, our aggregate payment obligations under this plan totaled $2.7 million and $2.8 million, respectively.

We established a Salary Continuation Plan on January 1, 2011. The plan was to provide a percentage of salary continuation benefits to a select group of executive management upon retirement. At December 31, 2011, our liability under the Salary Continuation Plans was $114 thousand recorded in interest payable and other liabilities. This Plan is unfunded and nonqualified for tax purposes and for purposes of Title I of the Employee Retirement Income Security Act of 1974.

For additional information, see Note 11 to the Consolidated Financial Statements in Item 8 below.

Off Balance Sheet Arrangements

We make commitments to extend credit in the normal course of business to meet the financing needs of our customers. For additional information, see Note 17 to the Consolidated Financial Statements in Item 8 below.

Commitments

The following is a summary of our contractual commitments as of December 31, 2011.

Table 16 Contractual Commitments at December 31, 2011

	Payments due by period				
(in thousands)	<1 year	1-3 years	4-5 years	>5 years	Total
Operating leases	$ 2,670	$ 5,212	$ 5,315	$ 14,091	$ 27,288
Federal Home Loan Bank borrowings	20,000	---	---	15,000	35,000
Subordinated debenture	---	---	---	5,000	5,000
Total	$ 22,670	$ 5,212	$ 5,315	$ 34,091	$ 67,288

The contractual amount of loan commitments not reflected on the Consolidated Statement of Condition was $276.8 million and $252.7 million at December 31, 2011 and 2010, respectively.

As permitted or required under California law and to the maximum extent allowable under that law, we have certain obligations to indemnify our current and former officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. These indemnification obligations are valid as long as the director or officer acted in good faith and in a manner the person reasonably believed to be in, or not opposed to, our best interests, and with respect to any criminal action or proceeding, had no reasonable cause to believe his or her conduct was unlawful. The maximum potential amount of future payments we could be required to make under these indemnification obligations is unlimited; however, we have a director and officer insurance policy that mitigates our exposure and enables us to recover a portion of any future amounts paid. As we believe the possibility of potential claims to be remote and any amounts under the indemnifications would be covered by the insurance policy, we have not recorded an indemnification obligation.

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Capital Adequacy

As discussed in Note 16 to the Consolidated Financial Statements, the Bank's capital ratios are above regulatory guidelines to be considered "well capitalized" and Bancorp's ratios exceed the required minimum ratios for capital adequacy purposes. The Bank's total risk-based capital ratio increased from 12.70% at December 31, 2010 to 12.89% at December 31, 2011, primarily due to the accumulation of net income of the Bank in 2011 of $16.1 million, partially offset by the effect of growth in total risk-weighted assets driven mainly by the loan portfolio purchased from the acquisition and increases in investment securities. Bancorp's total risk-based capital ratio decreased from 13.34% at December 31, 2010 to 13.13% at December 31, 2011, primarily due to an increase in total risk-weighted assets, partially offset by the accumulation of net income of Bancorp of $15.6 million in 2011, net of 3.5 million dividends paid to stockholders.

We expect to maintain strong capital levels. Our potential sources of capital include future earnings and shares issued upon the exercise of stock options. In addition, the warrant to purchase 154,908 shares of our common stock remains outstanding. The warrant, if exercised, would provide us with $4.2 million additional Tier 1 capital. We are also positioned to access capital markets, if necessary, for up to $75 million through a shelf registration filed on Form S-3 in the fourth quarter of 2009.

Liquidity

The goal of liquidity management is to provide adequate funds to meet both loan demand and unexpected deposit withdrawals. We accomplish this goal by maintaining an appropriate level of liquid assets, and formal lines of credit with the FHLB, FRB and correspondent banks that enable us to borrow funds as needed. Our Asset/Liability Management Committee ("ALCO"), which is comprised of certain directors of the Bank, is responsible for establishing and monitoring our liquidity targets and strategies.

Management regularly adjusts our investments in liquid assets based upon our assessment of expected loan demand, expected deposit flows, yields available on interest-earning securities and the objectives of our asset/liability management program. ALCO has also developed a contingency plan should liquidity drop unexpectedly below internal requirements.

We obtain funds from the repayment and maturity of loans as well as deposit inflows, investment security maturities and paydowns, Federal funds purchased, FHLB advances, and other borrowings. Our primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposits, maturity of certificate of deposits, repayment of borrowings and dividends to stockholders.

We must retain and attract new deposits, which depends upon the variety and effectiveness of our customer account products, service and convenience, and rates paid to customers, as well as our financial strength. Any long-term decline in retail deposit funding would adversely impact our liquidity. Management does not anticipate significant reliance on Federal funds purchased and FHLB advances in the near future, as our core deposit inflow has provided adequate liquidity to fund our operations. If we were to rely on Federal Funds purchased or FHLB advances in the future, we expect to have the ability to post adequate collateral for such funding requirements.

As presented in the accompanying consolidated statements of cash flows, the sources of liquidity vary between periods. Consolidated cash and cash equivalents at December 31, 2011 totaled $129.7 million, an increase of $44.5 million over December 31, 2010. The primary sources of funds during 2011 included a $93.2 million net increase in deposits, $44.0 million of cash received from the Acquisition, $70.0 million in pay-downs and maturities of investment securities, and $22.4 million net cash provided by operating activities. The primary uses of funds were $119.5 million for investment securities purchases, $33.5 million in repayment of FHLB borrowings, and $25.2

million in loan originations (net of principal collections). The banking industry, as a whole, is experiencing diminished loan demand from qualified borrowers.

At December 31, 2011, our cash and cash equivalents and unpledged available-for-sale securities maturing within one year totaled $136.6 million. The remainder of the unpledged available-for-sale securities portfolio of $123.5 million provides additional liquidity. These liquid assets equaled 18.7% of our assets at December 31, 2011, compared to 15.1% at December 31, 2010, well in excess of our internal liquidity policy. The increased liquidity at December 31, 2011 was primarily due to deposit growth exceeding loan growth and cash received from the Acquisition.

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We anticipate that cash and cash equivalents on hand and other sources of funds will provide adequate liquidity for our operating, investing and financing needs and our regulatory liquidity requirements for the foreseeable future. Management monitors our liquidity position daily, balancing loan funding/payments with changes in deposit activity and overnight investments. Our emphasis on local deposits combined with our 9.7% equity to assets ratio, provides a very stable funding base. In addition to cash and cash equivalents, we have substantial additional borrowing capacity including unsecured lines of credit totaling $77.0 million with correspondent banks. Further, on March 30, 2009, we pledged a certain residential loan portfolio that increased our borrowing capacity with the FRBSF, which totaled $41.2 million at December 31, 2011. As of December 31, 2011, there is no debt outstanding to correspondent banks or the FRBSF. We are also a member of the FHLB and have a line of credit (secured under terms of a blanket collateral agreement by a pledge of essentially all of our financial assets) in the amount of $261.2 million, of which $226.2 million was available at December 31, 2011. Borrowings under the line are limited to eligible collateral. The interest rates on overnight borrowings with both correspondent banks and the FHLB are determined daily and generally approximate the Federal Funds target rate.

Undisbursed loan commitments, which are not reflected on the consolidated statement of condition, totaled $276.8 million at December 31, 2011 at rates ranging from 1.91% to 18.00%. This amount included $155.3 million under commercial lines of credit (these commitments are contingent upon customers maintaining specific credit standards), $75.6 million under revolving home equity lines, $23.7 million under undisbursed construction loans, $9.3 million under personal and other lines of credit, and a remaining $12.9 million under standby letters of credit. These commitments, to the extent used, are expected to be funded primarily through the repayment of existing loans, deposit growth and existing balance sheet liquidity. Over the next twelve months, $156.8 million of time deposits will mature. We expect these funds to be replaced with new time or savings accounts.

Since Bancorp is a holding company and does not conduct regular banking operations, its primary sources of liquidity are dividends from the Bank. Under the California Financial Code, payment of a dividend from the Bank to Bancorp is restricted to the lesser of the Bank's retained earnings or the amount of the Bank's undistributed net profits from the previous three fiscal years. The primary uses of funds for Bancorp are stockholder dividends and ordinary operating expenses. At December 31, 2011, Bancorp held $2.8 million of cash and approximately $2.7 million of the Bank's retained earnings is available to be distributed to Bancorp. When combined, these funds are deemed sufficient to cover Bancorp's operational needs and cash dividends to shareholders for the next twelve months. Management anticipates that there will be sufficient earnings at the Bank level to provide dividends to Bancorp to meet its funding requirements for the foreseeable future.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our most significant form of market risk is interest rate risk. The risk is inherent in our deposit and lending activities. Management, together with ALCO, has sought to manage rate sensitivity and maturities of assets and liabilities to minimize the exposure of our earnings and capital to changes in interest rates. Additionally, interest rate risk exposure is managed with the goal of minimizing the impact of interest rate volatility on our net interest margin. Interest rate changes can create fluctuations in the net interest margin due to an imbalance in the timing of repricing or maturity of assets or liabilities. Interest rate risk exposure is managed with the goal of minimizing the impact of interest rate volatility on the net interest margin.

