

TRICO BANCSHARES /  
Form 10-Q  
November 07, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**for the quarterly period ended: September 30, 2014**

**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: 000-10661**

**TriCo Bancshares**

**(Exact Name of Registrant as Specified in Its Charter)**

**CALIFORNIA**  
**(State or Other Jurisdiction of**

**94-2792841**  
**(I.R.S. Employer**

**Incorporation or Organization)**

**Identification Number)**

**63 Constitution Drive**

**Chico, California 95973**

**(Address of Principal Executive Offices)(Zip Code)**

**(530) 898-0300**

**(Registrant's Telephone Number, Including Area Code)**

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

Indicate the number of shares outstanding for each of the issuer's classes of common stock, as of the latest practical date:

Common stock, no par value: 22,714,964 shares outstanding as of October 31, 2014

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TriCo Bancshares

FORM 10-Q

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**FORWARD-LOOKING STATEMENTS**

This report on Form 10-Q contains forward-looking statements about TriCo Bancshares (the "Company") that are subject to the protection of the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on the current knowledge and belief of the Company's management ("Management") and include information concerning the Company's possible or assumed future financial condition and results of operations. When you see any of the words "believes", "expects", "anticipates", "estimates", or similar expressions, it may mean the Company is making forward-looking statements. A number of factors, some of which are beyond the Company's ability to predict or control, could cause future results to differ materially from those contemplated. The reader is directed to the Company's filings with the U.S. Securities and Exchange Commission, including the Company's annual report on Form 10-K for the year ended December 31, 2013, and Part II, Item 1A of this report for further discussion of factors which could affect the Company's business and cause actual results to differ materially from those suggested by any forward-looking statement made in this report. Such Form 10-K and this report should be read to put any forward-looking statements in context and to gain a more complete understanding of the risks and uncertainties involved in the Company's business. Any forward-looking statement may turn out to be wrong and cannot be guaranteed. The Company does not intend to update any forward-looking statement after the date of this report.



**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****TRICO BANCSHARES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except share data; unaudited)

|   | At September 30,<br>2014 | At December 31,<br>2013 |
|---|--------------------------|-------------------------|
| <b>Assets:</b>                              |                          |                         |
| Cash and due from banks                     | \$ 74,476                | \$ 76,915               |
| Cash at Federal Reserve and other banks     | 295,203                  | 521,453                 |
| Cash and cash equivalents                   | 369,679                  | 598,368                 |
| <b>Investment securities:</b>               |                          |                         |
| Available for sale                          | 84,962                   | 104,647                 |
| Held to maturity                            | 443,509                  | 240,504                 |
| Restricted equity securities                | 11,582                   | 9,163                   |
| Loans held for sale                         | 2,724                    | 2,270                   |
| Loans                                       | 1,765,871                | 1,672,007               |
| Allowance for loan losses                   | (37,920)                 | (38,245)                |
| Total loans, net                            | 1,727,951                | 1,633,762               |
| Foreclosed assets, net                      | 5,096                    | 6,262                   |
| Premises and equipment, net                 | 32,181                   | 31,612                  |
| Cash value of life insurance                | 53,596                   | 52,309                  |
| Accrued interest receivable                 | 6,862                    | 6,516                   |
| Goodwill                                    | 15,519                   | 15,519                  |
| Other intangible assets, net                | 726                      | 883                     |
| Mortgage servicing rights                   | 5,985                    | 6,165                   |
| Other assets                                | 34,571                   | 36,086                  |
| <b>Total assets</b>                         | <b>\$ 2,794,943</b>      | <b>\$ 2,744,066</b>     |
| <b>Liabilities and Shareholders Equity:</b> |                          |                         |
| <b>Liabilities:</b>                         |                          |                         |
| <b>Deposits:</b>                            |                          |                         |
| Noninterest-bearing demand                  | \$ 762,452               | \$ 789,458              |
| Interest-bearing                            | 1,674,904                | 1,621,025               |
| Total deposits                              | 2,437,356                | 2,410,483               |
| Accrued interest payable                    | 753                      | 938                     |
| Reserve for unfunded commitments            | 2,220                    | 2,415                   |

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|   |                     |                     |
|---|---------------------|---------------------|
| Other liabilities   | 33,331              | 31,711              |
| Other borrowings  | 12,665              | 6,335               |
| Junior subordinated debt  | 41,238              | 41,238              |
| <b>Total liabilities</b>  | <b>2,527,563</b>    | <b>2,493,120</b>    |
| Commitments and contingencies (Note 18)   |                     |                     |
| Shareholders' equity:   |                     |                     |
| Common stock, no par value: 50,000,000 shares authorized; issued and outstanding: |                     |                     |
| 16,139,414 at September 30, 2014  | 92,692              |                     |
| 16,076,662 at December 31, 2013   |                     | 89,356              |
| Retained earnings   | 172,892             | 159,733             |
| Accumulated other comprehensive income, net of tax                                | 1,796               | 1,857               |
| <b>Total shareholders' equity</b>   | <b>267,380</b>      | <b>250,946</b>      |
| <b>Total liabilities and shareholders' equity</b>                                 | <b>\$ 2,794,943</b> | <b>\$ 2,744,066</b> |

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

Table of Contents**TRICO BANCSHARES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(In thousands, except per share data; unaudited)

|  | Three months ended<br>September 30, |               | Nine months ended<br>September 30, |               |
|--|-------------------------------------|---------------|------------------------------------|---------------|
|  | 2014                                | 2013          | 2014                               | 2013          |
| Interest and dividend income:                                      |                                     |               |                                    |               |
| Loans, including fees  | \$ 24,980                           | \$ 25,123     | \$ 73,151                          | \$ 73,078     |
| Investment securities:   |                                     |               |                                    |               |
| Taxable  | 3,623                               | 1,742         | 9,885                              | 4,022         |
| Tax exempt   | 115                                 | 172           | 368                                | 423           |
| Dividends  | 200                                 | 121           | 508                                | 257           |
| Interest bearing cash at<br>Federal Reserve and other banks        | 213                                 | 378           | 796                                | 1,318         |
| <b>Total interest and dividend income</b>                          | <b>29,131</b>                       | <b>27,536</b> | <b>84,708</b>                      | <b>79,098</b> |
| Interest expense:  |                                     |               |                                    |               |
| Deposits   | 772                                 | 854           | 2,322                              | 2,634         |
| Other borrowings   |                                     | 1             | 2                                  | 3             |
| Junior subordinated debt   | 310                                 | 314           | 920                                | 936           |
| <b>Total interest expense</b>                                      | <b>1,082</b>                        | <b>1,169</b>  | <b>3,244</b>                       | <b>3,573</b>  |
| <b>Net interest income</b>   | <b>28,049</b>                       | <b>26,367</b> | <b>81,464</b>                      | <b>75,525</b> |
| Reversal of provision for loan losses                              | (2,977)                             | (393)         | (2,624)                            | (887)         |
| <b>Net interest income after reversal of provision loan losses</b> | <b>31,026</b>                       | <b>26,760</b> | <b>84,088</b>                      | <b>76,412</b> |
| Noninterest income:  |                                     |               |                                    |               |
| Service charges and fees   | 6,090                               | 6,662         | 17,071                             | 19,284        |
| Gain on sale of loans  | 509                                 | 1,083         | 1,487                              | 4,967         |
| Commissions on sale of non-deposit investment products             | 703                                 | 692           | 2,317                              | 2,294         |
| Increase in cash value of life insurance                           | 490                                 | 531           | 1,287                              | 1,337         |
| Other  | 797                                 | 159           | 2,599                              | 1,594         |
| <b>Total noninterest income</b>                                    | <b>8,589</b>                        | <b>9,127</b>  | <b>24,761</b>                      | <b>29,476</b> |
| Noninterest expense:   |                                     |               |                                    |               |
| Salaries and related benefits                                      | 13,369                              | 12,861        | 39,989                             | 38,712        |
| Other  | 12,011                              | 10,755        | 33,824                             | 30,014        |
| <b>Total noninterest expense</b>                                   | <b>25,380</b>                       | <b>23,616</b> | <b>73,813</b>                      | <b>68,726</b> |

|                            |          |          |           |           |
|----------------------------|----------|----------|-----------|-----------|
| Income before income taxes | 14,235   | 12,271   | 35,036    | 37,162    |
| Provision for income taxes | 6,001    | 4,910    | 14,578    | 14,999    |
| Net income                 | \$ 8,234 | \$ 7,361 | \$ 20,458 | \$ 22,163 |
| Earnings per share:        |          |          |           |           |
| Basic                      | \$ 0.51  | \$ 0.46  | \$ 1.27   | \$ 1.38   |
| Diluted                    | \$ 0.50  | \$ 0.45  | \$ 1.25   | \$ 1.37   |

See accompanying notes to unaudited condensed consolidated financial statements.



Table of Contents**TRICO BANCSHARES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(In thousands; unaudited)

|  | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |           |
|--|-------------------------------------|----------|------------------------------------|-----------|
|  | 2014                                | 2013     | 2014                               | 2013      |
| Net income   | \$ 8,234                            | \$ 7,361 | \$ 20,458                          | \$ 22,163 |
| Other comprehensive income (loss), net of tax:                                       |                                     |          |                                    |           |
| Unrealized gains (losses) on available for sale securities arising during the period | (398)                               | 83       | (77)                               | (2,027)   |
| Change in minimum pension liability  | 6                                   |          | 16                                 |           |
| Other comprehensive income (loss)  | (392)                               | 83       | (61)                               | (2,027)   |
| Comprehensive income   | \$ 7,842                            | \$ 7,444 | \$ 20,397                          | 20,136    |

See accompanying notes to unaudited condensed consolidated financial statements.

**TRICO BANCSHARES****CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

(In thousands, except share and per share data; unaudited)

|  | Shares of<br>Common<br>Stock | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|--|------------------------------|-----------------|----------------------|---|------------|
| Balance at December 31, 2012           | 16,000,838                   | \$ 85,561       | \$ 141,639           | \$ 2,159  | \$ 229,359 |
| Net income                             |                              |                 | 22,163               |   | 22,163     |
| Other comprehensive loss               |                              |                 |                      | (2,027)   | (2,027)    |
| Stock option vesting                   |                              | 849             |                      |   | 849        |
| Stock option forfeiture                |                              | (22)            |                      |   | (22)       |
| Stock options exercised                | 248,765                      | 3,240           |                      |   | 3,240      |
| Tax benefit of stock options exercised |                              | 356             |                      |   | 356        |
| Repurchase of common stock             | (172,941)                    | (930)           | (2,560)              |   | (3,490)    |
| Dividends paid (\$ 0.31 per share)     |                              |                 | (4,976)              |   | (4,976)    |
| Balance at September 30, 2013          | 16,076,662                   | \$ 89,054       | \$ 156,266           | \$ 132  | \$ 245,452 |
| Balance at December 31, 2013           | 16,076,662                   | \$ 89,356       | \$ 159,733           | \$ 1,857  | \$ 250,946 |

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|  |            |           |            |         |       |            |
|--|------------|-----------|------------|---------|-------|------------|
| Net income                             |            |           | 20,458     |         |       | 20,458     |
| Other comprehensive loss               |            |           |            |         | (61)  | (61)       |
| Stock option vesting                   |            | 745       |            |         |       | 745        |
| RSU vesting                            |            | 49        |            |         |       | 49         |
| PSU vesting                            |            | 16        |            |         |       | 16         |
| Stock options exercised                | 166,020    | 2,875     |            |         |       | 2,875      |
| Tax benefit of stock options exercised |            | 225       |            |         |       | 225        |
| Repurchase of common stock             | (103,268)  | (574)     |            | (1,977) |       | (2,551)    |
| Dividends paid (\$ 0.33 per share)     |            |           |            | (5,322) |       | (5,322)    |
| Balance at September 30, 2014          | 16,139,414 | \$ 92,692 | \$ 172,892 | \$      | 1,796 | \$ 267,380 |

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**TRICO BANCSHARES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands; unaudited)

|   | For the nine months ended September 30, |               |
|---|---|---------------|
|   | 2014                                    | 2013          |
| <b>Operating activities:</b>  |   |               |
| Net income  | \$ 20,458                               | \$ 22,163     |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |               |
| Depreciation of premises and equipment, and amortization                          | 4,035                                   | 3,229         |
| Amortization of intangible assets   | 157                                     | 157           |
| Benefit from reversal of provision for loan losses                                | (2,624)                                 | (887)         |
| Amortization of investment securities premium, net                                | 578                                     | 597           |
| Originations of loans for resale  | (49,241)                                | (123,834)     |
| Proceeds from sale of loans originated for resale                                 | 49,834                                  | 136,421       |
| Gain on sale of loans   | (1,487)                                 | (4,967)       |
| Change in market value of mortgage servicing rights                               | 620                                     | (311)         |
| Provision for losses on foreclosed assets   | 137                                     | 620           |
| Gain on sale of foreclosed assets   | (1,853)                                 | (1,479)       |
| (Gain) loss on disposal of fixed assets   | (60)                                    | 12            |
| Increase in cash value of life insurance  | (1,287)                                 | (1,337)       |
| Equity compensation vesting expense   | 810                                     | 849           |
| Equity compensation tax benefits  | (225)                                   | (356)         |
| Change in:  |   |               |
| Reserve for unfunded commitments  | (195)                                   | (740)         |
| Interest receivable   | (346)                                   | 186           |
| Interest payable  | (185)                                   | (99)          |
| Other assets and liabilities, net   | 2,625                                   | 3,408         |
| <b>Net cash from operating activities</b>   | <b>21,751</b>                           | <b>33,632</b> |
| <b>Investing activities:</b>  |   |               |
| Proceeds from maturities of securities available for sale                         | 19,226                                  | 43,768        |
| Proceeds from maturities of securities held to maturity                           | 18,727                                  | 1,629         |
| Purchases of securities held to maturity  | (221,984)                               | (194,942)     |
| (Purchase) redemption of restricted equity securities                             | (2,419)                                 | 484           |
| Loan origination and principal collections, net                                   | (64,023)                                | (39,986)      |
| Loans purchased   | (32,017)                                | (62,698)      |
| Improvement of foreclosed assets  | (461)                                   |               |
| Proceeds from sale of other real estate owned                                     | 7,818                                   | 12,252        |
| Proceeds from sale of premises and equipment                                      | 120                                     | 9             |
| Purchases of premises and equipment   | (3,857)                                 | (6,771)       |
| Life insurance proceeds   |   | 706           |

|   |            |            |
|---|------------|------------|
| Net cash used by investing activities   | (278,870)  | (245,549)  |
| <b>Financing activities:</b>  |            |            |
| Net increase in deposits  | 26,873     | 3,609      |
| Net change in other borrowings  | 6,330      | 5,429      |
| Equity compensation tax benefits  | 225        | 356        |
| Repurchase of common stock  | (292)      | (501)      |
| Dividends paid  | (5,322)    | (4,976)    |
| Exercise of stock options   | 616        | 251        |
| Net cash provided by financing activities   | 28,430     | 4,168      |
| Net change in cash and cash equivalents   | (228,689)  | (207,749)  |
| Cash and cash equivalents and beginning of year   | 598,368    | 748,899    |
| Cash and cash equivalents at end of period  | \$ 369,679 | \$ 541,150 |
| <b>Supplemental disclosure of noncash activities:</b>   |            |            |
| Unrealized (loss) gain on securities available for sale   | \$ (133)   | \$ 8,035   |
| Loans transferred to foreclosed assets  | \$ 4,475   | \$ 3,498   |
| Market value of shares tendered in-lieu of cash to pay for exercise of options and/or related taxes | \$ 2,259   | \$ 3,490   |
| <b>Supplemental disclosure of cash flow activity:</b>   |            |            |
| Cash paid for interest expense  | \$ 3,429   | \$ 3,672   |
| Cash paid for income taxes  | \$ 14,405  | \$ 15,110  |
| See accompanying notes to unaudited condensed consolidated financial statements.                    |            |            |

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**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 - Summary of Significant Accounting Policies**

**Description of Business and Basis of Presentation**

TriCo Bancshares is a California corporation organized to act as a bank holding company for Tri Counties Bank (the Bank ). The Company and the Bank are headquartered in Chico, CA. The Bank is a state-chartered financial institution that is engaged in the general commercial banking business in 26 California counties. Tri Counties Bank currently operates from 61 traditional branches and 20 in-store branches, including 22 locations acquired in the Company's recent merger with North Valley Bancorp on October 3, 2014. The Company also formed two subsidiary business trusts, TriCo Capital Trust I and TriCo Capital Trust II (collectively, the Trusts), to issue trust preferred securities.