Activities in asset and liability management include, but are not limited to, lending, borrowing, accepting deposits and investing in securities. Interest rate risk is the primary market risk associated with asset and liability management. Sensitivity of net interest income ("NII") to interest rate changes results from differences in the maturity or repricing, of asset and liability portfolios. To mitigate interest rate risk, the structure of our assets and liabilities is managed with the objective of correlating the movements of interest rates on loans and investments with those of deposits and borrowings. The asset and liability policy sets limits on the acceptable amount of change to NII in changing interest

rate environments. We use simulation models to forecast NII.

From time to time, we enter into certain interest rate swap contracts designated as fair value hedges to mitigate the changes in the fair value of specified long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans caused by changes in interest rates. See Note 15 to the consolidated financial statements.

Exposure to interest rate risk is reviewed at least quarterly by the ALCO and the Board of Directors. They utilize interest rate sensitivity simulation models as a tool for achieving these objectives and for developing ways in which to improve profitability. A simplified statement of condition is prepared on a quarterly basis as a starting point, using as inputs, actual loans, investments, borrowings and deposits. If potential changes to net equity value and net interest income resulting from hypothetical interest changes are not within the limits established by the Board of Directors, Management may adjust the asset and liability mix to bring interest rate risk within approved limits.

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To measure the relative magnitude of the repricing for each category of interest earning asset and interest bearing liability given various changes in market rates, we rely on a sophisticated simulation model. At December 31, 2011, the model indicated that we had low interest rate risk and we were slightly asset sensitive in a rising interest rate environment. In 2011, our asset sensitivity increased from the rise in liquidity and variable rate loans. That asset sensitivity was partially offset by the increase in investment securities and interest bearing transactions, savings and money market deposit accounts. As shown in Table 17 below, if the market rates rise by more than 200 basis points, we expect asset sensitivity to increase as our loans with interest rates on floors will start to float again and net interest income will increase.

In the following simulation of NII under various interest rate scenarios, the simplified statement of condition is processed against four interest rate change scenarios, in 100 basis point increments. As the Federal funds target rate at December 31, 2011 was already at its historic low of 0-0.25%, it is unlikely that there will be further reductions in the target rate. Therefore, a reduction-in-rate scenario is not considered in the following table at December 31, 2011. Each of these scenarios assumes that the change in interest rates is immediate and interest rates remain at the new levels.

Table 17 summarizes the effect on NII due to changing interest rates as measured against the flat rate scenario.

Table 17 Effect of Interest Rate Change on Net Interest Income at December 31, 2011

Changes in Interest Rates (in basis points)	Estimated change in NII (as percent of NII)
up 400	4.3%
up 300	2.7%
up 200	1.3%
up 100	0.3%

The above table estimates the impact of interest rate changes. The estimated changes are within our policy guidelines established by ALCO. The results shown reflect a lag in the upward re-pricing of loans due to loans on floors.

As stated previously in the section captioned "Supervision and Regulation" in Item 1 Business of this report, the Dodd-Frank Act repealed the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts beginning July 21, 2011. We have not incurred significant interest expense on business transaction accounts since the legislation took effect in July 2011. If we are to pay interest on certain deposits that are currently non-interest bearing, causing these deposits to become rate sensitive in the future, we will become less asset sensitive than the model currently indicates.

Interest rate sensitivity is a function of the repricing characteristics of our assets and liabilities. As with any simulation model or other method of measuring interest rate risk, certain limitations are inherent in the process. For example, although certain of our assets and liabilities may have similar maturities or repricing time frames, they may react differently to changes in market interest rates. In addition, the changes in interest rates on certain categories of either our assets or liabilities may precede or lag changes in market interest rates. Further, the actual rates and timing of prepayments on loans and investment securities could vary significantly from the assumptions used in the various scenarios. Lastly, changes in U.S. Treasury rates accompanied by a change in the shape of the yield curve could produce different results from those presented in the table. Accordingly, the results presented should not be relied upon as indicative of actual results in the event of changing market interest rates.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Bank of Marin Bancorp

We have audited the accompanying consolidated statements of condition of Bank of Marin Bancorp and subsidiary (the "Company") as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. We also have audited the Company's internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting and Compliance with Applicable Laws and Regulations. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall consolidated financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Bank of Marin Bancorp and subsidiary as of December 31, 2011 and 2010, and the

consolidated results of their operations and their cash flows each of the three years in the period ended December 31, 2011, in conformity with generally accepted accounting principles in the United States of America. Also in our opinion, Bank of Marin Bancorp maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ Moss Adams LLP
Stockton, California
March 12, 2012

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504 Redwood Blvd, Suite 100
Novato, CA 94947

March 12, 2012

To the Stockholders:

Management's Report on Internal Control over Financial Reporting and Compliance with Applicable Laws and Regulations

Management of the Bank of Marin Bancorp and its subsidiary (”Bancorp”) is responsible for preparing the Bancorp's annual consolidated financial statements in accordance with generally accepted accounting principles. Management is also responsible for establishing and maintaining internal control over financial reporting, including controls over the preparation of regulatory financial statements, and for complying with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions. Bancorp's internal control contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in the effectiveness of any internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Management has assessed Bancorp's internal control over financial reporting encompassing both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes as of December 31, 2011. The assessment was based on criteria for effective internal control over financial reporting described in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, Management believes that, as of December 31, 2011, Bancorp maintained effective internal control over financial reporting encompassing both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes in all material respects. Management also believes that Bancorp complied with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions during 2011.

Management's assessment of the effectiveness of Bancorp's internal control over financial reporting as of December 31, 2011 has been audited by Moss Adams LLP, an independent registered public accounting firm, which expresses an unqualified opinion as stated in their report which appears on the previous page.

/s/ Russell A. Colombo
Russell A. Colombo, President and Chief Executive Officer

/s/ Christina J. Cook
Christina J. Cook, EVP and Chief Financial Officer

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CONSOLIDATED STATEMENTS OF CONDITION
at December 31, 2011 and 2010

(in thousands, except share data)		December 31, 2011		December 31, 2010
Assets				
Cash and due from banks	$	127,732	$	65,724
Short-term investments		2,011		19,508
Cash and cash equivalents		129,743		85,232
Investment securities				
Held to maturity, at amortized cost		59,738		34,917
Available for sale (at fair value, amortized cost $132,348 and $109,070 at December 31, 2011 and 2010, respectively)		135,104		111,736
Total investment securities		194,842		146,653
Loans, net of allowance for loan losses of $14,639 and $12,392 at December 31, 2011 and 2010, respectively		1,016,515		929,008
Bank premises and equipment, net		9,498		8,419
Interest receivable and other assets		42,665		38,838
Total assets	$	1,393,263	$	1,208,150
Liabilities and Stockholders' Equity				
Liabilities				
Deposits				
Non-interest bearing	$	359,591	$	282,195
Interest bearing				
Transaction accounts		134,673		105,177
Savings accounts		75,617		56,760
Money market accounts		434,461		371,352
CDARS® time accounts		46,630		67,261
Other time accounts		152,000		132,994
Total deposits		1,202,972		1,015,739
Federal Home Loan Bank borrowings		35,000		55,000
Subordinated debenture		5,000		5,000
Interest payable and other liabilities		14,740		10,491
Total liabilities		1,257,712		1,086,230
Stockholders' Equity				
Preferred stock, no par value				
Authorized - 5,000,000 shares; none issued		---		---
Common stock, no par value				
Authorized - 15,000,000 shares				
		56,854		55,383

Issued and outstanding - 5,336,927 shares and 5,290,082 shares at December 31, 2011 and 2010, respectively				
Retained earnings		77,098		64,991
Accumulated other comprehensive income, net		1,599		1,546
Total stockholders' equity		135,551		121,920
Total liabilities and stockholders' equity	$	1,393,263	$	1,208,150

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

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CONSOLIDATED STATEMENTS OF INCOME
for the fiscal years ended December 31, 2011, 2010 and 2009

(in thousands, except per share data)	December 31, 2011	Years ended December 31, 2010	December 31, 2009
Interest income			
Interest and fees on loans	$ 63,479	$ 56,239	$ 54,816
Interest on investment securities			
Securities of U.S. Government agencies	3,478	3,234	3,304
Obligations of state and political subdivisions	1,299	1,146	1,103
Corporate debt securities and other	636	593	506
Interest on Federal funds sold and short-term investments	222	145	5
Total interest income	69,114	61,357	59,734
Interest expense			
Interest on interest bearing transaction accounts	151	110	115
Interest on savings accounts	98	104	94
Interest on money market accounts	1,286	2,467	3,235
Interest on CDARS® time accounts	237	842	721
Interest on other time accounts	1,314	1,495	1,541
Interest on borrowed funds	2,209	1,430	1,461
Total interest expense	5,295	6,448	7,167
Net interest income	63,819	54,909	52,567
Provision for loan losses	7,050	5,350	5,510
Net interest income after provision for loan losses	56,769	49,559	47,057
Non-interest income			
Service charges on deposit accounts	1,836	1,797	1,782
Wealth Management and Trust Services	1,834	1,521	1,383
Other income	2,599	2,203	2,017
Total non-interest income	6,269	5,521	5,182
Non-interest expense			
Salaries and related benefits	20,211	18,240	17,001
Occupancy and equipment	4,002	3,576	3,516
Depreciation and amortization	1,293	1,344	1,370
FDIC insurance	1,000	1,506	1,800
Data processing	2,690	1,916	1,650
Professional services	2,499	1,917	1,727
Other expense	6,588	4,858	4,632
Total non-interest expense	38,283	33,357	31,696
Income before provision for income taxes	24,755	21,723	20,543
Provision for income taxes	9,191	8,171	7,778
Net income	$ 15,564	$ 13,552	$ 12,765

Preferred stock dividends and accretion		---		---	$	(1,299)
Net income available to common stockholders	$	15,564	$	13,552	$	11,466
Net income per common share:						
Basic	$	2.94	$	2.59	$	2.21
Diluted	$	2.89	$	2.55	$	2.19
Weighted average shares used to compute net income per common share:						
Basic		5,302		5,238		5,182
Diluted		5,384		5,314		5,242
Dividends declared per common share	$	0.65	$	0.61	$	0.57

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

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CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
for the fiscal years ended December 31, 2011, 2010 and 2009

(dollars in thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income, Net of Taxes	Total
Balance at December 31, 2008	27,055	5,146,798	51,965	46,138	388	125,546
Comprehensive Income:						
Net income	---	---	---	12,765	---	12,765
Other comprehensive income						
Net change in unrealized gain on available for sale securities (net of tax effect of $168)	---	---	---	---	230	230
Comprehensive income	---	---	---	12,765	230	12,995
Accretion of preferred stock	945	---	---	(945)	---	---
Repurchase of preferred stock	(28,000)	---	---	---	---	(28,000)
Stock options exercised	---	61,175	873	---	---	873
Excess tax benefit - stock-based compensation	---	---	291	---	---	291
Stock issued under employee stock purchase plan	---	894	24	---	---	24
Restricted stock granted	---	11,575	---	---	---	---
Stock-based compensation - stock options	---	---	330	---	---	330
Stock-based compensation - restricted stock	---	---	73	---	---	73
Cash dividends paid on common stock	---	---	---	(2,960)	---	(2,960)
Dividends on preferred stock	---	---	---	(354)	---	(354)
Stock issued in payment of director fees	---	9,087	233	---	---	233
Balance at December 31, 2009	---	5,229,529	$53,789	$54,644	$ 618	$109,051
Net income	---	---	---	13,552	---	13,552
Other comprehensive income						
Net change in unrealized gain on available for sale securities (net of tax effect of $672)	---	---	---	---	928	928
Comprehensive income	---	---	---	13,552	928	14,480
Stock options exercised	---	49,940	895	---	---	895
Excess tax benefit - stock-based compensation	---	---	132	---	---	132
Stock issued under employee stock purchase plan	---	563	17	---	---	17
Restricted stock granted	---	6,150	---	---	---	---
Restricted stock forfeited / cancelled	---	(2,320)	---	---	---	---
	---	---	241	---	---	241

Stock-based compensation - stock options						
Stock-based compensation - restricted stock	---	---	109	---	---	109
Cash dividends paid on common stock	---	---	---	(3,205)	---	(3,205)
Stock issued in payment of director fees	---	6,220	200	---	---	200
Balance at December 31, 2010	---	5,290,082	$55,383	$64,991	$ 1,546	$121,920
Net income	---	---	---	15,564	---	15,564
Other comprehensive income						
Net change in unrealized gain on available for sale securities (net of tax effect of $37)	---	---	---	---	53	53
Comprehensive income	---	---	---	15,564	53	15,617
Stock options exercised	---	34,913	741	---	---	741
Excess tax benefit - stock-based compensation	---	---	120	---	---	120
Stock issued under employee stock purchase plan	---	982	33	---	---	33
Restricted stock granted	---	5,675	---	---	---	---
Restricted stock forfeited / cancelled	---	(315)	---	---	---	---
Stock-based compensation - stock options	---	---	234	---	---	234
Stock-based compensation - restricted stock	---	---	143	---	---	143
Cash dividends paid on common stock	---	---	---	(3,457)	---	(3,457)
Stock issued in payment of director fees	---	5,590	200	---	---	200
Balance at December 31, 2011	---	5,336,927	$56,854	$77,098	$ 1,599	$135,551

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

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BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
for the fiscal years ended December 31, 2011, 2010 and 2009

(in thousands)	Year ended December 31, 2011	2010	2009
Cash Flows from Operating Activities:			
Net income	$15,564	$13,552	$12,765
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	7,050	5,350	5,510
Compensation expense--common stock for director fees	200	200	210
Stock-based compensation expense	377	350	403
Excess tax benefits from exercised stock options	(99)	(102)	(157)
Amortization and impairment write-off of core deposit intangible	725	---	---
Amortization of investment security premiums, net of accretion of discounts	1,385	1,194	337
Accretion on acquired loans	(4,275)	---	---
Decrease in deferred loan origination fees, net1	(1,200)	(119)	(172)
Loss on sale of investment securities	---	---	4
Depreciation and amortization	1,293	1,344	1,370
Bargain purchase gain on acquisition, net of tax	(85)	---	---
Loss on disposal of premise and equipment	117	3	---
Earnings on bank owned life insurance policies1	(752)	(690)	(696)
(Gain) loss on sale of repossessed assets	(10)	15	29
Net change in operating assets and liabilities:			
Interest receivable	(431)	131	(257)
Interest payable	(33)	97	57
Deferred rent and other rent-related expenses	236	253	260
Other assets1	1,051	713	(6,507)
Other liabilities	1,268	1,138	675
Net cash provided by operating activities	22,381	23,429	13,831
Cash Flows from Investing Activities:			
Proceeds from sale of premises and equipment	18	---	---
Purchase of securities held to maturity	(26,804)	(5,464)	(8,706)
Purchase of securities available for sale	(92,686)	(50,517)	(57,814)
Proceeds from sale of securities	---	---	5,343
Proceeds from paydowns/maturity of:			
Securities held to maturity	1,755	790	320
Securities available for sale	68,251	37,158	36,209
Loans originated and principal collected, net1	(25,182)	(26,804)	(33,984)
Purchase of bank owned life insurance policies	(2,500)	---	---
Purchase of premises and equipment	(2,472)	(1,723)	(1,121)
Proceeds from sale of repossessed assets	421	216	42
Cash receipt from acquisition	44,042	---	---
Redemption of Federal Home Loan Bank stock	219	---	---
Net cash used in investing activities	(34,938)	(46,344)	(59,711)