The following unaudited condensed financial statements of the Company have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. In the opinion of Management, all adjustments, consisting solely of normal recurring adjustments, considered necessary for a fair presentation of results for the interim periods presented have been included. These interim condensed consolidated financial statements should be read in conjunction with the financial statements and related notes contained in the Company's 2013 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 7, 2014. Operating results for the three and nine months ended September 30, 2014 do not include the operating results of North Valley Bancorp, which the Company acquired on October 3, 2014.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned financial subsidiary, Tri Counties Bank. All significant intercompany balances and transactions have been eliminated. TriCo Capital Trust I and TriCo Capital Trust II, which were formed solely for the purpose of issuing trust preferred securities, are unconsolidated subsidiaries as the Company is not the primary beneficiary of the trusts and they are not considered variable interest entities. Operating results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. Certain amounts in the consolidated financial statements for the year ended December 31, 2013 and for the three and nine months ended September 30, 2014 may have been reclassified to conform to the presentation of the condensed consolidated financial statements in 2014.

**Use of Estimates in the Preparation of Financial Statements**

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 assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including those related to the adequacy of the allowance for loan losses, investments, intangible assets, income taxes and contingencies. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The allowance for loan losses, indemnification asset, foreclosed assets, goodwill and other intangible assets, income taxes, fair value of assets acquired and liabilities assumed in business combinations, the valuation of securities available-for-sale, and the

valuation of mortgage servicing rights are the only accounting estimates that materially affect the Company's consolidated financial statements.

During each of 2011 and 2010, the Bank assumed the banking operations of a failed financial institution from the FDIC under whole bank purchase agreement. The acquired assets and assumed liabilities were measured at estimated fair value values under the acquisition method of accounting. The Company made significant estimates and exercised significant judgment in accounting for the acquisitions. The Company determined loan fair values based on loan file reviews, loan risk ratings, appraised collateral values, expected cash flows and historical loss factors. Foreclosed assets were primarily valued based on appraised values of the repossessed loan collateral. An identifiable intangible was also recorded representing the fair value of the core deposit customer base based on an evaluation of the cost of such deposits relative to alternative funding sources. The fair value of time deposits and borrowings were determined based on the present value of estimated future cash flows using current rates as of the acquisition date.

### **Significant Group Concentration of Credit Risk**

The Company grants agribusiness, commercial, consumer, and residential loans to customers located throughout the northern San Joaquin Valley, the Sacramento Valley and northern mountain regions of California. The Company has a diversified loan portfolio within the business segments located in this geographical area. The Company currently classifies all its operations into one business segment that it denotes as community banking.

### **Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Net cash flows are reported for loan and deposit transactions and other borrowings.

### **Investment Securities**

The Company classifies its debt and marketable equity securities into one of three categories: trading, available for sale or held to maturity. Trading securities are bought and held principally for the purpose of selling in the near term. Held to maturity securities are those securities which the Company has the ability and intent to hold until maturity. These securities are carried at cost adjusted for amortization of premium and accretion of discount, computed by the effective interest method over their contractual lives. All other securities not included in trading or held to maturity are classified as available for sale. Available for sale securities are recorded at fair value. Unrealized gains and losses, net of the related tax effect, on available for sale securities are reported as a separate component of other accumulated comprehensive income in

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shareholders' equity until realized. Premiums and discounts are amortized or accreted over the life of the related investment security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized when earned. Realized gains and losses are derived from the amortized cost of the security sold. During the nine months ended September 30, 2014 and the year ended December 31, 2013, the Company did not have any securities classified as trading. During the three months ended March 31, 2013, the Company did not have any securities classified as held to maturity.

The Company assesses other-than-temporary impairment ( OTTI ) based on whether it intends to sell a security or if it is likely that the Company would be required to sell the security before recovery of the amortized cost basis of the investment, which may be maturity. For debt securities, if the Company intends to sell the security or it is likely that it will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If the Company does not intend to sell the security and it is not likely that it will be required to sell the security but it does not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ( OCI ). Impairment losses related to all other factors are presented as separate categories within OCI. The accretion of the amount recorded in OCI increases the carrying value of the investment and does not affect earnings. If there is an indication of additional credit losses the security is re-evaluated according to the procedures described above. No OTTI losses were recognized during the nine months ended September 30, 2014 or the year ended December 31, 2013.

**Restricted Equity Securities**

Restricted equity securities represent the Company's investment in the stock of the Federal Home Loan Bank of San Francisco ( FHLB ) and are carried at par value, which reasonably approximates its fair value. While technically these are considered equity securities, there is no market for the FHLB stock. Therefore, the shares are considered as restricted investment securities. Management periodically evaluates FHLB stock for other-than-temporary impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB.

As a member of the FHLB system, the Company is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. The Company may request redemption at par value of any stock in excess of the minimum required investment. Stock redemptions are at the discretion of the FHLB.

**Loans Held for Sale**

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by aggregate outstanding commitments from investors of current investor yield requirements. Net unrealized losses are recognized through a valuation allowance by charges to noninterest income.

Mortgage loans held for sale are generally sold with the mortgage servicing rights retained by the Company. Gains or losses on the sale of loans that are held for sale are recognized at the time of the sale and determined by the difference between net sale proceeds and the net book value of the loans less the estimated fair value of any retained mortgage servicing rights.

### **Loans and Allowance for Loan Losses**

Loans originated by the Company, i.e., not purchased or acquired in a business combination, are referred to as originated loans. Originated loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal amount outstanding, net of deferred loan fees and costs. Loan origination and commitment fees and certain direct loan origination costs are deferred, and the net amount is amortized as an adjustment of the related loan's yield over the actual life of the loan. Originated loans on which the accrual of interest has been discontinued are designated as nonaccrual loans.

Originated loans are placed in nonaccrual status when reasonable doubt exists as to the full, timely collection of interest or principal, or a loan becomes contractually past due by 90 days or more with respect to interest or principal and is not well secured and in the process of collection. When an originated loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of Management, the loan is estimated to be fully collectible as to both principal and interest.

An allowance for loan losses for originated loans is established through a provision for loan losses charged to expense. The allowance is maintained at a level which, in Management's judgment, is adequate to absorb probable incurred credit losses inherent in the loan portfolio as of the balance sheet date. Originated loans and deposit related overdrafts are charged against the allowance for loan losses when Management believes that the collectability of the principal is unlikely or, with respect to consumer installment loans, according to an established delinquency schedule. The allowance is an amount that Management believes will be adequate to absorb probable incurred losses inherent in existing loans and leases, based on evaluations of the collectability, impairment and prior loss experience of loans and leases. The evaluations take into consideration such factors as changes in the nature and size of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrower's ability to pay. The Company defines an originated loan as impaired when it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement.



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Impaired originated loans are measured based on the present value of expected future cash flows discounted at the loan's original effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance.

In situations related to originated loans where, for economic or legal reasons related to a borrower's financial difficulties, the Company grants a concession for other than an insignificant period of time to the borrower that the Company would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). The Company strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where the Company grants the borrower new terms that result in the loan being classified as a TDR, the Company measures any impairment on the restructuring as noted above for impaired loans. TDR loans are classified as impaired until they are fully paid off or charged off. Loans that are in nonaccrual status at the time they become TDR loans, remain in nonaccrual status until the borrower demonstrates a sustained period of performance which the Company generally believes to be six consecutive months of payments, or equivalent. Otherwise, TDR loans are subject to the same nonaccrual and charge-off policies as noted above with respect to their restructured principal balance.

Credit risk is inherent in the business of lending. As a result, the Company maintains an allowance for loan losses to absorb probable incurred losses inherent in the Company's originated loan portfolio. This is maintained through periodic charges to earnings. These charges are included in the Consolidated Statements of Income as provision for loan losses. All specifically identifiable and quantifiable losses are immediately charged off against the allowance. However, for a variety of reasons, not all losses are immediately known to the Company and, of those that are known, the full extent of the loss may not be quantifiable at that point in time. The balance of the Company's allowance for originated loan losses is meant to be an estimate of these unknown but probable losses inherent in the portfolio.

The Company formally assesses the adequacy of the allowance for originated loan losses on a quarterly basis. Determination of the adequacy is based on ongoing assessments of the probable risk in the outstanding originated loan portfolio, and to a lesser extent the Company's originated loan commitments. These assessments include the periodic re-grading of credits 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, growth of the portfolio as a whole or by segment, and other factors as warranted. Loans are initially graded when originated. They are re-graded as they are renewed, when there is a new loan to the same borrower, when identified facts demonstrate heightened risk of nonpayment, or if they become delinquent. Re-grading of larger problem loans occurs at least quarterly. Confirmation of the quality of the grading process is obtained by independent credit reviews conducted by consultants specifically hired for this purpose and by various bank regulatory agencies.

The Company's method for assessing the appropriateness of the allowance for originated loan losses includes specific allowances for impaired originated loans and leases, formula allowance factors for pools of credits, and allowances for changing environmental factors (e.g., interest rates, growth, economic conditions, etc.). Allowance factors for loan pools were based on historical loss experience by product type and prior risk rating.

During the three months ended March 31, 2013, the Company changed the method it uses to estimate net sale proceeds from real estate collateral sales when calculating the allowance for loan losses associated with impaired real estate collateral dependent loans. Previously, the Company used the greater of fifteen percent or actual estimated selling costs. Currently, the Company uses the actual estimated selling costs, and an adjustment to appraised value

based on the age of the appraisal. These changes are intended to more accurately reflect the estimated net sale proceeds from the sale of impaired collateral dependent real estate loans. This change in methodology resulted in the allowance for loan losses as of March 31, 2013 being \$494,000 more than it would have been without this change in methodology.

During the three months ended June 30, 2013, the Company modified its loss migration analysis methodology used to determine the formula allowance factors. When the Company originally established its loss migration analysis methodology during the quarter ended March 31, 2012, it reviewed the loss experience of each rolling twelve month period over the previous three years in order to calculate an annualized loss rate by loan category and risk rating. The use of three years of loss experience data was originally used because that was the extent of the detailed loss data by loan category and risk rating that was available at the time. This three year historical look-back period was used through the quarter ended March 31, 2013. Starting with the quarter ended June 30, 2013, the Company reviews all available detailed loss experience data, going back to, and including, the twelve month period ended June 30, 2009, and does not limit the look-back period to the most recent three years of historical loss data. Using this data, the Company calculates loss factors for each quarter from the quarter ended June 30, 2009 to the most recent quarter. The Company then calculates a weighted average formula allowance factor for each loan category and risk rating with the most recent quarterly loss factor being weighted 125%, the quarter ended June 30, 2009 loss factor being weighted 75%, and the loss factors for all the quarters between the most recent quarter and the quarter ended June 30, 2009, being weighted on a linear scale from 75% to 125%. This change is intended to more accurately reflect the risk inherent in the loan portfolio by considering historical loss data for all years as the data for new periods becomes available. This change in methodology resulted in the allowance for loan losses as of June 30, 2013 being \$1,314,000 more than it would have been without this change in methodology.

During the three months ended September 30, 2013, the Company modified its methodology used to determine the allowance for changing environmental factors. Previously, the Company compared the current value of each environmental factor to a fixed baseline value. The deviation of the current value from the baseline value was then multiplied by a conversion factor to determine the required allowance related to each environmental factor. As of September 30, 2013, the Company replaced the fixed baseline values with average baseline values derived from historical averages, and adjusted the conversion factors. This change is intended to more accurately reflect the risk inherent in the portfolio by recognizing that baseline, or normal, levels for environmental factors may change over time. This change in methodology resulted in the allowance for loan losses as of September 30, 2013 being \$1,665,000 more than it would have been without this change in methodology.

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During the three months ended March 31, 2014, the Company modified its methodology used to determine the allowance for changing environmental factors by adding a new environmental factor based on the California Home Affordability Index ( CHAI ). The CHAI measures the percentage of households in California that can afford to purchase the median priced home in California based on current home prices and mortgage interest rates. The use of the CHAI environmental factor consists of comparing the current CHAI to its historical baseline, and allows management to consider the adverse impact that a lower than historical CHAI may have on general economic activity and the performance of our borrowers. Based on an analysis of historical data, management believes this environmental factor gives a better estimate of current economic activity compared to other environmental factors that may lag current economic activity to some extent. This change in methodology resulted in no change to the allowance for loan losses as of March 31, 2014 compared to what it would have been without this change in methodology.

During the three months ended June 30, 2014, the Company refined the method it uses to evaluate historical losses for the purpose of estimating the pool allowance for unimpaired loans. In the third quarter of 2010, the Company moved from a six point grading system (Grades A-F) to a nine point risk rating system (Risk Ratings 1-9), primarily to allow for more distinction within the Pass risk rating. Initially, there was not sufficient loss experience within the nine point scale to complete a migration analysis for all nine risk ratings, all loans risk rated Pass or 2-5 were grouped together, a loss rate was calculated for that group, and that loss rate was established as the loss rate for risk rating 4. The reserve ratios for risk ratings 2, 3 and 5 were then interpolated from that figure. As of June 30, 2014, the Company was able to compile twelve quarters of historical loss information for all risk ratings and use that information to calculate the loss rates for each of the nine risk ratings without interpolation. This refinement led to an increase of \$1,438,000 in the reserve requirement for unimpaired loans, driven primarily by home equity lines of credit with a risk rating of 5 or Pass-Watch.

Loans purchased or acquired in a business combination are referred to as acquired loans. Acquired loans are valued as of the acquisition date in accordance with Financial Accounting Standards Board Accounting Standards Codification ( FASB ASC ) Topic 805, *Business Combinations*. Loans acquired with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are referred to as purchased credit impaired (PCI) loans. PCI loans are accounted for under FASB ASC Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. Under FASB ASC Topic 805 and FASB ASC Topic 310-30, PCI loans are recorded at fair value 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 as of the acquisition date. Fair value is defined as the present value of the future estimated principal and interest payments of the loan, with the discount rate used in the present value calculation representing the estimated effective yield of the loan. Default rates, loss severity, and prepayment speed assumptions are periodically reassessed and our estimate of future payments is adjusted accordingly. The difference between contractual future payments and estimated future payments is referred to as the nonaccretable difference. The difference between estimated future payments and the present value of the estimated future payments is referred to as the accretable yield. The accretable yield represents the amount that is expected to be recorded as interest income over the remaining life of the loan. If after acquisition, the Company determines that the estimated future cash flows of a PCI loan are expected to be more than originally estimated, an increase in the discount rate (effective yield) would be made such that the newly increased accretable yield would be recognized, on a level yield basis, over the remaining estimated life of the loan. If, after acquisition, the Company determines that the estimated future cash flows of a PCI loan are expected to be less than previously estimated, the discount rate would first be reduced until the present value of the reduced cash flow estimate equals the previous present value however, the discount rate may not be lowered below its original level at acquisition. If the discount rate has been lowered to its original level and the present value has not been sufficiently lowered, an allowance for loan loss would be established through a provision for loan losses charged to expense to decrease the present value to the required level. If the estimated cash flows improve after an allowance has been established for a loan, the allowance may be partially or fully reversed depending on the improvement in the estimated cash flows. Only after the allowance

has been fully reversed may the discount rate be increased. PCI loans are put on nonaccrual status when cash flows cannot be reasonably estimated. PCI loans on nonaccrual status are accounted for using the cost recovery method or cash basis method of income recognition. PCI loans are charged off when evidence suggests cash flows are not recoverable. Foreclosed assets from PCI loans are recorded in foreclosed assets at fair value with the fair value at time of foreclosure representing cash flow from the loan. ASC 310-30 allows PCI loans with similar risk characteristics and acquisition time frame to be pooled and have their cash flows aggregated as if they were one loan. The Company elected to use the pooled method of ASC 310-30 for PCI other loans in the acquisition of certain assets and liabilities of Granite Community Bank, N.A. ( Granite ) during 2010 and Citizens Bank of Northern California ( Citizens ) during 2011.

Acquired loans that are not PCI loans are referred to as purchased not credit impaired (PNCI) loans. PNCI loans are accounted for under FASB ASC Topic 310-20, *Receivables - Nonrefundable Fees and Other Costs*, in which interest income is accrued on a level-yield basis for performing loans. For income recognition purposes, this method assumes that all contractual cash flows will be collected, and no allowance for loan losses is established at the time of acquisition. Post-acquisition date, an allowance for loan losses may need to be established for acquired loans through a provision charged to earnings for credit losses incurred subsequent to acquisition. Under ASC 310-20, the loss would be measured based on the probable shortfall in relation to the contractual note requirements, consistent with our allowance for loan loss policy for similar loans.