Cash Flows from Financing Activities:			
Net increase in deposits	93,152	71,678	91,771
Proceeds from stock options exercised	741	895	873
Repayment of Federal Home Loan Bank borrowings	(33,500)	---	(1,800)
Preferred stock repurchased	---	---	(28,000)
Cash dividends paid on common stock	(3,457)	(3,205)	(2,960)
Cash dividends paid on preferred stock	---	---	(451)
Stock issued under employee stock purchase plan	33	17	24
Excess tax benefits from exercised stock options	99	102	157
Net cash provided by financing activities	57,068	69,487	59,614
Net increase in cash and cash equivalents	44,511	46,572	13,734
Cash and cash equivalents at beginning of period	85,232	38,660	24,926
Cash and cash equivalents at end of period	$129,743	$85,232	$38,660
Supplemental disclosure of cash flow information:			
Cash paid for interest	$5,328	$7,246	$7,110
Cash paid for income taxes	$9,159	$7,610	$8,571
Supplemental disclosure of non-cash investing and financing activities:			
Loans transferred to repossessed assets	$301	$270	$168
Stock issued in payment of director fees	$200	$200	$233
Accretion of preferred stock	---	---	$945
Acquisition:			
Fair value of assets acquired	$107,763	---	---
Fair value of liabilities assumed	$107,678	---	---

1 Amounts for prior periods have been reclassified to conform to current financial statement presentation.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Introductory Explanation

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

Note 1: Summary of Significant Accounting Policies

Basis of Presentation: The consolidated financial statements include the accounts of Bank of Marin Bancorp (“Bancorp”), a bank holding company, and its sole and wholly-owned bank subsidiary, Bank of Marin (the “Bank”, a California state-chartered commercial bank). All material intercompany transactions have been eliminated. In the opinion of Management, the consolidated financial statements contain all adjustments necessary to present fairly the financial position, results of operations, changes in stockholders’ equity and cash flows. All adjustments are of a normal, recurring nature. We have evaluated subsequent events through the date of filing with the Securities and Exchange Commission (“SEC”) and have determined that there are no subsequent events that require additional recognition or disclosure.

Nature of Operations: Bancorp, headquartered in Novato, CA, conducts business primarily through its wholly-owned subsidiary, the Bank, which provides a wide range of financial services to customers, who are predominantly professionals, small and middle-market businesses, and individuals who work and/or reside in Marin, Napa, San Francisco and Sonoma counties. Besides the headquarter office in Novato, CA, the Bank operates ten branches in Marin County, one in Napa County, one in San Francisco and five in Sonoma County. Our accounting and reporting policies conform to generally accepted accounting principles and general practice within the banking industry. A summary of our significant policies follows.

Cash and Cash Equivalents include cash, due from banks, Federal funds sold and other short-term investments with maturity less than three months at the time of origination.

Investment Securities are classified as "held to maturity," "trading securities" or "available for sale." Investments classified as held to maturity are those that we have the ability and intent to hold until maturity and are reported at cost, adjusted for the amortization or accretion of premiums or discounts. Investments held for resale in anticipation of short-term market movements are classified as trading securities and are reported at fair value, with unrealized gains and losses included in earnings. Investments that are neither held to maturity nor trading are classified as available for sale and are reported at fair value. Unrealized gains and losses, net of related tax, are reported as a separate component of comprehensive income and included in stockholders' equity until realized. For discussion of our methodology in determining fair value, see Note 10.

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

For each security in an unrealized loss position, we assess whether we intend to sell the security, or it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired, are not intended for sale and will not be required to be sold prior to recovery of our amortized cost basis, we separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is calculated as the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is deemed to be due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes. The other-than-temporary impairment recognized in other comprehensive income for debt securities classified as held-to-maturity is accreted from other comprehensive income to the amortized cost of the debt security over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized when earned. Realized gains and losses for securities are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Originated Loans are reported at the principal amount outstanding net of deferred fees, charge-offs and the allowance for loan losses ("ALLL"). Interest income is accrued daily using the simple interest method. Loans are placed on non-accrual status when Management believes that there is doubt as to the collection of principal or interest, generally when they become contractually past due by ninety days or more with respect to principal or interest, except for loans that are well-secured and in the process of collection. When loans are placed on non-accrual status, any accrued but uncollected interest is reversed from current-period interest income and interest income is recorded only after the loan is brought current or after all principal and past due interest has been collected. For loans whose contractual terms have been restructured in a manner which grants a concession to a borrower experiencing financial difficulties ("troubled debt restructuring"), they are returned to accrual status when there has been a sustained period of repayment performance (generally, six consecutive monthly payments) according to the modified terms and there is reasonable assurance of repayment and of performance.

Loan origination fees and commitment fees, offset by certain direct loan origination costs, are deferred and amortized as yield adjustments over the contractual lives of the related loans.

Loan Charge-Off Policy: For all types of loans except overdraft accounts, we generally fully or partially charge down to its net realizable value for a non-collateral-dependent loan, or the fair value of collateral securing the loan for a collateral-dependent loan when: (1) it is deemed uncollectable; (2) the loan has been classified as a loss by either our internal loan review process or external examiners; or (3) the loan is 180 days past due unless both well secured and in the process of collection. For an overdraft account, we generally charge it off when it is more than 90 days delinquent.

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 specific allowances for individually identified impaired loans, an allowance factor for pools of credits and allowances for changing environmental factors (e.g., portfolio trends, concentration of credit, growth, economic factors, etc.).

The first component, the specific allowance, results from the analysis of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. Through Management's ongoing loan grading and credit monitoring process, individual loans are identified that have conditions that indicate the borrower may be unable to pay all amounts due under the contractual terms. These loans are evaluated for impairment individually by Management. Management considers a loan to be impaired when it is probable we will be unable to collect all amounts due according to the contractual terms of the loan agreement. When the fair value of the impaired loan is less than the recorded investment in the loan, the difference is recorded as 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, based on the loan's observable market price, or based on the fair value of the collateral, if the loan is collateral dependent. 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.

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The second component is an estimate of the probable inherent losses in each loan pool stratified by major segments of loans with similar characteristics in our loan portfolio. This analysis encompasses our entire loan portfolio and excludes acquired loans where the discount has not been fully accreted. Loans are segmented into the following pools: commercial real estate, construction, commercial, and consumer loans. Management also sub-segments these segments into classes based on the associated risks within those segments. Commercial real estate loans are divided into the following two classes: owner-occupied and non-owner-occupied. Consumer loans are divided into three classes: residential real estate, home equity and other consumer loans. The total amount allocated for the second component is determined by applying loss multipliers to outstanding loans in each loan pool. Loss multipliers for loan pools are based on analysis of local economic factors, current loan portfolio quality, historical loss experience and trends applicable to each loan pool. Local economic factors considered include state and local unemployment rates, occupancy rates and sales statistics as external criteria for loan loss estimation. In addition, additional loss factors are applied to substandard loans based on the increased risk of loss inherent in those credits.

The third component of the ALLL is an economic component, which is Management's best estimate of the probable impact that economic changes may have on the loan portfolio as a whole. It is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by portfolio trends, concentration of credit, growth, and economic trends.

Acquired Loans are recorded at their estimated fair values at acquisition date, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses is not carried over or recorded for acquired loans as of the acquisition date.

Purchased credit-impaired (“PCI”) loans are those acquired with evidence of credit quality deterioration subsequent to their origination and for which it was probable, at acquisition, that we would be unable to collect all contractually required payments. Management has applied significant judgment in determining which loans are PCI loans. Evidence of credit quality deterioration as of the purchase date may include statistics such as past due and nonaccrual status, risk grades and recent loan-to-value percentages. Revolving credit agreements (e.g. home equity lines of credit and revolving commercial loans), if at the acquisition date the borrower had revolving privileges, are not considered PCI loans as cash flows cannot be reasonably estimated.

The excess of the cash flows of PCI loans initially expected to be collected over the fair value of the loans at the acquisition date (i.e., the accretable yield) is accreted into interest income using the effective yield method, provided that the timing and amount of future cash flows is reasonably estimable. The difference between the contractually required payments and the cash flows expected to be collected at acquisition, considering the impact of prepayments, is referred to as the nonaccretable difference and is not recorded. The estimate of cash flows expected to be collected is updated quarterly and requires the continued usage of key assumptions and estimates similar to the initial estimate of fair value. For discussion of the initial assumptions used in determining the fair value of the acquired loans, see Note 2.

For purposes of accounting for the PCI loans purchased in the FDIC1-assisted acquisition of certain assets and the assumption of certain liabilities of the former Charter Oak Bank on February 18, 2011 (the “Acquisition”), we elected to account for these loans individually. Resolution of loans, which may include sales of loans to third parties, receipt of payments in full by the borrower and foreclosure of the collateral, result in removal of the loans from the PCI loan portfolio at its carrying amount, and any gains and losses as a result of resolutions are included in interest income.

Subsequent to the Acquisition, if we have probable decreases in cash flows expected to be collected (other than due to decreases in interest rate indices), we charge the provision for loan losses and specific allowances are allocated to PCI loans that have experienced credit deterioration. If we have probable and significant increases in cash flows expected to be collected on PCI loans, we first reverse any previously established specific allowances and then increase interest

income as a prospective yield adjustment over the remaining life of the loans. Changes in cash flows due to changes in interest rate indices for variable rate loans and prepayment assumptions are recorded in interest income via prospective yield adjustment. At Acquisition, PCI loans with future cash flows that could be reasonably estimated were not classified as nonperforming because we believed that we would fully collect the new carrying value of these loans. When there is doubt as to the timing and amount of future cash flows to be collected, PCIs are classified as non-accrual loans. It is important to note that judgment is required to classify PCI loans as performing or non-accrual, and is dependent on having a reasonable expectation about the timing and amount of cash flows expected to be collected.

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1 Federal Deposit Insurance Corporation

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For acquired loans not considered credit-impaired, the difference between the contractual amounts due (unpaid principal amount) and the fair value is accreted to interest income over the lives of the loans. We elect to recognize the entire fair value discount based on the acquired loan's contractual cash flows using an effective interest rate method for term loans, and a straight line method for revolving lines, as the timing and amount of cash flows under revolving lines are not predictable. The accretion is recognized through the net interest margin. Subsequent to the Acquisition, if the probable and estimable losses for non-PCI loans exceed the amount of the remaining unaccreted discount, the excess is established as an ALLL.

For further information regarding our acquired loans, see Note 2 and Note 4.

Transfers of Financial Assets: We have entered into certain participation agreements with other organizations. We account for these transfers of financial assets as sales when control over the transferred financial assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from us, (2) the transferee has the right to pledge or exchange the assets (or beneficial interests) it received, free of conditions that constrain it from taking advantage of that right, and (3) we do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets. No gain or loss has been recognized by us on the sale of these participation interests through December 31, 2011.

Premises and Equipment consist of leasehold improvements, furniture, fixtures and equipment and are stated at cost, less accumulated depreciation and amortization, which are calculated on a straight-line basis over the estimated useful life of the property or the term of the lease (if less). Furniture and fixtures are depreciated over eight years and equipment is generally depreciated over three to twenty years. Leasehold improvements are amortized over the lesser of their estimated useful lives or the terms of the leases. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred.

Employee Stock Ownership Plan ("ESOP"): We recognize compensation cost of the ESOP contribution when funds become committed for the purchase of Bancorp's common shares into the ESOP in the year in which the employees render service entitling them to the contribution. If we contribute stock, the compensation cost is the fair value of the shares when they are committed to be released, i.e. when the number of shares becomes known. During 2011 and 2010, the Bank only made cash contributions to the ESOP without leveraging.

Income Taxes reported in the consolidated financial statements are computed based on an asset and liability approach. We recognize the amount of taxes payable or refundable for the current year, and deferred tax assets and liabilities for the future tax consequences that have been recognized in the financial statement or tax returns. The measurement of tax assets and liabilities is based on the provisions of enacted tax laws. Bancorp files consolidated federal and combined state income tax returns.

Earnings per share ("EPS") are based upon the weighted average number of common shares outstanding during each year. The following table shows: (1) weighted average basic shares, (2) potential common shares related to stock options, non-vested restricted stock, and stock warrant, and (3) weighted average diluted shares. Net income available to common stockholders is calculated as net income reduced by dividends accumulated on preferred stock and amortization of discounts on the preferred stock. Basic EPS are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock awards. Diluted EPS are calculated using the weighted average diluted shares. The number of potential common shares included in annual diluted EPS is a year-to-date weighted average of the number of potential common shares included in each quarterly diluted EPS computation under the treasury stock method. 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 stockholders and they both share

equally in undistributed earnings.

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(in thousands, except per share data)		2011		2010		2009
Weighted average basic shares outstanding		5,302		5,238		5,182
Add: Potential common shares related to stock options		41		46		47
Potential common shares related to non-vested restricted stock		4		4		2
Potential common shares related to warrant		37		26		11
Weighted average diluted shares outstanding		5,384		5,314		5,242
Net income	$	15,564	$	13,552	$	12,765
Preferred stock dividends and accretion		---		---		(1,299)
Net income available to common stockholders	$	15,564	$	13,552	$	11,466
Basic EPS	$	2.94	$	2.59	$	2.21
Diluted EPS	$	2.89	$	2.55	$	2.19
Weighted average anti-dilutive shares not included in the calculation of diluted EPS-Stock options		70		151		156

Share-Based Compensation: All share-based payments granted subsequent to January 1, 2006, including stock options and restricted stock, are recognized as stock-based compensation expense in the statements of income based on the grant-date fair value of the award with a corresponding increase in common stock. The grant-date fair value of the award is amortized over the requisite service period, which is generally the vesting period. The stock-based compensation expense also includes share-based awards granted prior to, but not yet vested as of January 1, 2006, the date we adopted grant-date fair value accounting for share-based payments.

We determine fair value at grant date using the Black-Scholes pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock, the expected dividend yield and the risk-free interest rate over the expected life of the option. The Black-Scholes option valuation model requires the input of highly subjective assumptions, including the expected life of the stock-based award and stock price volatility. The assumptions used represent Management's best estimates based on historical information, but these estimates involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, the recorded stock-based compensation expense could have been materially different from that recorded in its financial statements. In addition, we are required to estimate the expected forfeiture rates. If our actual forfeiture rate is materially different from the estimate, the share-based compensation expense could be materially different.

Derivative Financial Instruments and Hedging Activities:

Fair Value Hedges: All of our interest rate swap contracts are designated and qualified as fair value hedges. We apply shortcut hedge accounting for one of our interest rate swap contracts, as it is structured to mirror all of the provisions of the hedged loan agreement. This interest rate swap is carried on the consolidated statements of condition at its fair value in other assets (when the fair value is positive) or in other liabilities (when the fair value is negative). The change in the fair value of the interest rate swap is recorded in other non-interest income. As a result of interest rate fluctuations, the hedged fixed-rate loan also gains or loses market value. The unrealized gain or loss resulting from the change in market value of the hedged-loan is recorded as an adjustment to the hedged loan and offset in other non-interest income. Under shortcut hedge accounting treatment, the change in fair value of the interest rate swap is deemed perfectly offset by the change in fair value of the hedged loan, resulting in zero impact to net income.

Six of our interest rate swap contracts are accounted for using non-shortcut hedge accounting treatment. The interest

rate swaps are closely aligned to the terms of the designated fixed-rate loans. The hedging relationships are tested for effectiveness on a quarterly basis. The interest rate swaps are carried on the consolidated statements of condition at their fair value in other assets (when the fair value is positive) or in other liabilities (when the fair value is negative). The changes in the fair value of the interest rate swaps are recorded in interest income. The unrealized gains or losses due to changes in fair value of the hedged fixed-rate loans are recorded as an adjustment to the hedged loans and offset in interest income. For derivative instruments executed with the same counterparty under a master netting arrangement, we do not offset fair value amounts of interest rate swaps in liability position with the ones in asset position. For further detail, see Note 15.

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Advertising Costs are expensed as incurred. For the years ended December 31, 2011, 2010, and 2009, advertising costs totaled $589 thousand, $459 thousand, and $528 thousand, respectively.

Comprehensive Income for Bancorp includes net income reported on the statements of income and changes in the fair value of investment securities available for sale, net of related taxes, reported as a component of stockholders' equity.

Segment Information: Our two operating segments include the traditional community banking activities provided through our branch network and our Wealth Management and Trust Services ("WMTS"). The activities of these two segments are monitored and reported by Management as separate operating segments. The accounting policies of the segments are the same as those described in this note. We evaluate segment performance based on total segment revenue and do not allocate expenses between the segments. WMTS revenues were $1.8 million, $1.5 million and $1.4 million in 2011, 2010 and 2009, respectively, which are included in non-interest income in the statements of income. Non-interest expenses applicable to WMTS totaled $1.3 million, $1.3 million and $1.2 million in 2011, 2010 and 2009, respectively. The revenues of the community banking segment are reflected in all other income lines in the statements of income.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant accounting estimates reflected in the consolidated financial statements include ALLL, other-than-temporary impairment of investment securities, estimated cash flows on PCI loans, accounting for income taxes and fair value measurements as discussed in the Notes herein.

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. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. This ASU is effective for annual periods beginning on or after January 1, 2013, and interim periods within those annual periods. We do not expect this ASU to have a significant impact on our financial condition or results of operations.