Throughout these financial statements, and in particular in Note 4 and Note 5, when we refer to Loans or Allowance for loan losses we mean all categories of loans, including Originated, PNCI, PCI cash basis, and PCI - other. When we are not referring to all categories of loans, we will indicate which we are referring to Originated, PNCI, PCI cash basis, or PCI - other.

When referring to PNCI and PCI loans we will use the terms nonaccretable difference , accretable yield , or purchase discount . Nonaccretable difference is the difference between undiscounted contractual cash flows due and undiscounted cash flows we expect to collect, or put another way, it is the undiscounted contractual cash flows we do not expect to collect. Accretable yield is the difference between undiscounted cash flows we expect to collect and the value at which we have recorded the loan on our financial statements. On the

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date of acquisition, all purchased loans are recorded on our consolidated financial statements at estimated fair value. Purchase discount is the difference between the estimated fair value of loans on the date of acquisition and the principal amount owed by the borrower, net of charge offs, on the date of acquisition. We may also refer to discounts to principal balance of loans owed, net of charge-offs. Discounts to principal balance of loans owed, net of charge-offs is the difference between principal balance of loans owed, net of charge-offs, and loans as recorded on our financial statements. Discounts to principal balance of loans owed, net of charge-offs arise from purchase discounts, and equal the purchase discount on the acquisition date.

Loans are also categorized as covered or noncovered. Covered loans refer to loans covered by a Federal Deposit Insurance Corporation (FDIC) loss sharing agreement. Noncovered loans refer to loans not covered by a FDIC loss sharing agreement.

**Foreclosed Assets**

Foreclosed assets include assets acquired through, or in lieu of, loan foreclosure. Foreclosed assets are held for sale and are initially recorded at fair value less estimated costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, management periodically performs valuations and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other noninterest expense. Gain or loss on sale of foreclosed assets is included in noninterest income. Foreclosed assets that are not subject to a FDIC loss-share agreement are referred to as noncovered foreclosed assets.

Foreclosed assets acquired through FDIC-assisted acquisitions that are subject to a FDIC loss-share agreement, and all assets acquired via foreclosure of covered loans are referred to as covered foreclosed assets. Covered foreclosed assets are reported exclusive of expected reimbursement cash flows from the FDIC. Foreclosed covered loan collateral is transferred into covered foreclosed assets at the loan's carrying value, inclusive of the acquisition date fair value discount.

Covered foreclosed assets are initially recorded at estimated fair value less estimated costs to sell on the acquisition date based on similar market comparable valuations less estimated selling costs. Any subsequent valuation adjustments due to declines in fair value will be charged to noninterest expense, and will be mostly offset by noninterest income representing the corresponding increase to the FDIC indemnification asset for the offsetting loss reimbursement amount. Any recoveries of previous valuation adjustments will be credited to noninterest expense with a corresponding charge to noninterest income for the portion of the recovery that is due to the FDIC.

**Premises and Equipment**

Land is carried at cost. Land improvements, buildings and equipment, including those acquired under capital lease, are stated at cost less accumulated depreciation and amortization. Depreciation and amortization expenses are computed using the straight-line method over the estimated useful lives of the related assets or lease terms. Asset lives range from 3-10 years for furniture and equipment and 15-40 years for land improvements and buildings.

**Goodwill and Other Intangible Assets**

Goodwill represents the excess of costs over fair value of net assets of businesses acquired. Goodwill and other intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment.

The Company has an identifiable intangible asset consisting of core deposit intangibles (CDI). CDI are amortized over their respective estimated useful lives, and reviewed for impairment.

### **Impairment of Long-Lived Assets and Goodwill**

Long-lived assets, such as premises and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the consolidated balance sheet.

As of December 31 of each year, goodwill is tested for impairment, and is tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. This determination is made at the reporting unit level. The Company may choose to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, the Company determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then goodwill is deemed not to be impaired. However, if the Company concludes otherwise, or if the Company elected not to first assess qualitative factors, then the Company performs the first step of a two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Currently, and historically, the Company is comprised of only one reporting unit that operates within the business segment it has identified as community banking. Goodwill was not impaired as of December 31, 2013 because the fair value of the reporting unit exceeded its carrying value.

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Mortgage servicing rights (MSR) represent the Company's right to a future stream of cash flows based upon the contractual servicing fee associated with servicing mortgage loans. The Company's MSR arise from residential mortgage loans that it originates and sells, but retains the right to service the loans. The net gain from the retention of the servicing right is included in gain on sale of loans in noninterest income when the loan is sold. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. Servicing fees are recorded in noninterest income when earned.

The Company accounts for MSR at fair value. The determination of fair value of our MSR requires management judgment because they are not actively traded. The determination of fair value for MSR requires valuation processes which combine the use of discounted cash flow models and extensive analysis of current market data to arrive at an estimate of fair value. The cash flow and prepayment assumptions used in our discounted cash flow model are based on empirical data drawn from the historical performance of our MSR, which we believe are consistent with assumptions used by market participants valuing similar MSR, and from data obtained on the performance of similar MSR. The key assumptions used in the valuation of MSR include mortgage prepayment speeds and the discount rate. These variables can, and generally will, change from quarter to quarter as market conditions and projected interest rates change. The key risks inherent with MSR are prepayment speed and changes in interest rates. The Company uses an independent third party to determine fair value of MSR.

**Indemnification Asset**

The Company accounts for amounts receivable or payable under its loss-share agreements entered into with the FDIC in connection with its purchase and assumption of certain assets and liabilities of Granite as indemnification assets in accordance with FASB ASC Topic 805, *Business Combinations*. FDIC indemnification assets are initially recorded at fair value, based on the discounted value of expected future cash flows under the loss-share agreements. The difference between the fair value and the undiscounted cash flows the Company expects to collect from the FDIC will be accreted into noninterest income over the life of the FDIC indemnification asset. FDIC indemnification assets are reviewed quarterly and adjusted for any changes in expected cash flows based on recent performance and expectations for future performance of the covered portfolios. These adjustments are measured on the same basis as the related covered loans and covered other real estate owned. Any increases in cash flow of the covered assets over those expected will reduce the FDIC indemnification asset and any decreases in cash flow of the covered assets under those expected will increase the FDIC indemnification asset. Increases and decreases to the FDIC indemnification asset are recorded as adjustments to noninterest income.

**Reserve for Unfunded Commitments**

The reserve for unfunded commitments is established through a provision for losses—unfunded commitments charged to noninterest expense. The reserve for unfunded commitments is an amount that Management believes will be adequate to absorb probable losses inherent in existing commitments, including unused portions of revolving lines of credits and other loans, standby letters of credits, and unused deposit account overdraft privilege. The reserve for unfunded commitments is based on evaluations of the collectability, and prior loss experience of unfunded commitments. The evaluations take into consideration such factors as changes in the nature and size of the loan portfolio, overall loan portfolio quality, loan concentrations, specific problem loans and related unfunded commitments, and current economic conditions that may affect the borrower's or depositor's ability to pay.

During the three months ended June 30, 2013, the Company modified the methodology employed to estimate potential losses on unfunded commitments. Similar to the Allowance for Loan Losses, the Company performs a migration analysis of historical loss experience. Prior to this quarter, the loss experience of each quarter over the previous three years was reviewed in order to calculate an annualized loss rate by loan category. Going forward, the Company has chosen to review all loss experience available since the conversion to a loss migration analysis. This change is intended to more accurately reflect the risk inherent in the unfunded commitments and appropriately consider all losses incurred in prior years. This change in methodology resulted in the reserve for unfunded commitments as of June 30, 2013 being \$335,000 more than it would have been without this change in methodology.

### **Income Taxes**

The Company's accounting for income taxes is based on an asset and liability approach. The Company recognizes 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 its financial statements or tax returns. The measurement of tax assets and liabilities is based on the provisions of enacted tax laws. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent upon the generation of a sufficient level of future taxable income and recoverable taxes paid in prior years. Although realization is not assured, management believes it is more likely than not that all of the deferred tax assets will be realized. Interest and/or penalties related to income taxes are reported as a component of noninterest income.

### **Off-Balance Sheet Credit Related Financial Instruments**

In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

### **Geographical Descriptions**

For the purpose of describing the geographical location of the Company's loans, the Company has defined northern California as that area of California north of, and including, Stockton; central California as that area of the state south of Stockton, to and including, Bakersfield; and southern California as that area of the state south of Bakersfield.



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Certain amounts reported in previous consolidated financial statements have been reclassified to conform to the presentation in this report. These reclassifications did not affect previously reported net income or total shareholders equity.

**Recent Accounting Pronouncements**

FASB issued ASU No. 2014-04, *Receivables (Topic 310): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. ASU 2014-04 clarifies when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. ASU 2014-04 is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. ASU 2014-04 is not expected to have a significant impact on the Company's consolidated financial statements.

FASB issued ASU No. 2014-08, *Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*. ASU 2014-08 improves the definition of discontinued operations by limiting discontinued operations reporting to disposals of components of an entity that represent strategic shifts that have (or will have) a major effect on an entity's operations and financial results. ASU 2014-08 requires expanded disclosures for discontinued operations that provide users of financial statements with more information about the assets, liabilities, revenues, and expenses of discontinued operations. ASU 2014-08 also requires an entity to disclose the pretax profit or loss of an individually significant component of an entity that does not qualify for discontinued operations reporting, and provide users with information about the financial effects of significant disposals that do not qualify for discontinued operations reporting. The amendments in ASU 2014-08 include several changes to the Accounting Standards Codification to improve the organization and readability of Subtopic 205-20 and Subtopic 360-10, Property, Plant, and Equipment Overall. ASU 2014-08 is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. ASU 2014-08 is not expected to have a significant impact on the Company's consolidated financial statements.

FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The core principle of the guidance under ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for a public entity for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. ASU 2014-09 is not expected to have a significant impact on the Company's consolidated financial statements.

FASB issued ASU No. 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. ASU 2014-11 requires that repurchase-to-maturity transactions be accounted for as secured borrowings consistent with the accounting for other repurchase agreements. In addition, ASU 2014-11 requires separate accounting for repurchase financings, which entails the transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty. ASU 2014-11 requires entities to disclose certain information about transfers accounted for as sales in transactions that are economically similar to repurchase agreements. In addition, ASU 2014-11 requires disclosures related to collateral, remaining contractual tenor and of the potential risks associated with repurchase agreements, securities lending transactions and repurchase-to-maturity transactions. ASU 2014-11 is effective for public business entities for the first interim or

annual period beginning after December 15, 2014. An entity is required to present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Earlier application for a public business entity is prohibited. ASU 2014-11 is not expected to have a significant impact on the Company's consolidated financial statements.

FASB issued ASU No. 2014-12, *Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*. ASU 2014-12 requires that a performance target that affects the vesting of a share-based payment award and that could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing guidance in Topic 718 as it relates to awards with performance conditions that affect vesting to account for such awards. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. The stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period. Current U.S. GAAP does not contain explicit guidance on whether to treat a performance target that could be achieved after the requisite service period as a performance condition that affects vesting or as a nonvesting condition that affects the grant-date fair value of an award. ASU 2014-12 provides explicit guidance for those awards. For all entities, ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted.

FASB issued ASU No. 2014-14, *Receivables - Troubled Debt Restructurings by Creditors (Topic 310): Classification of Certain Government Mortgage Loans upon Foreclosure*. ASU 2014-14 requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: 1) the loan has a government guarantee that is not separable from the loan before foreclosure, 2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, and 3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. For public business entities, ASU 2014-14 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2014. Earlier adoption is permitted.

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**Note 2 - Business Combinations**

On October 3, 2014, TriCo completed its acquisition of North Valley Bancorp originally announced January 21, 2014. Based on a fixed exchange ratio of 0.9433 shares of TriCo common stock for each share of North Valley Bancorp common stock, North Valley Bancorp shareholders received 6,575,550 shares of TriCo common stock and \$6,823 of cash in-lieu of fractional shares. The 6,575,550 shares of TriCo common stock issued to North Valley Bancorp shareholders represents, on a pro forma basis, approximately 28.9% of the 22,714,964 shares of the combined company outstanding on October 3, 2014. Based on TriCo's closing stock price of \$23.01 on October 3, 2014, North Valley Bancorp shareholders received consideration valued at \$151,310,000 or approximately \$21.71 per share of North Valley common stock outstanding. TriCo appointed three North Valley Bancorp directors to TriCo's board upon closing of the merger on October 3, 2014 as contemplated by the merger agreement with North Valley Bancorp.

North Valley Bancorp, was headquartered in Redding, California, and was the parent of North Valley Bank that had approximately \$935 million in assets and 22 commercial banking offices in Shasta, Humboldt, Del Norte, Mendocino, Yolo, Sonoma, Placer and Trinity Counties in Northern California at June 30, 2014. In connection with the acquisition, North Valley Bank was merged into Tri Counties Bank on October 3, 2014. The assets and liabilities acquired in the acquisition of North Valle Bancorp will be recorded at fair value at the date of acquisition and will be reflected in the December 31, 2014 financial statements. However, at the time of these financial statements, the appraisals and valuations are still in process. The Company also expects to record goodwill and a core deposit intangible related to this transaction, but the amounts attributable to those assets are dependent on the appraisals and valuations that are still in process. As this transaction was structured as a tax free exchange, the goodwill will not be deductible for tax purposes.

The Company's operating results for the three and nine months ended September 30, 2014 do not include North Valley Bancorp's operating results.

**Table of Contents****Note 3 - Investment Securities**

The amortized cost and estimated fair values of investments in debt and equity securities are summarized in the following tables:

|  | Amortized<br>Cost | September 30, 2014<br>Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|--|-------------------------------|----------------------------|
| (in thousands)   |                   |  |                               |                            |
| <b>Securities Available for Sale</b>                     |                   |  |                               |                            |
| Obligations of U.S. government corporations and agencies | \$ 75,877         | \$ 4,095   | \$ (112)                      | \$ 79,860                  |
| Obligations of states and political subdivisions         | 3,129             | 61   |                               | 3,190                      |
| Corporate debt securities                                | 1,887             | 25   |                               | 1,912                      |
| <b>Total securities available for sale</b>               | <b>\$ 80,893</b>  | <b>\$ 4,181</b>                                    | <b>\$ (112)</b>               | <b>\$ 84,962</b>           |

| <b>Securities Held to Maturity</b>                       |                   |                 |                   |                   |
|--|-------------------|-----------------|-------------------|-------------------|
| Obligations of U.S. government corporations and agencies | \$ 430,899        | \$ 5,337        | \$ (1,930)        | \$ 434,306        |
| Obligations of states and political subdivisions         | 12,610            | 22              | (134)             | 12,498            |
| <b>Total securities held to maturity</b>                 | <b>\$ 443,509</b> | <b>\$ 5,359</b> | <b>\$ (2,064)</b> | <b>\$ 446,804</b> |

|  | Amortized<br>Cost | December 31, 2013<br>Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|---|-------------------------------|----------------------------|
| (in thousands)   |                   |   |                               |                            |
| <b>Securities Available for Sale</b>                     |                   |   |                               |                            |
| Obligations of U.S. government corporations and agencies | \$ 93,055         | \$ 4,445  | \$ (357)                      | \$ 97,143                  |
| Obligations of states and political subdivisions         | 5,513             | 77  | (1)                           | 5,589                      |
| Corporate debt securities                                | 1,877             | 38  |                               | 1,915                      |
| <b>Total securities available for sale</b>               | <b>\$ 100,445</b> | <b>\$ 4,560</b>                                   | <b>\$ (358)</b>               | <b>\$ 104,647</b>          |

| <b>Securities Held to Maturity</b>                       |                   |               |                   |                   |
|--|-------------------|---------------|-------------------|-------------------|
| Obligations of U.S. government corporations and agencies | \$ 227,864        | \$ 298        | \$ (5,540)        | \$ 222,622        |
| Obligations of states and political subdivisions         | 12,640            |               | (1,455)           | 11,185            |
| <b>Total securities held to maturity</b>                 | <b>\$ 240,504</b> | <b>\$ 298</b> | <b>\$ (6,995)</b> | <b>\$ 233,807</b> |

No investment securities were sold during the nine months ended September 30, 2014 or the year ended December 31, 2013. Investment securities with an aggregate carrying value of \$81,828,000 and \$62,064,000 at September 30, 2014 and December 31, 2013, respectively, were pledged as collateral for specific borrowings, lines of credit and local agency deposits.

The amortized cost and estimated fair value of debt securities at September 30, 2014 by contractual maturity are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. At September 30, 2014, obligations of U.S. government corporations and agencies with a cost basis totaling \$506,776,000 consist almost entirely of mortgage-backed securities whose contractual maturity, or principal repayment, will follow the repayment of the underlying mortgages.

For purposes of the following table, the entire outstanding balance of these mortgage-backed securities issued by U.S. government corporations and agencies is categorized based on final maturity date. At September 30, 2014, the Company estimates the average remaining life of these mortgage-backed securities issued by U.S. government corporations and agencies to be approximately 5.7 years. Average remaining life is defined as the time span after which the principal balance has been reduced by half.

| Investment Securities<br>(In thousands) | Available for Sale |                         | Held to Maturity  |                            |
|---|--------------------|-------------------------|-------------------|----------------------------|
|   | Amortized<br>Cost  | Estimated<br>Fair Value | Amortized<br>Cost | Estimated<br>Fair<br>Value |
| Due in one year                         | \$ 2,012           | \$ 2,044                |                   |                            |
| Due after one year through five years   | 1,193              | 1,244                   |                   |                            |
| Due after five years through ten years  | 33,218             | 34,556                  |                   |                            |
| Due after ten years                     | 44,470             | 47,118                  | \$ 443,509        | \$ 446,804                 |
| <b>Totals</b>                           | <b>\$ 80,893</b>   | <b>\$ 84,962</b>        | <b>\$ 443,509</b> | <b>\$ 446,804</b>          |

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Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows:

|  | Less than 12 months |                 | 12 months or more |                 | Total      |                 |
|--|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
|  | (in thousands)      |                 |                   |                 |            |                 |
| <b>September 30, 2014</b>                                |                     |                 |                   |                 |            |                 |
| Securities available for sale:                           |                     |                 |                   |                 |            |                 |
| Obligations of U.S. government corporations and agencies | \$ 2,631            | \$ (16)         | \$ 6,956          | \$ (96)         | \$ 9,587   | \$ (112)        |
| Obligations of states and political subdivisions         |                     |                 |                   |                 |            |                 |
| Corporate debt securities                                |                     |                 |                   |                 |            |                 |
| Total securities available for sale                      | \$ 2,631            | \$ (16)         | \$ 6,956          | \$ (96)         | \$ 9,587   | \$ (112)        |
| Securities held to maturity:                             |                     |                 |                   |                 |            |                 |
| Obligations of U.S. government corporations and agencies | \$ 46,073           | \$ (134)        | \$ 56,245         | \$ (1,796)      | \$ 102,318 | \$ (1,930)      |
| Obligations of states and political subdivisions         | 788                 | (22)            | 7,357             | (112)           | 8,145      | (134)           |
| Total securities held to maturity                        | \$ 46,861           | \$ (156)        | \$ 63,602         | \$ (1,908)      | \$ 110,463 | \$ (2,064)      |
| <b>December 31, 2013</b>                                 |                     |                 |                   |                 |            |                 |
| Securities available for sale:                           |                     |                 |                   |                 |            |                 |
| Obligations of U.S. government corporations and agencies | \$ 10,287           | \$ (357)        |                   |                 | \$ 10,287  | \$ (357)        |
| Obligations of states and political subdivisions         | 199                 | (1)             |                   |                 | 199        | (1)             |
| Corporate debt securities                                |                     |                 |                   |                 |            |                 |
| Total securities available for sale                      | \$ 10,486           | \$ (358)        |                   |                 | \$ 10,486  | \$ (358)        |
| Securities held to maturity:                             |                     |                 |                   |                 |            |                 |
| Obligations of U.S. government corporations and agencies | \$ 188,218          | \$ (5,540)      |                   |                 | \$ 188,218 | \$ (5,540)      |
| Obligations of states and political subdivisions         | 11,185              | (1,455)         |                   |                 | 11,185     | (1,455)         |

|                                   |            |            |            |            |
|-----------------------------------|------------|------------|------------|------------|
| Total securities held to maturity | \$ 199,403 | \$ (6,995) | \$ 199,403 | \$ (6,995) |
|-----------------------------------|------------|------------|------------|------------|

Obligations of U.S. government corporations and agencies: Unrealized losses on investments in obligations of U.S. government corporations and agencies are caused by interest rate increases. The contractual cash flows of these securities are guaranteed by U.S. Government Sponsored Entities (principally Fannie Mae and Freddie Mac). It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell and more likely than not will not be required to sell, these investments are not considered other-than-temporarily impaired. At September 30, 2014, 13 debt securities representing obligations of U.S. government corporations and agencies had unrealized losses with aggregate depreciation of 1.79% from the Company's amortized cost basis.

Obligations of states and political subdivisions: The unrealized losses on investments in obligations of states and political subdivisions were caused by increases in required yields by investors in these types of securities. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell and more likely than not will not be required to sell, these investments are not considered other-than-temporarily impaired. At September 30, 2014, 10 debt securities representing obligations of states and political subdivisions had unrealized losses with aggregate depreciation of 1.62% from the Company's amortized cost basis.

Corporate debt securities: At September 30, 2014, no corporate debt securities had unrealized losses.

**Table of Contents****Note 4 - Loans**

A summary of loan balances follows (in thousands):

|   | September 30, 2014  |                   |                     |                  |                     |
|---|---------------------|-------------------|---------------------|------------------|---------------------|
|   | Originated          | PNCI              | PCI -<br>Cash basis | PCI -<br>Other   | Total               |
| <b>Mortgage loans on real estate:</b>                                   |                     |                   |                     |                  |                     |
| Residential 1-4 family  | \$ 141,854          | \$ 82,766         |                     | \$ 3,787         | \$ 228,407          |
| Commercial  | 906,977             | 52,070            |                     | 26,699           | 985,746             |
| <b>Total mortgage loan on real estate</b>                               | <b>1,048,831</b>    | <b>134,836</b>    |                     | <b>30,486</b>    | <b>1,214,153</b>    |
| <b>Consumer:</b>  |                     |                   |                     |                  |                     |
| Home equity lines of credit   | 300,995             | 11,744            | \$ 5,545            | 3,658            | 321,942             |
| Home equity loans   | 21,609              | 153               | 126                 | 490              | 22,378              |
| Auto Indirect   | 212                 |                   |                     |                  | 212                 |
| Other   | 27,201              | 1,823             |                     | 64               | 29,088              |
| <b>Total consumer loans</b>   | <b>350,017</b>      | <b>13,720</b>     | <b>5,671</b>        | <b>4,212</b>     | <b>373,620</b>      |
| Commercial  | 128,791             | 474               | 9                   | 5,811            | 135,085             |
| <b>Construction:</b>  |                     |                   |                     |                  |                     |
| Residential   | 22,860              |                   |                     | 1,526            | 24,386              |
| Commercial  | 18,553              |                   |                     | 74               | 18,627              |
| <b>Total construction</b>   | <b>41,413</b>       |                   |                     | <b>1,600</b>     | <b>43,013</b>       |
| <b>Total loans, net of deferred loan fees and discounts</b>             | <b>\$ 1,569,052</b> | <b>\$ 149,030</b> | <b>\$ 5,680</b>     | <b>\$ 42,109</b> | <b>\$ 1,765,871</b> |
| <b>Total principal balance of loans owed, net of charge-offs</b>        |                     |                   |                     |                  |                     |
|   | \$ 1,573,693        | \$ 154,730        | \$ 14,981           | \$ 49,919        | \$ 1,793,323        |
| Unamortized net deferred loan fees                                      | (4,641)             |                   |                     |                  | (4,641)             |
| Discounts to principal balance of loans owed, net of charge-offs        |                     | (5,700)           | (9,301)             | (7,810)          | (22,811)            |
| <b>Total loans, net of unamortized deferred loan fees and discounts</b> | <b>\$ 1,569,052</b> | <b>\$ 149,030</b> | <b>\$ 5,680</b>     | <b>\$ 42,109</b> | <b>\$ 1,765,871</b> |
| Noncovered loans  | \$ 1,569,052        | \$ 149,030        | \$ 5,680            | \$ 17,890        | \$ 1,741,652        |
| Covered loans   |                     |                   |                     | 24,219           | \$ 24,219           |
| <b>Total loans, net of unamortized deferred loan fees and discounts</b> | <b>\$ 1,569,052</b> | <b>\$ 149,030</b> | <b>\$ 5,680</b>     | <b>\$ 42,109</b> | <b>\$ 1,765,871</b> |
| Allowance for loan losses   | \$ (31,249)         | \$ (3,262)        | \$ (398)            | \$ (3,011)       | \$ (37,920)         |





**Table of Contents****Note 4 - Loans (continued)**

A summary of loan balances follows (in thousands):

|   | December 31, 2013   |                   |                     |                   |                     |
|---|---------------------|-------------------|---------------------|-------------------|---------------------|
|   | Originated          | PNCI              | PCI -<br>Cash basis | PCI -<br>Other    | Total               |
| <b>Mortgage loans on real estate:</b>                                   |                     |                   |                     |                   |                     |
| Residential 1-4 family  | \$ 129,882          | \$ 60,475         |                     | \$ 4,656          | \$ 195,013          |
| Commercial  | 824,912             | 57,678            |                     | 30,260            | 912,850             |
| <b>Total mortgage loan on real estate</b>                               | <b>954,794</b>      | <b>118,153</b>    |                     | <b>34,916</b>     | <b>1,107,863</b>    |
| <b>Consumer:</b>  |                     |                   |                     |                   |                     |
| Home equity lines of credit   | 316,207             | 13,576            | \$ 6,200            | 3,883             | 339,866             |
| Home equity loans   | 13,849              | 253               |                     | 486               | 14,588              |
| Auto Indirect   | 946                 |                   |                     |                   | 946                 |
| Other   | 25,608              | 2,074             |                     | 81                | 27,763              |
| <b>Total consumer loans</b>   | <b>356,610</b>      | <b>15,903</b>     | <b>6,200</b>        | <b>4,450</b>      | <b>383,163</b>      |
| Commercial  | 124,650             | 693               | 19                  | 6,516             | 131,878             |
| <b>Construction:</b>  |                     |                   |                     |                   |                     |
| Residential   | 30,367              |                   |                     | 1,566             | 31,933              |
| Commercial  | 17,125              |                   |                     | 45                | 17,170              |
| <b>Total construction</b>   | <b>47,492</b>       |                   |                     | <b>1,611</b>      | <b>49,103</b>       |
| <b>Total loans, net of deferred loan fees and discounts</b>             | <b>\$ 1,483,546</b> | <b>\$ 134,749</b> | <b>\$ 6,219</b>     | <b>\$ 47,493</b>  | <b>\$ 1,672,007</b> |
| <b>Total principal balance of loans owed, net of charge-offs</b>        |                     |                   |                     |                   |                     |
|   | \$ 1,487,240        | \$ 142,786        | \$ 16,475           | \$ 56,879         | \$ 1,703,380        |
| Unamortized net deferred loan fees                                      | (3,694)             |                   |                     |                   | (3,694)             |
| Discounts to principal balance of loans owed, net of charge-offs        |                     | (8,037)           | (10,256)            | (9,386)           | (27,679)            |
| <b>Total loans, net of unamortized deferred loan fees and discounts</b> | <b>\$ 1,483,546</b> | <b>\$ 134,749</b> | <b>\$ 6,219</b>     | <b>\$ 47,493</b>  | <b>\$ 1,672,007</b> |
| <b>Noncovered loans</b>   | <b>\$ 1,483,546</b> | <b>\$ 134,749</b> | <b>\$ 6,219</b>     | <b>\$ 19,581</b>  | <b>\$ 1,644,095</b> |
| <b>Covered loans</b>  |                     |                   |                     | <b>27,912</b>     | <b>27,912</b>       |
| <b>Total loans, net of unamortized deferred loan fees and discounts</b> | <b>\$ 1,483,546</b> | <b>\$ 134,749</b> | <b>\$ 6,219</b>     | <b>\$ 47,493</b>  | <b>\$ 1,672,007</b> |
| <b>Allowance for loan losses</b>  | <b>\$ (31,354)</b>  | <b>\$ (2,850)</b> | <b>\$ (385)</b>     | <b>\$ (3,656)</b> | <b>\$ (38,245)</b>  |

The following is a summary of the change in accretable yield for PCI other loans during the periods indicated (in thousands):

|   | Three months ended September 30, |           | Three months ended September 30, |           |
|---|----------------------------------|-----------|----------------------------------|-----------|
|   | 2014                             | 2013      | 2014                             | 2013      |
| Change in accretable yield:                         |                                  |           |                                  |           |
| Balance at beginning of period                      | \$ 16,298                        | \$ 19,727 | \$ 18,232                        | \$ 22,337 |
| Accretion to interest income                        | (1,355)                          | (1,656)   | (4,368)                          | (4,847)   |
| Reclassification (to) from nonaccretable difference | (70)                             | 1,850     | 1,009                            | 2,431     |
| Balance at end of period                            | \$ 14,873                        | \$ 19,921 | \$ 14,873                        | \$ 19,921 |

Throughout these consolidated financial statements, and in particular in this Note 4 and Note 5, when we refer to Loans or Allowance for loan losses we mean all categories of loans, including Originated, PNCI, PCI cash basis, and PCI - other. When we are not referring to all categories of loans, we will indicate which we are referring to Originated, PNCI, PCI cash basis, or PCI - other.

**Table of Contents****Note 5 - Allowance for Loan Losses**

The following tables summarize the activity in the allowance for loan losses, and ending balance of loans, net of unearned fees for the periods indicated.

## Allowance for Loan Losses Three Months Ended September 30, 2014

| (in thousands)       | RE Mortgage |          | Home Equity |          | Auto     | Other   | C&I      | Construction |          | Total     |
|----------------------|-------------|----------|-------------|----------|----------|---------|----------|--------------|----------|-----------|
|                      | Resid.      | Comm.    | Lines       | Loans    | Indirect | Consum. |          | Resid.       | Comm.    |           |
| Beginning balance    | \$ 2,832    | \$ 9,831 | \$ 18,055   | \$ 1,411 | \$ 28    | \$ 556  | \$ 4,407 | \$ 1,511     | \$ 1,337 | \$ 39,968 |
| Charge-offs          | (31)        | (49)     | (136)       |          |          | (118)   | (11)     |              |          | (345)     |
| Recoveries (Benefit) |             | 42       | 249         | 4        | 19       | 71      | 94       | 769          | 26       | 1,274     |
| provision            | 51          | (53)     | (1,239)     | 229      | (31)     | 160     | (428)    | (702)        | (964)    | (2,977)   |
| Ending balance       | \$ 2,852    | \$ 9,771 | \$ 16,929   | \$ 1,644 | \$ 16    | \$ 669  | \$ 4,062 | \$ 1,578     | \$ 399   | \$ 37,920 |

## Allowance for Loan Losses Nine Months Ended September 30, 2014

| (in thousands)       | RE Mortgage |          | Home Equity |          | Auto     | Other   | C&I      | Construction |          | Total     |
|----------------------|-------------|----------|-------------|----------|----------|---------|----------|--------------|----------|-----------|
|                      | Resid.      | Comm.    | Lines       | Loans    | Indirect | Consum. |          | Resid.       | Comm.    |           |
| Beginning balance    | \$ 3,154    | \$ 9,700 | \$ 16,375   | \$ 1,208 | \$ 66    | \$ 589  | \$ 4,331 | \$ 1,559     | \$ 1,263 | \$ 38,245 |
| Charge-offs          | (167)       | (107)    | (991)       | (11)     |          | (389)   | (401)    | (4)          | (69)     | (2,139)   |
| Recoveries (Benefit) |             | 513      | 758         | 31       | 70       | 373     | 1,155    | 1,377        | 161      | 4,438     |
| provision            | (135)       | (335)    | 787         | 416      | (120)    | 96      | (1,023)  | (1,354)      | (956)    | (2,624)   |
| Ending balance       | \$ 2,852    | \$ 9,771 | \$ 16,929   | \$ 1,644 | \$ 16    | \$ 669  | \$ 4,062 | \$ 1,578     | \$ 399   | \$ 37,920 |

Ending balance:

|                                   |        |        |          |        |  |       |        |       |  |          |
|-----------------------------------|--------|--------|----------|--------|--|-------|--------|-------|--|----------|
| Individ. evaluated for impairment | \$ 902 | \$ 413 | \$ 2,001 | \$ 213 |  | \$ 69 | \$ 433 | \$ 60 |  | \$ 4,091 |
|-----------------------------------|--------|--------|----------|--------|--|-------|--------|-------|--|----------|

|                             |          |          |           |          |       |        |          |        |        |           |
|-----------------------------|----------|----------|-----------|----------|-------|--------|----------|--------|--------|-----------|
| Loans pooled for evaluation | \$ 1,765 | \$ 9,182 | \$ 14,428 | \$ 1,431 | \$ 16 | \$ 600 | \$ 2,354 | \$ 349 | \$ 295 | \$ 30,420 |
|-----------------------------|----------|----------|-----------|----------|-------|--------|----------|--------|--------|-----------|

|   |        |        |        |  |  |  |          |          |        |          |
|---|--------|--------|--------|--|--|--|----------|----------|--------|----------|
| Loans acquired with deteriorated credit quality | \$ 185 | \$ 176 | \$ 500 |  |  |  | \$ 1,275 | \$ 1,169 | \$ 104 | \$ 3,409 |
|---|--------|--------|--------|--|--|--|----------|----------|--------|----------|