In June 2011, the FASB issued ASU No. 2011-05 Comprehensive Income (Topic 220) Presentation of Comprehensive Income. The ASU improves the comparability, consistency, and transparency of financial reporting and increases the prominence of items reported in other comprehensive income. The amendments to Topic 220, Comprehensive Income, require entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Entities are no longer permitted to present components of other comprehensive income as part of the statement of changes in stockholders' equity. Any adjustments for items that are reclassified from other comprehensive income to net income are to be presented on the face of the entities' financial statement regardless of the method of presentation for comprehensive income. The amendments do not change items to be reported in comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor do the amendments change the option to present the components of other comprehensive income either net of related tax effects or before related tax effects. In December 2011, the FASB issued ASU No. 2011-12 Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of

Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards which supersedes certain pending paragraphs in ASU No. 2011-05 that pertain to how, when, and where reclassification adjustments are presented. This ASU is effective for fiscal years, and interim periods beginning on or after December 15, 2011. The specific requirement to present items that are reclassified from other comprehensive income to net income alongside their respective components of net income and other comprehensive income is deferred until the FASB re-deliberates. We do not expect this ASU to have an impact on our financial condition or results of operations as it affects presentation only.

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In May 2011, the FASB issued ASU No. 2011-04 Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The ASU improves the comparability of fair value measurements presented and disclosed in accordance with U.S. GAAP and IFRS by changing the wording used to describe many of the requirements in U.S GAAP for measuring fair value and disclosure of information. The amendments to this ASU provide explanations on how to measure fair value but do not require any additional fair value measurements and do not establish valuation standards or affect valuation practices outside of financial reporting. The amendments clarify existing fair value measurements and disclosure requirements to include application of the highest and best use and valuation premises concepts; measuring fair value of an instrument classified in a reporting entity's shareholders' equity; and disclosure requirements regarding quantitative information about unobservable inputs categorized within Level 3 of the fair value hierarchy. In addition, clarification is provided for measuring the fair value of financial instruments that are managed in a portfolio and the application of premiums and discounts in a fair value measurement. For public entities, ASU 2011-04 is effective during interim and annual periods beginning after December 15, 2011. We do not expect this ASU to have a significant impact on our financial condition or results of operations.

In April 2011, the FASB issued ASU No. 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. The ASU clarifies which loan modifications constitute troubled debt restructurings. It is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring ("TDR"), both for purposes of recording an impairment loss and for disclosure of a TDR. In evaluating whether a restructuring constitutes a TDR, a creditor must separately conclude that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. The amendments to ASU Topic 310, Receivables, clarify the guidance on a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. ASU No. 2011-02 is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. We have adopted this ASU in the third quarter of 2011 and provided the applicable disclosure in Note 4 herein.

In December 2010, the FASB issued ASU No. 2010-29, Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations to address diversity in practice about the interpretation of the pro forma revenue and earnings disclosure requirements for business combinations. This ASU is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning January 1, 2011. It requires a public entity to disclose pro forma revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma revenue and earnings of the combined entity for the comparable prior reporting period should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period. The amendments also expand the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. Refer to Note 2 for further information.

Note 2: Acquisition

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

The P&A Agreement only covers designated assets and liabilities of Charter Oak Bank. Common stock of Charter

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

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

In FDIC-assisted transactions, only certain assets and liabilities are transferred to the acquirer and, depending on the nature and amount of the acquirer's bid, the FDIC may be required to make a cash payment to the acquirer or the acquirer may be required to make payment to the FDIC. We received cash totaling $32.6 million from the FDIC upon initial settlement of the transaction and recorded a receivable from the FDIC of $196 thousand, for consideration of the net liabilities assumed (i.e., the net difference between the liabilities assumed and the assets acquired). The $196 thousand receivable was settled in August 2011.

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

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

The bargain purchase gain represents the excess of the estimated fair value of the assets acquired over the estimated fair value of the liabilities assumed. We did not immediately acquire the banking facilities, including outstanding lease agreements, furniture, fixtures and equipment, as part of the P&A Agreement as of the acquisition date. We have since acquired all data processing equipment and the Napa branch fixed assets totaling $206 thousand, and renegotiated a new lease with the landlord. The smaller St. Helena branch acquired from Charter Oak Bank was closed effective April 29, 2011.

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

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

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

Loans

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

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

- For commercial and agriculture loans, a ten percent constant prepayment rate (“CPR”) was assumed based on research data associated with these loan types;
- A one percent CPR was assumed for commercial real estate, construction and land loans as research data indicated limited prepayment activity over the life of these loans;
- For single family residential loans, a twenty percent CPR was used, based on research data associated with these loan types;
- For home equity lines of credit, a CPR of fifteen percent was assumed based on the refinance likelihood and other research; and,
- For other consumer loans, a CPR of one and a half percent was used based on capital markets research data for consumer unsecured credit.

Prepayment assumptions were not factored into the calculation of expected cash flows on PCI loans. For more information, refer to Note 4 under "Purchased Credit-Impaired Loans".

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

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Deposits

The fair values used for the transaction, savings and money market deposits are equal to the amounts payable on demand at the reporting date. The fair values for time deposits were estimated using a discounted cash flow calculation that applies interest rates offered by market participants as of the acquisition date on time deposits with similar maturity terms as the discount rates. We recorded a core deposit intangible asset of $725 thousand at Acquisition, of which $683 thousand was written-off in the fourth quarter of 2011 and $42 thousand was amortized over the year. This write-off was primarily due to greater than anticipated runoff of the acquired deposits and a significant decline in alternative funding costs since the Acquisition. For income tax purposes, we continue to amortize the core deposit intangible asset over fifteen years.

Advances from the Federal Home Loan Bank

The advances from the Federal Home Loan Bank San Francisco (“FHLB”) were recorded at their estimated fair value, which was based on quoted prices supplied by the FHLB. Subsequent to the acquisition date, all of these advances were repaid in full in the first quarter of 2011.

Pro Forma Results of Operations

The contribution of the acquired operations of the former Charter Oak Bank to our results of operations for the period February 18 to December 31, 2011 is as follows: revenue of $9.1 million, expenses of $5.8 million (including a provision for loan losses of $2.3 million), resulting in income after income taxes of $2.0 million. These amounts include the bargain purchase gain, Acquisition-related third-party costs, accretion of the discount on the acquired loans, gains on payoff of PCI loans, amortization of the fair value mark on time deposits and the core deposit intangible amortization and write-off. Charter Oak Bank’s results of operations prior to the acquisition date are not included in our operating results for 2011. The contribution discussed above excludes allocated overhead and allocated cost of funds.

We acquired only certain assets and assumed certain liabilities from the former Charter Oak Bank. A significant portion of the former Charter Oak Bank’s operations, including certain delinquent loans, its St. Helena facilities and its central operations and administrative functions were not retained by us. Therefore, disclosure of supplemental pro forma financial information, especially prior period comparison is deemed neither practical nor meaningful given the troubled nature of Charter Oak Bank prior to the date of Acquisition. Additionally, the acquired operation was not considered significant, as defined by the Securities and Exchange Commission.

Acquisition-related expenses were recognized as incurred and continued until all systems had been converted and operational functions became fully integrated. We incurred third-party acquisition-related expenses in the following line items in the consolidated statements of income for the year ended December 31, 2011 as follows:

Acquisiton-related Expenses (in thousands)	Year Ended December 31, 2011
Professional services	$ 457
Data processing	455
Other	88
Total	$ 1,000

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Note 3: Investment Securities

Our investment securities portfolio at December 31, 2011 and 2010 consists primarily of U.S. government agency securities, including mortgage-backed securities ("MBS") and collateralized mortgage obligations ("CMOs") issued or guaranteed by FNMA, FHLMC, or GNMA. Our portfolio also includes obligations of state and political subdivisions, corporate bonds, debentures issued by government-sponsored agencies such as FNMA and FHLMC, as well as privately issued CMOs and Visa stock, as reflected in the table below:

	December 31, 2011				December 31, 2010			
(in thousands)	Amortized Cost	Fair Value	Gross Unrealized Gains	Gross Unrealized (Losses)	Amortized Cost	Fair Value	Gross Unrealized Gains	Gross Unrealized (Losses)
Held to maturity								
Obligations of state and political subdivisions	$ 54,738	$ 57,226	$ 2,688	$ (200)	$ 34,917	$ 35,090	$ 666	$ (493)
Corporate bonds	5,000	4,959	---	(41)	---	---	---	---
Total held to maturity	59,738	62,185	2,688	(241)	34,917	35,090	666	(493)
Available for sale								
Securities of U. S. government agencies:								
MBS pass-through securities issued by FNMA and FHLMC	26,360	27,486	1,126	---	16,119	16,424	419	(114)
CMOs issued by FNMA	10,775	11,099	324	---	12,770	13,236	466	---
CMOs issued by FHLMC	18,853	19,386	533	---	19,725	20,177	452	---
CMOs issued by GNMA	49,940	50,886	946	---	44,607	45,421	884	(70)
Debentures of government sponsored agencies	8,000	8,050	50	---	---	---	---	---
Privately issued CMOs	18,420	18,197	116	(339)	15,849	15,870	185	(164)
Visa stock	---	---	---	---	---	608	608	---
Total available for sale	132,348	135,104	3,095	(339)	109,070	111,736	3,014	(348)
Total investment securities	$ 192,086	$ 197,289	$ 5,783	$ (580)	$ 143,987	$ 146,826	$ 3,680	$ (841)

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock at a zero cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s covered litigation escrow account. The conversion rate will be determined upon the final resolution of the Visa Inc. covered litigation described in Note 13. The stock was re-classified from available-for-sale securities to other assets in March 2011 where it is accounted for on a cost basis. As the stock is still currently restricted from resale based on information received from Visa Inc, the unrealized gain on the stock, net of tax, at December 31, 2010 was reversed from other comprehensive income. The fair value of the Class B common stock we own was $732 thousand and $608 thousand at December 31, 2011 and December 31, 2010, respectively, based on the Class A as-converted rate of 0.4254 and 0.5102, respectively.

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

	December 31, 2011			
	Held to Maturity		Available for Sale	
(in thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	$ 3,343	$ 3,367	---	---
After one but within five years	22,940	23,133	$ 11,439	$ 11,616
After five years through ten years	22,145	24,240	11,334	11,507
After ten years	11,310	11,445	109,575	111,981
Total	$ 59,738	$ 62,185	$ 132,348	$ 135,104

There were no sales of available-for-sale or held-to-maturity securities in 2011 or 2010. During 2009, four held-to-maturity securities issued by the same issuer with a combined carrying value of $1.1 million, and another held-to-maturity security with a carrying value of $335 thousand were sold due to evidence of significant deterioration of creditworthiness. The proceeds from the sales totaled $1.4 million and the transactions resulted in net losses of $9 thousand recorded against 2009 earnings. In 2009, we also sold one available-for-sale security with a carrying value of $3.9 million. The proceeds from the sale totaled $3.9 million and the sale resulted in a gain of $5 thousand recognized in earnings.

Investment securities carried at $53.6 million and $44.4 million at December 31, 2011 and 2010, respectively, were pledged with the State of California: $52.9 million and $42.3 million to secure public deposits in compliance with the Local Agency Security Program at December 31, 2011 and 2010, respectively, and $707 thousand and $667 thousand to provide collateral for trust deposits at December 31, 2011 and 2010, respectively. In addition, investment securities carried at $1.1 million and $1.4 million were pledged to collateralize an internal WMTS checking account at December 31, 2011 and 2010, respectively. At December 30, 2011 and 2010, $4.8 million and $3.7 million of securities, respectively, were pledged to collateralize interest rate swaps as discussed in Note 15. At December 31, 2011 and 2010, investment securities carried at zero and $1.3 million, respectively, were pledged with the Federal Reserve Bank of San Francisco ("FRBSF") to secure our Treasury, Tax and Loan account.

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Other-Than-Temporarily Impaired Debt Securities

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

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

December 31, 2011	< 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	$ 17,607	$ (174)	$ 1,775	$ (26)	$ 19,382	$ (200)
Corporate bonds	4,959	(41)	---	---	4,959	(41)
Total held to maturity	22,566	(215)	1,775	(26)	24,341	(241)
Available for sale						
Privately issued CMOs	8,173	(205)	3,757	(134)	11,930	(339)
Total available for sale	8,173	(205)	3,757	(134)	11,930	(339)
Total temporarily impaired securities	$ 30,739	$ (420)	$ 5,532	$ (160)	$ 36,271	$ (580)

December 31, 2010	< 12 continuous months		> 12 continuous months		Total Securities in a loss position	
(In thousands)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity						
Obligations of state & political subdivisions	$ 11,622	$ (250)	$ 1,687	$ (243)	$ 13,309	$ (493)
Available for sale						
Securities of U. S. Government Agencies	12,888	(184)	---	---	12,888	(184)
Privately issued CMOs	7,070	(164)	---	---	7,070	(164)
Total available for sale	19,958	(348)	---	---	19,958	(348)
Total temporarily impaired securities	$ 31,580	$ (598)	$ 1,687	$ (243)	$ 33,267	$ (841)

Obligations of U.S. states and political subdivisions in our portfolio are all investment grade without delinquency history. Only one of them was in a loss position for more than twelve continuous months as of December 31, 2011. This debenture was issued by a local subdivision with payments collected through special property tax assessments in an affluent community and has very low lien-to-value ratio. This security is expected to perform based on past payment history and will continue to be monitored as part of our ongoing impairment analysis. Four state and municipal securities were in a temporary loss position for less than twelve months. These securities were all rated above A-/A1 by Standard & Poor's/Moody. As a result, we concluded that these securities were not

other-than-temporarily impaired at December 31, 2011.

The one corporate bond in a temporary loss position was newly issued and purchased in December 2011. Both Moody's and S&P ratings indicate this security is high quality with very low credit risk. We believe the temporary decline in its fair market value is primarily driven by fluctuation in interest rates and it is probable that we will be able to collect all amounts due according to the contractual terms and no other-than-temporary impairment exists.

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The unrealized losses associated with privately issued CMOs and an asset-based security is primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities are privately issued by financial institutions with no guarantee from government sponsored agencies. They are collateralized by residential mortgages or home equity loans and may be prepaid at par prior to maturity. Most of these securities were AAA rated by at least one major rating agency. We estimate loss projections for each security by assessing loans collateralizing the security and determining expected default rates and loss severities. Based upon our assessment of expected credit losses of each security given the performance of the underlying collateral and credit enhancements where applicable, we concluded that these securities were not other-than-temporarily impaired at December 30, 2011.

Securities Carried at Cost

As a member of the FHLB, we are required to maintain a minimum investment in the FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can also increase in the event we need to increase our borrowing capacity with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at its $100 per share par value. We held $5.4 million and $5.0 million of FHLB stock recorded at cost in other assets at December 31, 2011 and 2010, respectively. On February 22, 2012, FHLB declared a cash dividend for the fourth quarter of 2011 at an annualized dividend rate of 0.48%. 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.

Note 4: Loans and Allowance for Loan Losses

The majority of our loan activity is with customers located in California, primarily in the counties of Marin, Napa, San Francisco and Sonoma. More than half of our loans are for commercial real estate, 79% of which are secured by real estate located in Marin, Napa, Sonoma and San Francisco counties, California. Approximately 85% and 86% of total loans were secured by real estate at December 31, 2011 and 2010, respectively.

Outstanding loans by class and payment aging at December 31, 2011 and 2010 are as follows:

Credit Quality of Loans

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

(dollars in thousands)	Commercial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential 1	Installment and other consumer	Total
December 31, 2011								
30-59 days past due	$ 371	$ 576	$ 6,060	$ -	$ 195	$ -	$ 7	$ 7,209
60-89 days past due	139	-	-	-	-	-	34	173
Greater than 90 days past due (non-accrual) 2	2,955	2,033	741	3,014	766	1,942	519	11,970
Total past due	3,465	2,609	6,801	3,014	961	1,942	560	19,352
Current	172,325	172,096	439,624	48,943	97,082	59,560	22,172	1,011,802
Total loans 3	$ 175,790	$ 174,705	$ 446,425	$ 51,957	$ 98,043	$ 61,502	$ 22,732	$ 1,031,154

Non-accrual loans to total loans	1.7 %	1.2 %	0.2 %	5.8 %	0.8 %	3.2 %	2.3 %	1.2 %
December 31, 2010								
30-59 days past due	$ 20	$ -	$ -	$ -	$ 25	$ -	$ 307	$ 352
60-89 days past due	-	-	-	-	-	-	-	-
Greater than 90 days past due (non-accrual) 2	2,486	632	-	9,297	-	148	362	12,925
Total past due	2,506	632	-	9,297	25	148	669	13,277
Current	151,330	141,958	383,553	68,322	86,907	69,843	26,210	928,123
Total loans 3	$ 153,836	$ 142,590	$ 383,553	$ 77,619	$ 86,932	$ 69,991	$ 26,879	$ 941,400
Non-accrual loans to total loans	1.6 %	0.4 %	-	12.0 %	-	0.2 %	1.3 %	1.4 %

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 December 31, 2011 amounts include $2.5 million PCI loans that have stopped accreting interest and exclude accreting PCI loans of $3.4 million, as their accretable yield interest recognition is independent from the underlying contractual loan delinquency status. There were no loans past due more than 90 days still accruing interest at December 30, 2011 or at December 31, 2010.
3 Amounts were net of deferred loan fees of $1.6 million and $2.8 million at December 31, 2011 and December 31, 2010, respectively.