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| (in thousands)                                  | RE Mortgage |            | Loans, net of unearned fees |           |               | As of September 30, 2014     |            |           | Construction |              | Total |
|---|-------------|------------|-----------------------------|-----------|---------------|------------------------------|------------|-----------|--------------|--------------|-------|
|   | Resid.      | Comm.      | Home Equity Lines           | Loans     | Auto Indirect | Other Consum.                | C&I        | Resid.    | Comm.        |              |       |
| Ending balance:                                 |             |            |                             |           |               |                              |            |           |              |              |       |
| Total loans                                     | \$ 228,407  | \$ 985,746 | \$ 321,942                  | \$ 22,378 | \$ 212        | \$ 29,088                    | \$ 135,085 | \$ 24,386 | \$ 18,627    | \$ 1,765,871 |       |
| Individ. evaluated for impairment               | \$ 7,142    | \$ 50,322  | \$ 6,733                    | \$ 896    | \$ 23         | \$ 194                       | \$ 1,902   | \$ 2,720  | \$ 114       | \$ 70,046    |       |
| Loans pooled for evaluation                     | \$ 217,478  | \$ 908,725 | \$ 306,006                  | \$ 20,866 | \$ 189        | \$ 28,830                    | \$ 127,363 | \$ 20,140 | \$ 18,439    | \$ 1,648,036 |       |
| Loans acquired with deteriorated credit quality | \$ 3,787    | \$ 26,699  | \$ 9,203                    | \$ 616    |               | \$ 64                        | \$ 5,820   | \$ 1,526  | \$ 74        | \$ 47,789    |       |
|   |             |            |                             |           |               |                              |            |           |              |              |       |
| (in thousands)                                  | RE Mortgage |            | Allowance for Loan Losses   |           |               | Year Ended December 31, 2013 |            |           | Construction |              | Total |
|   | Resid.      | Comm.      | Home Equity Lines           | Loans     | Auto Indirect | Other Consum.                | C&I        | Resid.    | Comm.        |              |       |
| Beginning balance                               | \$ 3,523    | \$ 8,782   | \$ 21,367                   | \$ 1,155  | \$ 243        | \$ 696                       | \$ 4,703   | \$ 1,400  | \$ 779       | \$ 42,648    |       |
| Charge-offs                                     | (46)        | (2,038)    | (2,651)                     | (94)      | (68)          | (887)                        | (1,599)    | (20)      | (140)        | (7,543)      |       |
| Recoveries (Benefit) provision                  | 345 (668)   | 994 1,962  | 1,053 (3,394)               | 41 106    | 195 (304)     | 759 21                       | 340 887    | 63 116    | 65 559       | 3,855 (715)  |       |
| Ending balance                                  | \$ 3,154    | \$ 9,700   | \$ 16,375                   | \$ 1,208  | \$ 66         | \$ 589                       | \$ 4,331   | \$ 1,559  | \$ 1,263     | \$ 38,245    |       |
| Ending balance:                                 |             |            |                             |           |               |                              |            |           |              |              |       |
| Individ. evaluated for impairment               | \$ 775      | \$ 1,198   | \$ 1,140                    | \$ 169    | \$ 1          | \$ 8                         | \$ 585     | \$ 91     | \$ 8         | \$ 3,975     |       |
| Loans pooled for evaluation                     | \$ 2,039    | \$ 7,815   | \$ 14,749                   | \$ 1,039  | \$ 65         | \$ 581                       | \$ 2,402   | \$ 751    | \$ 789       | \$ 30,230    |       |
| Loans acquired with deteriorated credit quality | \$ 340      | \$ 687     | \$ 486                      |           |               |                              | \$ 1,344   | \$ 717    | \$ 466       | \$ 4,040     |       |

**Table of Contents****Note 5 - Allowance for Loan Losses (continued)**

| (in thousands)                                  | Loans, net of unearned fees As of December 31, 2013 |            |             |           |          |           |            |              |           |              |
|---|---|------------|-------------|-----------|----------|-----------|------------|--------------|-----------|--------------|
|   | RE Mortgage   |            | Home Equity |           | Auto     | Other     | C&I        | Construction |           | Total        |
|   | Resid.  | Comm.      | Lines       | Loans     | Indirect | Consum.   |            | Resid.       | Comm.     |              |
| Ending balance:                                 |   |            |             |           |          |           |            |              |           |              |
| Total loans                                     | \$ 195,013  | \$ 912,850 | \$ 339,866  | \$ 14,588 | \$ 946   | \$ 27,763 | \$ 131,878 | \$ 31,933    | \$ 17,170 | \$ 1,672,007 |
| Individ. evaluated for impairment               | \$ 7,342  | \$ 59,936  | \$ 6,918    | \$ 778    | \$ 60    | \$ 90     | \$ 3,177   | \$ 2,756     | \$ 178    | \$ 81,235    |
| Loans pooled for evaluation                     | \$ 183,015  | \$ 822,654 | \$ 322,865  | \$ 13,324 | \$ 886   | \$ 27,592 | \$ 122,166 | \$ 27,611    | \$ 16,947 | \$ 1,537,060 |
| Loans acquired with deteriorated credit quality | \$ 4,656  | \$ 30,260  | \$ 10,083   | \$ 486    |          | \$ 81     | \$ 6,535   | \$ 1,566     | \$ 45     | \$ 53,712    |

| (In thousands)      | Allowance for Loan Losses Three months ended September 30, 2013 |          |             |          |          |         |          |              |          |           |
|---------------------|---|----------|-------------|----------|----------|---------|----------|--------------|----------|-----------|
|                     | RE Mortgage   |          | Home Equity |          | Auto     | Other   | C&I      | Construction |          | Total     |
|                     | Resid.  | Comm.    | Lines       | Loans    | Indirect | Consum. |          | Resid.       | Comm.    |           |
| Beginning balance   | \$ 3,231  | \$ 8,764 | \$ 18,710   | \$ 1,109 | \$ 114   | \$ 567  | \$ 4,929 | \$ 1,288     | \$ 887   | \$ 39,599 |
| Charge-offs         | (4)   | (23)     | (331)       | (30)     | (9)      | (239)   | (318)    |              | (31)     | (985)     |
| Recoveries          | 154   | 295      | 304         | 3        | 34       | 199     | 108      | 2            | 20       | 1,119     |
| (Benefit) provision | (190)   | 704      | (871)       | (50)     | (58)     | 7       | (234)    | 157          | 142      | (393)     |
| Ending balance      | \$ 3,191  | \$ 9,740 | \$ 17,812   | \$ 1,032 | \$ 81    | \$ 534  | \$ 4,485 | \$ 1,447     | \$ 1,018 | \$ 39,340 |

| (In thousands)      | Allowance for Loan Losses As of and nine months ended September 30, 2013 |          |             |          |          |         |          |              |        |           |
|---------------------|--|----------|-------------|----------|----------|---------|----------|--------------|--------|-----------|
|                     | RE Mortgage  |          | Home Equity |          | Auto     | Other   | C&I      | Construction |        | Total     |
|                     | Resid.   | Comm.    | Lines       | Loans    | Indirect | Consum. |          | Resid.       | Comm.  |           |
| Beginning balance   | \$ 3,523   | \$ 8,782 | \$ 21,367   | \$ 1,155 | \$ 243   | \$ 696  | \$ 4,703 | \$ 1,400     | \$ 779 | \$ 42,648 |
| Charge-offs         | (46)   | (1,712)  | (1,843)     | (56)     | (67)     | (724)   | (1,143)  | (20)         | (92)   | (5,703)   |
| Recoveries          | 345  | 965      | 809         | 29       | 180      | 601     | 244      | 63           | 46     | 3,282     |
| (Benefit) provision | (631)  | 1,705    | (2,521)     | (96)     | (275)    | (39)    | 681      | 4            | 285    | (887)     |

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|  |          |          |           |          |       |        |          |          |          |           |
|--|----------|----------|-----------|----------|-------|--------|----------|----------|----------|-----------|
| Ending balance   | \$ 3,191 | \$ 9,740 | \$ 17,812 | \$ 1,032 | \$ 81 | \$ 534 | \$ 4,485 | \$ 1,447 | \$ 1,018 | \$ 39,340 |
| Ending balance:<br>Individ.<br>evaluated for<br>impairment | \$ 623   | \$ 1,446 | \$ 1,554  | \$ 49    | \$ 2  | \$ 6   | \$ 678   | \$ 91    | \$ 9     | \$ 4,458  |
| Loans pooled<br>for evaluation                             | \$ 2,235 | \$ 7,748 | \$ 15,259 | \$ 983   | \$ 79 | \$ 521 | \$ 2,448 | \$ 723   | \$ 653   | \$ 30,649 |
| Loans<br>acquired with<br>deteriorated<br>credit quality   | \$ 333   | \$ 546   | \$ 999    |          |       | \$ 7   | \$ 1,359 | \$ 633   | \$ 356   | \$ 4,233  |

| (In thousands)   | Loans, net of unearned fees As of September 30, 2013 |            |             |           |          |           |              |           |           | Total        |
|--|--|------------|-------------|-----------|----------|-----------|--------------|-----------|-----------|--------------|
|  | RE Mortgage  |            | Home Equity |           | Auto     | Other     | Construction |           |           |              |
|  | Resid.   | Comm.      | Lines       | Loans     | Indirect | Consum.   | C&I          | Resid.    | Comm.     |              |
| Ending balance:<br>Total loans                           | \$ 197,129   | \$ 894,346 | \$ 346,348  | \$ 13,730 | \$ 1,351 | \$ 28,282 | \$ 133,616   | \$ 27,601 | \$ 14,648 | \$ 1,657,051 |
| Individ.<br>evaluated for<br>impairment                  | \$ 7,013   | \$ 69,373  | \$ 7,664    | \$ 551    | \$ 66    | \$ 94     | \$ 3,333     | \$ 2,872  | \$ 252    | \$ 91,218    |
| Loans pooled<br>for evaluation                           | \$ 183,769   | \$ 794,301 | \$ 328,215  | \$ 12,575 | \$ 1,285 | \$ 28,113 | \$ 123,476   | \$ 23,497 | \$ 13,822 | \$ 1,509,053 |
| Loans<br>acquired with<br>deteriorated<br>credit quality | \$ 6,347   | \$ 30,672  | \$ 10,469   | \$ 604    |          | \$ 75     | \$ 6,807     | \$ 1,232  | \$ 574    | \$ 56,780    |

**Table of Contents****Note 5 - Allowance for Loan Losses (continued)**

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including, but not limited to, trends relating to (i) the level of criticized and classified loans, (ii) net charge-offs, (iii) non-performing loans, and (iv) delinquency within the portfolio.

The Company utilizes a risk grading system to assign a risk grade to each of its loans. Loans are graded on a scale ranging from Pass to Loss. A description of the general characteristics of the risk grades is as follows:

*Pass* This grade represents loans ranging from acceptable to very little or no credit risk. These loans typically meet most if not all policy standards in regard to: loan amount as a percentage of collateral value, debt service coverage, profitability, leverage, and working capital.

*Special Mention* This grade represents Other Assets Especially Mentioned in accordance with regulatory guidelines and includes loans that display some potential weaknesses which, if left unaddressed, may result in deterioration of the repayment prospects for the asset or may inadequately protect the Company's position in the future. These loans warrant more than normal supervision and attention.

*Substandard* This grade represents Substandard loans in accordance with regulatory guidelines. Loans within this rating typically exhibit weaknesses that are well defined to the point that repayment is jeopardized. Loss potential is, however, not necessarily evident. The underlying collateral supporting the credit appears to have sufficient value to protect the Company from loss of principal and accrued interest, or the loan has been written down to the point where this is true. There is a definite need for a well defined workout/rehabilitation program.

*Doubtful* This grade represents Doubtful loans in accordance with regulatory guidelines. An asset classified as Doubtful has all the weaknesses inherent in a loan classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral, and financing plans.

*Loss* This grade represents Loss loans in accordance with regulatory guidelines. A loan classified as Loss is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the loan, even though some recovery may be affected in the future. The portion of the loan that is graded loss should be charged off no later than the end of the quarter in which the loss is identified.

The following tables present ending loan balances by loan category and risk grade for the periods indicated:



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| (in thousands)       | Credit Quality Indicators |                   |                      |                 |                  |                  | As of September 30, 2014 |                        |                       |              |
|----------------------|---------------------------|-------------------|----------------------|-----------------|------------------|------------------|--------------------------|------------------------|-----------------------|--------------|
|                      | RE Mortgage<br>Resid.     | Mortgage<br>Comm. | Home Equity<br>Lines | Equity<br>Loans | Auto<br>Indirect | Other<br>Consum. | C&I                      | Construction<br>Resid. | Construction<br>Comm. | Total        |
| Originated<br>loans: |                           |                   |                      |                 |                  |                  |                          |                        |                       |              |
| Pass                 | \$ 133,922                | \$ 857,171        | \$ 288,680           | \$ 19,402       | \$ 145           | \$ 26,639        | \$ 126,554               | \$ 19,565              | \$ 18,380             | \$ 1,490,458 |
| Special mention      | 832                       | 13,626            | 3,290                | 767             | 20               | 347              | 1,131                    | 858                    | 34                    | 20,905       |
| Substandard          | 7,100                     | 36,180            | 9,025                | 1,440           | 47               | 215              | 1,106                    | 2,437                  | 139                   | 57,689       |
| Loss                 |                           |                   |                      |                 |                  |                  |                          |                        |                       |              |
| Total originated     | \$ 141,854                | \$ 906,977        | \$ 300,995           | \$ 21,609       | \$ 212           | \$ 27,201        | \$ 128,791               | \$ 22,860              | \$ 18,553             | \$ 1,569,052 |
| PNCI loans:          |                           |                   |                      |                 |                  |                  |                          |                        |                       |              |
| Pass                 | \$ 82,180                 | \$ 44,652         | \$ 10,879            | \$ 153          |                  | \$ 1,719         | \$ 195                   |                        |                       | \$ 139,778   |
| Special mention      |                           | 4,697             | 229                  |                 |                  | 38               | 279                      |                        |                       | 5,243        |
| Substandard          | 586                       | 2,721             | 636                  |                 |                  | 66               |                          |                        |                       | 4,009        |
| Total PNCI           | \$ 82,766                 | \$ 52,070         | \$ 11,744            | \$ 153          |                  | \$ 1,823         | \$ 474                   |                        |                       | \$ 149,030   |
| PNCI loans           | \$ 3,787                  | \$ 26,699         | \$ 9,203             | \$ 616          |                  | \$ 64            | \$ 5,820                 | \$ 1,526               | \$ 74                 | \$ 47,789    |
| Total loans          | \$ 228,407                | \$ 985,746        | \$ 321,942           | \$ 22,378       | \$ 212           | \$ 29,088        | \$ 135,085               | \$ 24,386              | \$ 18,627             | \$ 1,765,871 |

| (in thousands)       | Credit Quality Indicators |                   |                      |                 |                  |                  | As of December 31, 2013 |                        |                       |              |
|----------------------|---------------------------|-------------------|----------------------|-----------------|------------------|------------------|-------------------------|------------------------|-----------------------|--------------|
|                      | RE Mortgage<br>Resid.     | Mortgage<br>Comm. | Home Equity<br>Lines | Equity<br>Loans | Auto<br>Indirect | Other<br>Consum. | C&I                     | Construction<br>Resid. | Construction<br>Comm. | Total        |
| Originated<br>loans: |                           |                   |                      |                 |                  |                  |                         |                        |                       |              |
| Pass                 | \$ 121,969                | \$ 768,596        | \$ 302,232           | \$ 12,284       | \$ 717           | \$ 24,653        | \$ 121,580              | \$ 25,836              | \$ 16,571             | \$ 1,394,438 |
| Special mention      | 1,265                     | 15,862            | 4,529                | 504             | 118              | 756              | 938                     | 96                     | 343                   | 24,411       |
| Substandard          | 6,648                     | 40,454            | 9,446                | 1,061           | 111              | 196              | 2,122                   | 4,435                  | 211                   | 64,684       |
| Loss                 |                           |                   |                      |                 |                  | 3                | 10                      |                        |                       | 13           |
| Total originated     | \$ 129,882                | \$ 824,912        | \$ 316,207           | \$ 13,849       | \$ 946           | \$ 25,608        | \$ 124,650              | \$ 30,367              | \$ 17,125             | \$ 1,483,546 |
| PNCI loans:          |                           |                   |                      |                 |                  |                  |                         |                        |                       |              |
| Pass                 | \$ 59,798                 | \$ 48,548         | \$ 12,716            | \$ 253          |                  | \$ 2,020         | \$ 380                  |                        |                       | \$ 123,715   |
| Special mention      |                           | 5,810             | 195                  |                 |                  | 18               | 313                     |                        |                       | 6,336        |
| Substandard          | 677                       | 3,320             | 665                  |                 |                  | 36               |                         |                        |                       | 4,698        |
| Total PNCI           | \$ 60,475                 | \$ 57,678         | \$ 13,576            | \$ 253          |                  | \$ 2,074         | \$ 693                  |                        |                       | \$ 134,749   |
| PNCI loans           | \$ 4,656                  | \$ 30,260         | \$ 10,083            | \$ 486          |                  | \$ 81            | \$ 6,535                | \$ 1,566               | \$ 45                 | \$ 53,712    |
| Total loans          | \$ 195,013                | \$ 912,850        | \$ 339,866           | \$ 14,588       | \$ 946           | \$ 27,763        | \$ 131,878              | \$ 31,933              | \$ 17,170             | \$ 1,672,007 |

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**Table of Contents****Note 5 - Allowance for Loan Losses (continued)**

Consumer loans, whether unsecured or secured by real estate, automobiles, or other personal property, are susceptible to three primary risks; non-payment due to income loss, over-extension of credit and, when the borrower is unable to pay, shortfall in collateral value. Typically non-payment is due to loss of job and will follow general economic trends in the marketplace driven primarily by rises in the unemployment rate. Loss of collateral value can be due to market demand shifts, damage to collateral itself or a combination of the two.

Problem consumer loans are generally identified by payment history of the borrower (delinquency). The Bank manages its consumer loan portfolios by monitoring delinquency and contacting borrowers to encourage repayment, suggest modifications if appropriate, and, when continued scheduled payments become unrealistic, initiate repossession or foreclosure through appropriate channels. Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, public value information (blue book values for autos), sales invoices, or other appropriate means. Appropriate valuations are obtained at initiation of the credit and periodically (every 3-12 months depending on collateral type) once repayment is questionable and the loan has been classified.

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner occupied real estate are primarily susceptible to changes in the business conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual fortunes of the business owner, and general economic conditions and changes in business cycles. These same risks apply to commercial loans whether secured by equipment or other personal property or unsecured. Losses on loans secured by owner occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often these shifts are a result of changes in general economic or market conditions or overbuilding and resultant over-supply. Losses are dependent on value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs.

Construction loans, whether owner occupied or non-owner occupied commercial real estate loans or residential development loans, are not only susceptible to the related risks described above but the added risks of construction itself including cost over-runs, mismanagement of the project, or lack of demand or market changes experienced at time of completion. Again, losses are primarily related to underlying collateral value and changes therein as described above.

Problem C&I loans are generally identified by periodic review of financial information which may include financial statements, tax returns, rent rolls and payment history of the borrower (delinquency). Based on this information the Bank may decide to take any of several courses of action including demand for repayment, additional collateral or guarantors, and, when repayment becomes unlikely through borrower's income and cash flow, repossession or foreclosure of the underlying collateral.

Collateral values may be determined by appraisals obtained through Bank approved, licensed appraisers, qualified independent third parties, public value information (blue book values for autos), sales invoices, or other appropriate means. Appropriate valuations are obtained at initiation of the credit and periodically (every 3-12 months depending on collateral type) once repayment is questionable and the loan has been classified.

Once a loan becomes delinquent and repayment becomes questionable, a Bank collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Bank will estimate its probable loss, using a recent valuation as appropriate to the underlying collateral less estimated costs of sale, and charge the loan down to the estimated net realizable amount. Depending on the length of time until ultimate collection, the Bank may revalue the underlying collateral and take additional charge-offs as warranted. Revaluations may occur as often as every 3-12 months depending on the underlying collateral and volatility of values. Final charge-offs or recoveries are taken when collateral is liquidated and actual loss is known. Unpaid balances on loans after or during collection and liquidation may also be pursued through lawsuit and attachment of wages or judgment liens on borrower's other assets.

The following table shows the ending balance of current, past due, and nonaccrual originated loans by loan category as of the date indicated:

| (in thousands)                  | Analysis of Past Due and Nonaccrual Originated Loans |                      |                      |                      |                  |                  |            | As of September 30, 2014 |                       | Total        |
|---------------------------------|--|----------------------|----------------------|----------------------|------------------|------------------|------------|--------------------------|-----------------------|--------------|
|                                 | RE Mortgage<br>Resid.                                | RE Mortgage<br>Comm. | Home Equity<br>Lines | Home Equity<br>Loans | Auto<br>Indirect | Other<br>Consum. | C&I        | Construction<br>Resid.   | Construction<br>Comm. |              |
| Originated<br>loan balance:     |  |                      |                      |                      |                  |                  |            |                          |                       |              |
| Past due:                       |  |                      |                      |                      |                  |                  |            |                          |                       |              |
| 30-59 Days                      | \$ 112   | \$ 933               | \$ 1,692             | \$ 202               | \$ 2             | \$ 81            | \$ 414     |                          |                       | \$ 3,436     |
| 60-89 Days                      | 509  | 205                  | 514                  | 208                  | 1                | 11               | 27         |                          |                       | 1,475        |
| > 90 Days                       | 591  | 1,490                | 521                  | 127                  | 20               | 10               | 99         |                          | 102                   | 2,960        |
| Total past due                  | \$ 1,212   | \$ 2,628             | \$ 2,727             | \$ 537               | \$ 23            | \$ 102           | \$ 540     |                          | \$ 102                | \$ 7,871     |
| Current                         | 140,642  | 904,349              | 298,268              | 21,072               | 189              | 27,099           | 128,251    | 22,860                   | 18,451                | 1,561,181    |
| Total orig.<br>loans            | \$ 141,854   | \$ 906,977           | \$ 300,995           | \$ 21,609            | \$ 212           | \$ 27,201        | \$ 128,791 | \$ 22,860                | \$ 18,553             | \$ 1,569,052 |
| > 90 Days and<br>still accruing |  | \$ 360               |                      |                      |                  |                  |            |                          |                       | \$ 360       |
| Nonaccrual<br>loans             | \$ 4,018   | \$ 21,471            | \$ 4,257             | \$ 838               | \$ 23            | \$ 19            | \$ 312     | \$ 2,437                 | \$ 114                | \$ 33,489    |

**Table of Contents****Note 5 - Allowance for Loan Losses (continued)**

The following table shows the ending balance of current, past due, and nonaccrual PNCI loans by loan category as of the date indicated:

| (in thousands)               | Analysis of Past Due and Nonaccrual PNCI Loans |                   |                   |                   |               |               | As of September 30, 2014 |                     | Total |                    |
|------------------------------|--|-------------------|-------------------|-------------------|---------------|---------------|--------------------------|---------------------|-------|--------------------|
|                              | RE Mortgage Resid.                             | RE Mortgage Comm. | Home Equity Lines | Home Equity Loans | Auto Indirect | Other Consum. | C&I                      | Construction Resid. |       | Construction Comm. |
| PNCI loan balance:           |  |                   |                   |                   |               |               |                          |                     |       |                    |
| Past due:                    |  |                   |                   |                   |               |               |                          |                     |       |                    |
| 30-59 Days                   | \$ 192   |                   |                   |                   |               |               |                          |                     |       | \$ 192             |
| 60-89 Days                   | 1,208  |                   |                   |                   |               |               |                          |                     |       | 1,208              |
| > 90 Days                    |  |                   | 36                |                   |               |               |                          |                     |       | 36                 |
| Total past due               | \$ 1,400                                       |                   | \$ 36             |                   |               |               |                          |                     |       | \$ 1,436           |
| Current                      | 81,366   | 52,070            | 11,708            | 153               |               | 1,823         | 474                      |                     |       | 147,594            |
| Total PNCI loans             | \$ 82,766                                      | \$ 52,070         | \$ 11,744         | \$ 153            |               | \$ 1,823      | \$ 474                   |                     |       | \$ 149,030         |
| > 90 Days and still accruing |  |                   |                   |                   |               |               |                          |                     |       |                    |
| Nonaccrual loans             |  |                   |                   |                   |               |               |                          |                     |       |                    |
|                              | \$ 349   | \$ 419            | \$ 314            |                   |               | \$ 31         |                          |                     |       | \$ 1,113           |

The following table shows the ending balance of current, past due, and nonaccrual originated loans by loan category as of the date indicated:

| (in thousands)           | Analysis of Past Due and Nonaccrual Originated Loans |                   |                   |                   |               |               | As of December 31, 2013 |                     | Total  |                    |
|--------------------------|--|-------------------|-------------------|-------------------|---------------|---------------|-------------------------|---------------------|--------|--------------------|
|                          | RE Mortgage Resid.                                   | RE Mortgage Comm. | Home Equity Lines | Home Equity Loans | Auto Indirect | Other Consum. | C&I                     | Construction Resid. |        | Construction Comm. |
| Originated loan balance: |  |                   |                   |                   |               |               |                         |                     |        |                    |
| Past due:                |  |                   |                   |                   |               |               |                         |                     |        |                    |
| 30-59 Days               | \$ 2,272   | \$ 2,304          | \$ 3,121          | \$ 264            | \$ 24         | \$ 40         | \$ 296                  |                     |        | \$ 8,321           |
| 60-89 Days               | 284  |                   | 1,070             | 16                | 1             | 16            | 76                      |                     | \$ 198 | 1,661              |
| > 90 Days                | 447  | 2,213             | 1,050             | 312               | 33            | 7             | 749                     | \$ 13               |        | 4,824              |
| Total past due           | \$ 3,003   | \$ 4,517          | \$ 5,241          | \$ 592            | \$ 58         | \$ 63         | \$ 1,121                | \$ 13               | \$ 198 | \$ 14,806          |
| Current                  | 126,879  | 820,395           | 310,966           | 13,257            | 888           | 25,545        | 123,529                 | 30,354              | 16,927 | 1,468,740          |

|                              |            |            |            |           |        |        |            |           |           |              |
|------------------------------|------------|------------|------------|-----------|--------|--------|------------|-----------|-----------|--------------|
| Total orig. loans            | \$ 129,882 | \$ 824,912 | \$ 316,207 | \$ 13,849 | \$ 946 | 25,608 | \$ 124,650 | \$ 30,367 | \$ 17,125 | \$ 1,483,546 |
| > 90 Days and still accruing |            |            |            |           |        |        |            |           |           |              |
| Nonaccrual loans             | \$ 4,697   | \$ 30,732  | \$ 4,972   | \$ 719    | \$ 54  | \$ 26  | \$ 1,280   | \$ 2,473  | \$ 178    | \$ 45,131    |

The following table shows the ending balance of current, past due, and nonaccrual PNCI loans by loan category as of the date indicated:

| (in thousands)               | Analysis of Past Due and Nonaccrual PNCI Loans |                   |                   |                   |               |               | As of December 31, 2013 |                     | Total |                    |
|------------------------------|--|-------------------|-------------------|-------------------|---------------|---------------|-------------------------|---------------------|-------|--------------------|
|                              | RE Mortgage Resid.                             | RE Mortgage Comm. | Home Equity Lines | Home Equity Loans | Auto Indirect | Other Consum. | C&I                     | Construction Resid. |       | Construction Comm. |
| PNCI loan balance:           |  |                   |                   |                   |               |               |                         |                     |       |                    |
| Past due:                    |  |                   |                   |                   |               |               |                         |                     |       |                    |
| 30-59 Days                   | \$ 799   | \$ 512            | \$ 313            |                   |               | \$ 49         |                         |                     |       | \$ 1,673           |
| 60-89 Days                   |  | 352               | 38                |                   |               |               |                         |                     |       | 390                |
| > 90 Days                    |  | 217               |                   |                   |               |               |                         |                     |       | 217                |
| Total past due               | \$ 799   | \$ 1,081          | \$ 351            |                   |               | \$ 49         |                         |                     |       | \$ 2,280           |
| Current                      | 59,676   | 56,597            | 13,225            | \$ 253            |               | 2,025         | \$ 693                  |                     |       | 132,469            |
| Total PNCI loans             | \$ 60,475                                      | \$ 57,678         | \$ 13,576         | \$ 253            |               | \$ 2,074      | \$ 693                  |                     |       | \$ 134,749         |
| > 90 Days and still accruing |  |                   |                   |                   |               |               |                         |                     |       |                    |
| Nonaccrual loans             | \$ 262   | \$ 1,139          | \$ 429            |                   |               | \$ 36         |                         |                     |       | \$ 1,866           |

Impaired originated loans are those where management has concluded that it is probable that the borrower will be unable to pay all amounts due under the contractual terms.

**Table of Contents****Note 5 - Allowance for Loan Losses (continued)**

The following tables show the recorded investment (financial statement balance), unpaid principal balance, average recorded investment, and interest income recognized for impaired Originated and PNCI loans, segregated by those with no related allowance recorded and those with an allowance recorded for the periods indicated.

| (in thousands)                      | Impaired Originated Loans As of, or for the Nine Months Ended, September 30, 2014 |                      |                      |                      |                  |                  |          |                        |                       | Total     |
|-------------------------------------|---|----------------------|----------------------|----------------------|------------------|------------------|----------|------------------------|-----------------------|-----------|
|                                     | RE Mortgage<br>Resid.   | RE Mortgage<br>Comm. | Home Equity<br>Lines | Home Equity<br>Loans | Auto<br>Indirect | Other<br>Consum. | C&I      | Construction<br>Resid. | Construction<br>Comm. |           |
| With no related allowance recorded: |   |                      |                      |                      |                  |                  |          |                        |                       |           |
| Recorded investment                 | \$ 3,576  | \$ 46,412            | \$ 2,655             | \$ 657               | \$ 23            | \$ 18            | \$ 789   | \$ 2,437               | \$ 114                | \$ 56,681 |
| Unpaid principal                    | \$ 5,671  | \$ 49,609            | \$ 5,645             | \$ 1,082             | \$ 60            | \$ 25            | \$ 806   | \$ 6,686               | \$ 198                | \$ 69,782 |
| Average recorded Investment         | \$ 3,971  | \$ 49,882            | \$ 3,182             | \$ 604               | \$ 39            | \$ 17            | \$ 1,218 | \$ 2,455               | \$ 92                 | \$ 61,460 |
| Interest income Recognized          | \$ 29   | \$ 999               | \$ 14                | \$ 1                 |                  |                  | \$ 37    |                        | \$ 3                  | \$ 1,083  |
| With an allowance recorded:         |   |                      |                      |                      |                  |                  |          |                        |                       |           |
| Recorded investment                 | \$ 2,838  | \$ 3,344             | \$ 3,291             | \$ 239               |                  |                  | \$ 1,105 | \$ 283                 |                       | \$ 11,100 |
| Unpaid principal                    | \$ 3,017  | \$ 3,489             | \$ 3,653             | \$ 323               |                  |                  | \$ 1,151 | \$ 283                 |                       | \$ 11,916 |
| Related allowance                   | \$ 745  | \$ 304               | \$ 1,764             | \$ 213               |                  |                  | \$ 433   | \$ 60                  |                       | \$ 3,519  |
| Average recorded Investment         | \$ 2,734  | \$ 4,320             | \$ 3,035             | \$ 233               | \$ 2             | \$ 5             | \$ 1,311 | \$ 283                 | \$ 55                 | \$ 11,978 |
| Interest income Recognized          | \$ 59   | \$ 133               | \$ 49                | \$ 3                 |                  |                  | \$ 41    | \$ 14                  |                       | \$ 299    |

| (in thousands)            | Impaired PNCI Loans As of, or for the Nine Months Ended, September 30, 2014 |                      |                      |                      |                  |                  |     |                        |                       | Total |
|---------------------------|---|----------------------|----------------------|----------------------|------------------|------------------|-----|------------------------|-----------------------|-------|
|                           | RE Mortgage<br>Resid.   | RE Mortgage<br>Comm. | Home Equity<br>Lines | Home Equity<br>Loans | Auto<br>Indirect | Other<br>Consum. | C&I | Construction<br>Resid. | Construction<br>Comm. |       |
| With no related allowance |   |                      |                      |                      |                  |                  |     |                        |                       |       |

|                             |        |          |        |        |       |          |
|-----------------------------|--------|----------|--------|--------|-------|----------|
| recorded:                   |        |          |        |        |       |          |
| Recorded investment         | \$ 299 | \$ 419   | \$ 314 | \$ 31  | \$ 8  | \$ 1,071 |
| Unpaid principal            | \$ 306 | \$ 2,636 | \$ 337 | \$ 44  | \$ 8  | \$ 3,331 |
| Average recorded Investment | \$ 224 | \$ 779   | \$ 270 | \$ 34  | \$ 10 | \$ 1,317 |
| Interest income Recognized  | \$ 12  |          |        |        | \$ 1  | \$ 13    |
| With an allowance recorded: |        |          |        |        |       |          |
| Recorded investment         | \$ 429 | \$ 147   | \$ 473 | \$ 145 |       | \$ 1,194 |
| Unpaid principal            | \$ 442 | \$ 147   | \$ 473 | \$ 145 |       | \$ 1,207 |
| Related allowance           | \$ 158 | \$ 109   | \$ 237 | \$ 69  |       | \$ 573   |
| Average recorded Investment | \$ 313 | \$ 148   | \$ 338 | \$ 87  |       | \$ 886   |
| Interest income Recognized  | \$ 6   | \$ 6     | \$ 16  | \$ 8   |       | \$ 36    |