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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 their 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 or other business assets such as accounts receivable or inventory and incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. We target stable local businesses with strong guarantors that have proven to be more resilient in periods of economic stress. Typically, the strong guarantors provide an additional source of repayment for our credit extensions.

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

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

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

We use a risk rating system as a tool used to evaluate asset quality, and to identify and monitor credit risk in individual loans, and ultimately in the portfolio. Definitions of risk grades of “Special Mention” or worse are consistent

with those used by the regulators. Our internally assigned grades are as follows:

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

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

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

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

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

- Generally, commercial borrowers with lines of credit are required to submit financial information regularly 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 as of December 31, 2011 and 2010:

Credit Quality Indicators As of December 31, 2011 and 2010

(in thousands)	Commercial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Purchased credit-impaired	Total
Credit Risk Profile by Internally Assigned Grade:									
December 31, 2011									
Pass	$ 148,806	$ 146,449	$ 433,307	$ 32,272	$ 93,188	$ 54,711	$ 21,648	$ 1,541	$ 931,922
Special Mention	7,874	18,434	4,877	-	838	2,010	-	529	34,562
Substandard	17,897	6,609	6,617	19,492	3,677	4,420	895	3,563	63,170
Doubtful	98	-	-	193	339	361	189	320	1,500
Total loans	$ 174,675	$ 171,492	$ 444,801	$ 51,957	$ 98,042	$ 61,502	$ 22,732	$ 5,953	$ 1,031,154
December 31, 2010									
Pass	$ 120,428	$ 135,443	$ 369,976	$ 57,779	$ 84,830	$ 64,570	$ 26,280	$ -	$ 859,306

Special mention	17,009	454	330	10,253	447	-	-	-	28,493
Substandard	16,169	6,693	13,247	9,587	1,655	5,421	427	-	53,199
Doubtful	230	-	-	-	-	-	172	-	402
Total loans	$ 153,836	$ 142,590	$ 383,553	$ 77,619	$ 86,932	$ 69,991	$ 26,879	$ -	$ 941,400

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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 may result from our loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. TDRs on nonaccrual status at the time of restructure may be returned to accruing status after considering the borrower’s sustained repayment performance for a reasonable period, generally six months.

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.

As a result of adopting the amendments in ASU No. 2011-02 discussed in Note 1, Management reassessed all loan modifications that occurred on or after January 1, 2011 for potential identification as TDRs. Management has identified TDRs for which the related allowance for loan losses had previously been measured under the general allowance for loan losses methodology. Upon identifying those receivables as TDRs, they are newly considered as impaired under the guidance in ASC Section 310-10-35. The amendments in ASU No. 2011-02 require prospective application of the impairment guidance in ASC Section 310-10-35 for those receivables newly identified as impaired. At the end of the first interim period of adoption (September 30, 2011), the recorded investment in receivables for which the allowance for loan losses had been previously measured under a general allowance for loan losses methodology and now considered impaired was $3.1 million, and the related specific allowance, based on a current evaluation of loss, was $11 thousand.

The table below, by loan class, presents the following information for all TDRs during 2011: 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. Modifications generally involved reductions in the interest rate, payment extensions or forbearances, or a combination of any of the above. As of December 31, 2010, there were $1.2 million of TDR loans (mostly installment and other consumer loans) which were performing. There were three TDRs in 2010 and 2011 with loan balances of $1.0 million that subsequently defaulted within twelve months of restructuring and were charged-off during 2011. The table below excludes fully charged-off TDR loans:

(dollars in thousands)	Number of Contracts Modified	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment at December 31, 20111
Troubled Debt Restructurings				
Commercial	27	$ 5,854	$ 5,940	$ 4,969
Commercial real estate, owner-occupied	2	1,366	1,403	1,403
Construction	2	817	817	800
Home equity	3	478	469	467
Other residential	3	1,467	1,467	1,464
Installment and other consumer	13	1,607	1,605	1,552

Total	50	$	11,589	$	11,701	$	10,655

1 Includes $6.3 million of TDR loans that were accruing interest as of December 31, 2011.

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

The table below summarizes information on impaired loans and their related allowance:

(in thousands)	Commercial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
December 31, 2011								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 2,866	$ 2,195	$ 648	$ 2,395	$ 591	$ 1,464	$ 1,022	$ 11,181
With a specific allowance recorded	2,969	1,018	623	909	454	1,942	1,049	8,964
Total recorded investment in impaired loans	$ 5,835	$ 3,213	$ 1,271	$ 3,304	$ 1,045	$ 3,406	$ 2,071	$ 20,145
Unpaid principal balance of impaired loans:								
With no specific allowance recorded	$ 4,730	$ 5,140	$ 648	$ 5,007	$ 1,077	$ 1,464	$ 1,064	$ 19,130
With a specific allowance recorded	4,598	1,862	825	1,095	544	1,942	1,049	11,915
Total unpaid principal balance of the impaired loans	$ 9,328	$ 7,002	$ 1,473	$ 6,102	$ 1,621	$ 3,406	$ 2,113	$ 31,045
Specific allowance	$ 1,285	$ 169	$ 163	$ 194	$ 262	$ 408	$ 465	$ 2,946
Average recorded investment in impaired loans during the year	4,695	1,873	595	3,505	813	1,612	1,844	14,937
Interest income recognized on impaired loans during the year	102	---	38	---	14	72	26	252
December 31, 2010								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 959	$ 633	$ ---	$ 8,742	$ ---	$ ---	$ 73	$ 10,407
	1,526	---	$ ---	555	259	148	1,214	3,702

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

The average recorded investment in impaired loans was $8.3 million in 2009. We recognized interest income of $407 thousand on these impaired loans for cash payments received during the year ended 2009. Substantially all interest income on impaired loans was recognized on the cash basis.

The gross interest income that would have been recorded had non-accrual loans been current totaled $821 thousand, $756 thousand and $728 thousand in the years ended December 31, 2011, 2010 and 2009, 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 page 71, "Purchased Credit-Impaired Loans" 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 cumulative charged-off portion of impaired loans outstanding at December 31, 2011 totaled approximately $5.8 million. At December 31, 2011, there were no significant commitments to extend credit on impaired loans, including loans to borrowers whose terms have been modified in troubled debt restructurings.

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The following table discloses loans by major portfolio categories and the specific allowance for loan losses disaggregated by impairment evaluation method as of December 31, 2011 and 2010, as well as activity in the allowance for loan losses for the years ended December 31, 2011 and 2010:

Allowance for Loan Losses and Recorded Investment in Loans as of and for the year ended December 31, 2011

(dollars in thousands)	Commercial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
Allowance for loan losses:									
Beginning balance	$ 3,114	$ 1,037	$ 4,134	$ 1,694	$ 643	$ 738	$ 835	$ 197	$ 12,392
Provision (reversal)	4,469	377	(424)	275	1,342	202	787	22	7,050
Charge-offs	(3,306)	(113)	---	(473)	(554)	---	(456)	---	(4,902)
Recoveries	57	4	---	9	13	---	16	---	99
Ending balance	$ 4,334	$ 1,305	$ 3,710	$ 1,505	$ 1,444	$ 940	$ 1,182	$ 219	$ 14,639
Ending ALLL related to loans collectively evaluated for impairment	$ 3,049	$ 1,136	$ 3,547	$ 1,311	$ 1,182	$ 532	$ 717	$ 219	$ 11,693
Ending ALLL related to loans individually evaluated for impairment	$ 957	$ -	$ 91	$ 194	$ 262	$ 408	$ 465	$ ---	$ 2,377
Ending ALLL related to purchased credit-impaired loans	$ 328	$ 169	$ 72	$ ---	$ ---	$ ---	$ ---	$ ---	$ 569