**Table of Contents****Note 5 - Allowance for Loan Losses (continued)**

| (in thousands)                      | Impaired Originated Loans |                   |                      |                      | As of, or for the Year Ended, December 31, 2013 |                  |          |                        |                       |           |
|-------------------------------------|---------------------------|-------------------|----------------------|----------------------|---|------------------|----------|------------------------|-----------------------|-----------|
|                                     | RE Mortgage<br>Resid.     | Mortgage<br>Comm. | Home Equity<br>Lines | Home Equity<br>Loans | Auto<br>Indirect                                | Other<br>Consum. | C&I      | Construction<br>Resid. | Construction<br>Comm. | Total     |
| With no related allowance recorded: |                           |                   |                      |                      |   |                  |          |                        |                       |           |
| Recorded investment                 | \$ 4,366                  | \$ 53,352         | \$ 3,710             | \$ 552               | \$ 55   | \$ 16            | \$ 1,648 | \$ 2,473               | \$ 69                 | \$ 66,241 |
| Unpaid principal                    | \$ 6,489                  | \$ 58,894         | \$ 7,299             | \$ 1,249             | \$ 123  | \$ 21            | \$ 1,665 | \$ 6,611               | \$ 138                | \$ 82,489 |
| Average recorded Investment         | \$ 4,123                  | \$ 58,205         | \$ 4,410             | \$ 463               | \$ 93   | \$ 18            | \$ 2,154 | \$ 1,567               | \$ 83                 | \$ 71,116 |
| Interest income Recognized          | \$ 336                    | \$ 3,361          | \$ 352               | \$ 36                | \$ 12   | \$ 1             | \$ 113   | \$ 108                 | \$ 7                  | \$ 4,326  |
| With an allowance recorded:         |                           |                   |                      |                      |   |                  |          |                        |                       |           |
| Recorded investment                 | \$ 2,630                  | \$ 5,296          | \$ 2,779             | \$ 226               | \$ 4  | \$ 10            | \$ 1,517 | \$ 284                 | \$ 109                | \$ 12,855 |
| Unpaid principal                    | \$ 2,689                  | \$ 5,659          | \$ 3,053             | \$ 291               | \$ 6  | \$ 10            | \$ 1,616 | \$ 284                 | \$ 288                | \$ 13,896 |
| Related allowance                   | \$ 648                    | \$ 1,084          | \$ 968               | \$ 169               | \$ 1  | \$ 5             | \$ 585   | \$ 91                  | \$ 7                  | \$ 3,558  |
| Average recorded Investment         | \$ 2,245                  | \$ 6,077          | \$ 3,064             | \$ 141               | \$ 12   | \$ 7             | \$ 1,817 | \$ 1,499               | \$ 188                | \$ 15,050 |
| Interest income Recognized          | \$ 124                    | \$ 287            | \$ 146               | \$ 18                | \$ 1  | \$ 2             | \$ 95    | \$ 19                  | \$ 15                 | \$ 707    |

| (in thousands)                      | Impaired PNCI Loans   |                   |                      |                      | As of, or for the Year Ended, December 31, 2013 |                  |       |                        |                       |          |
|-------------------------------------|-----------------------|-------------------|----------------------|----------------------|---|------------------|-------|------------------------|-----------------------|----------|
|                                     | RE Mortgage<br>Resid. | Mortgage<br>Comm. | Home Equity<br>Lines | Home Equity<br>Loans | Auto<br>Indirect                                | Other<br>Consum. | C&I   | Construction<br>Resid. | Construction<br>Comm. | Total    |
| With no related allowance recorded: |                       |                   |                      |                      |   |                  |       |                        |                       |          |
| Recorded investment                 | \$ 148                | \$ 1,139          | \$ 227               |                      |   | \$ 36            | \$ 12 |                        |                       | \$ 1,562 |
| Unpaid principal                    | \$ 158                | \$ 3,323          | \$ 287               |                      |   | \$ 45            | \$ 12 |                        |                       | \$ 3,825 |



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|                             |       |          |        |       |      |          |
|-----------------------------|-------|----------|--------|-------|------|----------|
| Average recorded Investment | \$ 37 | \$ 1,005 | \$ 333 | \$ 39 | \$ 7 | \$ 1,421 |
|-----------------------------|-------|----------|--------|-------|------|----------|

|                            |       |        |       |      |      |        |
|----------------------------|-------|--------|-------|------|------|--------|
| Interest income Recognized | \$ 11 | \$ 233 | \$ 21 | \$ 5 | \$ 1 | \$ 271 |
|----------------------------|-------|--------|-------|------|------|--------|

With an allowance recorded:

|                     |        |        |        |       |        |
|---------------------|--------|--------|--------|-------|--------|
| Recorded investment | \$ 198 | \$ 149 | \$ 203 | \$ 28 | \$ 578 |
|---------------------|--------|--------|--------|-------|--------|

|                  |        |        |        |       |        |
|------------------|--------|--------|--------|-------|--------|
| Unpaid principal | \$ 207 | \$ 149 | \$ 215 | \$ 28 | \$ 599 |
|------------------|--------|--------|--------|-------|--------|

|                   |        |        |        |      |        |
|-------------------|--------|--------|--------|------|--------|
| Related allowance | \$ 128 | \$ 114 | \$ 172 | \$ 3 | \$ 417 |
|-------------------|--------|--------|--------|------|--------|

|                             |        |        |        |       |        |
|-----------------------------|--------|--------|--------|-------|--------|
| Average recorded Investment | \$ 275 | \$ 250 | \$ 162 | \$ 29 | \$ 716 |
|-----------------------------|--------|--------|--------|-------|--------|

|                            |       |      |       |      |       |
|----------------------------|-------|------|-------|------|-------|
| Interest income Recognized | \$ 12 | \$ 9 | \$ 10 | \$ 1 | \$ 32 |
|----------------------------|-------|------|-------|------|-------|

Impaired Originated Loans As of, or for the Nine Months Ended, September 30, 2013

| (in thousands) | RE Mortgage Resid. | RE Mortgage Comm. | Home Equity Lines | Home Equity Loans | Auto Indirect | Other Consum. | C&I | Construction Resid. | Construction Comm. | Total |
|----------------|--------------------|-------------------|-------------------|-------------------|---------------|---------------|-----|---------------------|--------------------|-------|
|----------------|--------------------|-------------------|-------------------|-------------------|---------------|---------------|-----|---------------------|--------------------|-------|

With no related allowance recorded:

|                     |          |           |          |        |       |       |          |          |       |           |
|---------------------|----------|-----------|----------|--------|-------|-------|----------|----------|-------|-----------|
| Recorded investment | \$ 4,195 | \$ 61,418 | \$ 3,938 | \$ 442 | \$ 61 | \$ 19 | \$ 1,161 | \$ 2,588 | \$ 68 | \$ 73,890 |
|---------------------|----------|-----------|----------|--------|-------|-------|----------|----------|-------|-----------|

|                  |          |           |          |          |        |       |          |          |       |           |
|------------------|----------|-----------|----------|----------|--------|-------|----------|----------|-------|-----------|
| Unpaid principal | \$ 6,320 | \$ 67,314 | \$ 7,445 | \$ 1,131 | \$ 135 | \$ 32 | \$ 1,182 | \$ 7,345 | \$ 68 | \$ 90,972 |
|------------------|----------|-----------|----------|----------|--------|-------|----------|----------|-------|-----------|

|                             |          |           |          |        |        |       |          |          |        |           |
|-----------------------------|----------|-----------|----------|--------|--------|-------|----------|----------|--------|-----------|
| Average recorded Investment | \$ 3,911 | \$ 61,375 | \$ 4,543 | \$ 415 | \$ 120 | \$ 19 | \$ 2,802 | \$ 1,837 | \$ 137 | \$ 75,159 |
|-----------------------------|----------|-----------|----------|--------|--------|-------|----------|----------|--------|-----------|

|                            |        |          |        |       |       |      |       |       |      |          |
|----------------------------|--------|----------|--------|-------|-------|------|-------|-------|------|----------|
| Interest income Recognized | \$ 246 | \$ 2,644 | \$ 268 | \$ 21 | \$ 10 | \$ 2 | \$ 61 | \$ 81 | \$ 1 | \$ 3,334 |
|----------------------------|--------|----------|--------|-------|-------|------|-------|-------|------|----------|

With an allowance recorded:

|                     |          |          |          |        |      |      |          |        |        |           |
|---------------------|----------|----------|----------|--------|------|------|----------|--------|--------|-----------|
| Recorded investment | \$ 2,468 | \$ 6,990 | \$ 3,232 | \$ 109 | \$ 5 | \$ 9 | \$ 2,158 | \$ 284 | \$ 184 | \$ 15,439 |
|---------------------|----------|----------|----------|--------|------|------|----------|--------|--------|-----------|

|                  |          |          |          |        |      |       |          |        |        |           |
|------------------|----------|----------|----------|--------|------|-------|----------|--------|--------|-----------|
| Unpaid principal | \$ 2,510 | \$ 7,670 | \$ 3,703 | \$ 161 | \$ 7 | \$ 10 | \$ 3,063 | \$ 284 | \$ 426 | \$ 17,834 |
|------------------|----------|----------|----------|--------|------|-------|----------|--------|--------|-----------|

|                   |        |          |          |       |      |      |        |       |      |          |
|-------------------|--------|----------|----------|-------|------|------|--------|-------|------|----------|
| Related allowance | \$ 480 | \$ 1,293 | \$ 1,350 | \$ 49 | \$ 2 | \$ 3 | \$ 678 | \$ 91 | \$ 9 | \$ 3,955 |
|-------------------|--------|----------|----------|-------|------|------|--------|-------|------|----------|

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|                                |          |          |          |        |       |       |          |          |        |           |
|--------------------------------|----------|----------|----------|--------|-------|-------|----------|----------|--------|-----------|
| Average recorded<br>Investment | \$ 2,304 | \$ 5,568 | \$ 3,722 | \$ 126 | \$ 19 | \$ 12 | \$ 2,519 | \$ 1,438 | \$ 242 | \$ 15,950 |
| Interest income<br>Recognized  | \$ 93    | \$ 388   | \$ 109   | \$ 8   |       | \$ 1  | \$ 155   | \$ 14    | \$ 16  | \$ 784    |

**Table of Contents****Note 5 - Allowance for Loan Losses (continued)**

| (in thousands)                      | Impaired PNCI Loans |          |                   |            |                        | As of, or for the Nine Months Ended, September 30, 2013 |                     |       |  | Total    |
|-------------------------------------|---------------------|----------|-------------------|------------|------------------------|---|---------------------|-------|--|----------|
|                                     | RE Mortgage Resid.  | Comm.    | Home Equity Lines | Auto Loans | Other Indirect Consum. | C&I   | Construction Resid. | Comm. |  |          |
| With no related allowance recorded: |                     |          |                   |            |                        |   |                     |       |  |          |
| Recorded investment                 |                     | \$ 800   | \$ 290            |            |                        | \$ 38   | \$ 14               |       |  | \$ 1,142 |
| Unpaid principal                    |                     | \$ 2,893 | \$ 342            |            |                        | \$ 46   | \$ 14               |       |  | \$ 3,295 |
| Average recorded Investment         |                     | \$ 1,088 | \$ 367            |            |                        | \$ 30   | \$ 4                |       |  | \$ 1,489 |
| Interest income Recognized          |                     | \$ 154   | \$ 19             |            |                        | \$ 4  |                     |       |  | \$ 177   |
| With an allowance recorded:         |                     |          |                   |            |                        |   |                     |       |  |          |
| Recorded investment                 | \$ 350              | \$ 165   | \$ 204            |            |                        | \$ 28   |                     |       |  | \$ 747   |
| Unpaid principal                    | \$ 366              | \$ 165   | \$ 214            |            |                        | \$ 28   |                     |       |  | \$ 773   |
| Related allowance                   | \$ 193              | \$ 133   | \$ 179            |            |                        | \$ 10   |                     |       |  | \$ 515   |
| Average recorded Investment         | \$ 276              | \$ 292   | \$ 121            |            |                        | \$ 40   |                     |       |  | \$ 729   |
| Interest income Recognized          | \$ 18               | \$ 7     | \$ 9              |            |                        | \$ 1  |                     |       |  | \$ 35    |

At September 30, 2014, \$53,102,000 of originated loans were TDRs and classified as impaired. The Company had obligations to lend \$29,000 in additional funds on these TDRs as of September 30, 2014. At September 30, 2014, \$1,344,000 of PNCI loans were TDRs and classified as impaired. The Company had no obligations to lend additional funds on these TDRs as of September 30, 2014.

At December 31, 2013, \$56,739,000 of originated loans were TDRs and classified as impaired. The Company had obligations to lend \$25,000 of additional funds on these TDRs as of December 31, 2013. At December 31, 2013, \$901,000 of PNCI loans were TDRs and classified as impaired. The Company had no obligations to lend additional funds on these TDRs as of December 31, 2013.

At September 30, 2013, \$54,551,000 of Originated loans were TDR and classified as impaired. The Company had obligations to lend \$50,000 of additional funds on these TDR as of September 30, 2013. At September 30, 2013, \$928,000 of PNCI loans and \$87,000 of PCI loans were TDR and classified as impaired. The Company had no obligations to lend additional funds on these TDR as of September 30, 2013.

Modifications classified as TDRs can include one or a combination of the following: rate modifications, term extensions, interest only modifications, either temporary or long-term, payment modifications, and collateral substitutions/additions. For all new TDRs, an impairment analysis is conducted. If the loan is determined to be collateral dependent, any additional amount of impairment will be calculated based on the difference between

estimated collectible value and the current carrying balance of the loan. This difference could result in an increased provision and is typically charged off. If the asset is determined not to be collateral dependent, the impairment is measured on the net present value difference between the expected cash flows of the restructured loan and the cash flows which would have been received under the original terms. The effect of this could result in a requirement for additional provision to the reserve. The effect of these required provisions for the period are indicated above. Typically if a TDR defaults during the period, the loan is then considered collateral dependent and, if it was not already considered collateral dependent, an appropriate provision will be reserved or charge will be taken. The additional provisions required resulting from default of previously modified TDR s are noted above.

The following tables show certain information regarding TDRs that occurred during the periods indicated:

| TDR Information for the Three Months Ended September 30, 2014                                     |             |          |             |       |          |         |              |        |       |          |
|---|-------------|----------|-------------|-------|----------|---------|--------------|--------|-------|----------|
| (in thousands)  | RE Mortgage |          | Home Equity |       | Auto     | Other   | Construction |        | Total |          |
|   | Resid.      | Comm.    | Lines       | Loans | Indirect | Consum. | C&I          | Resid. | Comm. |          |
| Number  | 1           | 3        | 1           |       |          | 1       | 3            |        |       | 9        |
| Pre-mod outstanding principal balance   | \$ 48       | \$ 1,156 | \$ 198      |       |          | \$ 147  | \$ 94        |        |       | \$ 1,643 |
| Post-mod outstanding principal balance  | \$ 50       | \$ 1,059 | \$ 200      |       |          | \$ 147  | \$ 95        |        |       | \$ 1,551 |
| Financial impact due to TDR taken as additional provision   |             | \$ 4     |             |       |          | \$ 66   | \$ 34        |        |       | \$ 104   |
| Number that defaulted during the period   |             |          |             |       |          |         |              |        |       |          |
| Recorded investment of TDRs that defaulted during the period                                      |             |          |             |       |          |         |              |        |       |          |
| Financial impact due to the default of previous TDR taken as charge-offs or additional provisions |             |          |             |       |          |         |              |        |       |          |

**Table of Contents****Note 5 - Allowance for Loan Losses (continued)**

The following tables show certain information regarding Troubled Debt Restructurings (TDRs) that occurred during the periods indicated:

| TDR Information for the Nine Months Ended September 30, 2014                                      |             |          |             |       |          |         |        |              |        |          |
|---|-------------|----------|-------------|-------|----------|---------|--------|--------------|--------|----------|
| (in thousands)  | RE Mortgage |          | Home Equity |       | Auto     | Other   |        | Construction |        | Total    |
| Number  | Resid.      | Comm.    | Lines       | Loans | Indirect | Consum. | C&I    | Resid.       | Comm.  |          |
| Number  | 4           | 7        | 4           | 1     |          | 1       | 6      | 1            | 1      | 25       |
| Pre-mod outstanding principal balance   | \$ 854      | \$ 1,980 | \$ 677      | \$ 32 |          | \$ 147  | \$ 166 | \$ 102       | \$ 118 | \$ 4,076 |
| Post-mod outstanding principal balance  | \$ 857      | \$ 1,890 | \$ 691      | \$ 33 |          | \$ 147  | \$ 167 | \$ 84        | \$ 100 | \$ 3,969 |
| Financial impact due to TDR taken as additional provision   | \$ 37       | \$ 22    |             |       |          | \$ 66   | \$ 55  |              |        | \$ 180   |
| Number that defaulted during the period   | 1           | 2        |             |       |          |         | 1      |              |        | 4        |
| Recorded investment of TDRs that defaulted during the period                                      | \$ 152      | \$ 423   |             |       |          |         | \$ 116 |              |        | \$ 691   |
| Financial impact due to the default of previous TDR taken as charge-offs or additional provisions |             |          |             |       |          |         | (\$8)  |              |        | (\$8)    |

| TDR Information for the Three Months Ended September 30, 2013 |             |        |             |       |          |         |        |              |       |          |
|---|-------------|--------|-------------|-------|----------|---------|--------|--------------|-------|----------|
| (in thousands)  | RE Mortgage |        | Home Equity |       | Auto     | Other   |        | Construction |       | Total    |
| Number  | Resid.      | Comm.  | Lines       | Loans | Indirect | Consum. | C&I    | Resid.       | Comm. |          |
| Number  | 4           | 1      | 3           |       |          |         | 5      |              |       | 13       |
| Pre-mod outstanding principal balance                         | \$ 607      | \$ 25  | \$ 480      |       |          |         | \$ 113 |              |       | \$ 1,225 |
| Post-mod outstanding principal balance                        | \$ 607      | \$ 26  | \$ 482      |       |          |         | \$ 114 |              |       | \$ 1,229 |
| Financial impact due to TDR taken as additional provision     |             | \$ 4   | \$ 27       |       |          |         | \$ 30  |              |       | \$ 61    |
| Number that defaulted during the period                       |             | 3      | 2           |       |          |         |        |              |       | 5        |
| Recorded investment of TDRs that defaulted during the period  |             | \$ 674 | \$ 100      |       |          |         |        |              |       | \$ 774   |
|   |             |        | \$ 7        |       |          |         |        |              |       | \$ 7     |

Financial impact due to the default of previous TDR taken as charge-offs or additional provisions

| TDR Information for the Nine Months Ended September 30, 2013                                      |             |          |             |       |          |         |              |        |       |          |
|---|-------------|----------|-------------|-------|----------|---------|--------------|--------|-------|----------|
| (in thousands)  | RE Mortgage |          | Home Equity |       | Auto     | Other   | Construction |        | Total |          |
| Number  | Resid.      | Comm.    | Lines       | Loans | Indirect | Consum. | C&I          | Resid. | Comm. |          |
| Number  | 6           | 7        | 10          |       |          |         | 7            |        |       | 30       |
| Pre-mod outstanding principal balance   | \$ 1,039    | \$ 4,580 | \$ 1,062    |       |          |         | \$ 221       |        |       | \$ 6,902 |
| Post-mod outstanding principal balance  | \$ 1,043    | \$ 4,581 | \$ 1,069    |       |          |         | \$ 222       |        |       | \$ 6,915 |
| Financial impact due to TDR taken as additional provision   | \$ 151      | \$ 26    | \$ 220      |       |          |         | \$ 88        |        |       | \$ 485   |
| Number that defaulted during the period   | 2           | 7        | 2           |       |          |         | 3            | 1      |       | 15       |
| Recorded investment of TDRs that defaulted during the period                                      | \$ 181      | \$ 1,065 | \$ 100      |       |          |         | \$ 1,297     | \$ 73  |       | \$ 2,716 |
| Financial impact due to the default of previous TDR taken as charge-offs or additional provisions | \$ (3)      |          | \$ 7        |       |          |         |              | \$ 5   |       | \$ 9     |

**Table of Contents****Note 6 - Foreclosed Assets**

A summary of the activity in the balance of foreclosed assets follows (in thousands):

|   | Nine months ended September 30, 2014 |         |          | Nine months ended September 30, 2013 |          |           |
|---|--------------------------------------|---------|----------|--------------------------------------|----------|-----------|
|   | Noncovered                           | Covered | Total    | Noncovered                           | Covered  | Total     |
| Beginning balance, net                  | \$ 5,588                             | \$ 674  | \$ 6,262 | \$ 5,957                             | \$ 1,541 | \$ 7,498  |
| Additions/transfers from loans          | 4,936                                |         | 4,936    | 7,542                                | 493      | 8,035     |
| Dispositions/sales                      | (5,823)                              | (142)   | (5,965)  | (10,004)                             | (769)    | (10,773)  |
| Valuation adjustments                   | (125)                                | (12)    | (137)    | (539)                                | (81)     | (620)     |
| Ending balance, net                     | \$ 4,576                             | \$ 520  | \$ 5,096 | \$ 2,956                             | \$ 1,184 | \$ 4,140  |
| Ending valuation allowance              | \$ (169)                             | \$ (12) | \$ (181) | \$ (587)                             | \$ (340) | \$ (927)  |
| Ending number of foreclosed assets      | 23                                   | 2       | 25       | 26                                   | 5        | 31        |
| Proceeds from sale of foreclosed assets | \$ 7,650                             | \$ 168  | \$ 7,818 | \$ 11,383                            | \$ 869   | \$ 12,252 |
| Gain on sale of foreclosed assets       | \$ 1,827                             | \$ 26   | \$ 1,853 | \$ 1,379                             | \$ 100   | \$ 1,479  |

**Note 7 - Premises and Equipment**

Premises and equipment were comprised of:

|                                | September 30,<br>2014 | December 31,<br>2013 |
|--------------------------------|-----------------------|----------------------|
|                                | (In thousands)        |                      |
| Land & land improvements       | \$ 5,953              | \$ 5,975             |
| Buildings                      | 30,147                | 30,103               |
| Furniture and equipment        | 28,547                | 27,881               |
|                                | 64,647                | 63,959               |
| Less: Accumulated depreciation | (32,466)              | (32,397)             |
|                                | 32,181                | 31,562               |
| Construction in progress       |                       | 50                   |
| Total premises and equipment   | \$ 32,181             | \$ 31,612            |

Depreciation expense for premises and equipment amounted to \$1,063,000 and \$1,014,000 for the three months ended September 30, 2014 and 2013, respectively. Depreciation expense for premises and equipment amounted to \$3,227,000 and \$2,489,000 for the nine months ended September 30, 2014 and 2013, respectively.

**Note 8 - Cash Value of Life Insurance**

A summary of the activity in the balance of cash value of life insurance follows (in thousands):

|  | Nine months ended September 30, |           |
|--|---------------------------------|-----------|
|  | 2014                            | 2013      |
| Beginning balance                                  | \$ 52,309                       | \$ 50,582 |
| Increase in cash value of life insurance           | 1,287                           | 1,337     |
| Ending balance                                     | \$ 53,596                       | \$ 51,919 |
| End of period death benefit                        | \$ 95,896                       | \$ 95,206 |
| Number of policies owned                           | 133                             | 133       |
| Insurance companies used                           | 6                               | 6         |
| Current and former employees and directors covered | 36                              | 36        |

As of September 30, 2014, the Bank was the owner and beneficiary of 133 life insurance policies, issued by six life insurance companies, covering 36 current and former employees and directors. These life insurance policies are recorded on the Company's financial statements at their reported cash (surrender) values. As a result of current tax law and the nature of these policies, the Bank records any increase in cash value of these policies as nontaxable noninterest income. If the Bank decided to surrender any of the policies prior to the death of the insured, such surrender may result in a tax expense related to the life-to-date cumulative increase in cash value of the policy. If the Bank retains such policies until the death of the insured, the Bank would receive nontaxable proceeds from the insurance company equal to the death benefit of the policies. The Bank has entered into Joint Beneficiary Agreements (JBAs) with certain of the insured that for certain of the policies provide some level of sharing of the death benefit, less the cash surrender value, among the Bank and the beneficiaries of the insured upon the receipt of death benefits. See Note 15 of these condensed consolidated financial statements for additional information on JBAs.



**Table of Contents****Note 9 - Goodwill and Other Intangible Assets**

The following table summarizes the Company's goodwill intangible as of the dates indicated.

| (in thousands) | September 30,<br>2014 | Additions | Reductions | December 31,<br>2013 |
|----------------|-----------------------|-----------|------------|----------------------|
| Goodwill       | \$ 15,519             |           |            | \$ 15,519            |

The following table summarizes the Company's core deposit intangibles as of the dates indicated.

| (in thousands)                | September 30,<br>2014 | Additions | Reductions/<br>Amortization | Fully<br>Depreciated | December 31,<br>2013 |
|-------------------------------|-----------------------|-----------|-----------------------------|----------------------|----------------------|
| Core deposit intangibles      | \$ 1,460              |           |                             |                      | \$ 1,460             |
| Accumulated amortization      | (734)                 |           | \$ (157)                    |                      | (577)                |
| Core deposit intangibles, net | \$ 726                |           | \$ (157)                    |                      | \$ 883               |

The Company recorded additions to its core deposit intangibles of \$898,000 in conjunction with the Citizens acquisition on September 23, 2011 and \$562,000 in conjunction with the Granite acquisition on May 28, 2010. The following table summarizes the Company's estimated core deposit intangible amortization excluding the impact of any future acquisitions (dollars in thousands):

| Years Ended | Estimated Core Deposit<br>Intangible Amortization |
|-------------|---|
| 2014        | \$ 209  |
| 2015        | 209   |
| 2016        | 209   |
| 2017        | 209   |
| 2018        | \$ 47   |
| Thereafter  |   |

**Note 10 - Mortgage Servicing Rights**

The following tables summarize the activity in, and the main assumptions we used to determine the fair value of mortgage servicing rights (MSRs) for the periods indicated (dollars in thousands):

|                                | Three months ended September 30, |          | Nine months ended September 30, |          |
|--------------------------------|----------------------------------|----------|---------------------------------|----------|
|                                | 2014                             | 2013     | 2014                            | 2013     |
| Mortgage servicing rights:     |                                  |          |                                 |          |
| Balance at beginning of period | \$ 5,909                         | \$ 5,571 | \$ 6,165                        | \$ 4,552 |
| Additions                      | 164                              | 298      | 440                             | 1,187    |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Change in fair value                        | (88)       | 180        | (620)      | 310        |
| Balance at end of period                    | \$ 5,985   | \$ 6,049   | \$ 5,985   | \$ 6,049   |
| Servicing, late and ancillary fees received | \$ 413     | \$ 428     | \$ 1,244   | \$ 1,261   |
| Balance of loans serviced at:               |            |            |            |            |
| Beginning of period                         | \$ 667,969 | \$ 682,176 | \$ 680,197 | \$ 666,512 |
| End of period                               | \$ 664,342 | \$ 683,910 | \$ 664,342 | \$ 683,910 |
| Weighted-average prepayment speed (CPR)     |            |            | 10.4%      | 11.0%      |
| Discount rate                               |            |            | 10.0%      | 10.0%      |

The changes in fair value of MSRs that occurred during the three and nine months ended September 30, 2014 and 2013 were mainly due to principal reductions and changes in estimated life of the MSRs.

**Note 11 - Indemnification Asset**

A summary of the activity in the balance of indemnification asset (included in other assets) follows (in thousands):

|   | Three months ended September 30, |          | Nine months ended September 30, |          |
|---|----------------------------------|----------|---------------------------------|----------|
|   | 2014                             | 2013     | 2014                            | 2013     |
| Beginning (payable) receivable balance  | \$ (37)                          | \$ 1,441 | \$ 206                          | \$ 1,997 |
| Effect of actual covered losses and change in estimated future covered losses | (4)                              | (505)    | (569)                           | (783)    |
| Reimbursable expenses (revenue), net  | 8                                | 51       | 81                              | (42)     |
| Payments made (received)  | 30                               | (126)    | 279                             | (311)    |
| Ending (payable) receivable balance   | \$ (3)                           | \$ 861   | \$ (3)                          | \$ 861   |

**Table of Contents****Note 12 - Other Assets**

Other assets were comprised of (in thousands):

|                                 | September 30,<br>2014 | December 31,<br>2013 |
|---------------------------------|-----------------------|----------------------|
| Deferred tax asset, net         | \$ 27,957             | \$ 26,781            |
| Prepaid expense                 | 1,937                 | 2,131                |
| Software                        | 1,222                 | 1,318                |
| Advanced compensation           | 990                   | 1,175                |
| TriCo Capital Trust I & II      | 1,238                 | 1,238                |
| Indemnification asset (Note 11) | (3)                   | 206                  |
| Miscellaneous other assets      | 1,230                 | 3,237                |
| <br>Total other assets          | <br>\$ 34,571         | <br>\$ 36,086        |

**Note 13 - Deposits**

A summary of the balances of deposits follows (in thousands):

|                                       | September 30,<br>2014 | December 31,<br>2013 |
|---------------------------------------|-----------------------|----------------------|
| Noninterest-bearing demand            | \$ 762,452            | \$ 789,458           |
| Interest-bearing demand               | 553,053               | 533,351              |
| Savings                               | 872,432               | 798,986              |
| Time certificates, \$100,000 and over | 133,040               | 157,647              |
| Other time certificates               | 116,379               | 131,041              |
| <br>Total deposits                    | <br>\$ 2,437,356      | <br>\$ 2,410,483     |

Certificate of deposit balances of \$5,000,000 from the State of California were included in time certificates, \$100,000 and over, at each of September 30, 2014 and December 31, 2013. The Bank participates in a deposit program offered by the State of California whereby the State may make deposits at the Bank's request subject to collateral and credit worthiness constraints. The negotiated rates on these State deposits are generally more favorable than other wholesale funding sources available to the Bank. Overdrawn deposit balances of \$1,092,000 and \$1,212,000 were classified as consumer loans at September 30, 2014 and December 31, 2013, respectively.

**Note 14 - Reserve for Unfunded Commitments**

The following tables summarize the activity in reserve for unfunded commitments for the periods indicated (dollars in thousands):

|   | Three months ended September 30, |          | Nine months ended September 30, |          |
|---|----------------------------------|----------|---------------------------------|----------|
|   | 2014                             | 2013     | 2014                            | 2013     |
| Balance at beginning of period            | \$ 2,045                         | \$ 3,210 | \$ 2,415                        | \$ 3,615 |
| Provision for losses unfunded commitments | 175                              | (335)    | (195)                           | (740)    |
| Balance at end of period                  | \$ 2,220                         | \$ 2,875 | \$ 2,220                        | \$ 2,875 |

**Note 15 - Other Liabilities**

Other liabilities were comprised of (in thousands):

|                                 | September 30,<br>2014 | December 31,<br>2013 |
|---------------------------------|-----------------------|----------------------|
| Deferred compensation           | \$ 6,718              | \$ 7,357             |
| Pension liability               | 15,278                | 14,634               |
| Joint beneficiary agreements    | 2,812                 | 2,623                |
| Miscellaneous other liabilities | 8,523                 | 7,097                |
| Total other liabilities         | \$ 33,331             | \$ 31,711            |

**Note 16 - Other Borrowings**

A summary of the balances of other borrowings follows:

|  | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| (in thousands)   |                       |                      |
| Other collateralized borrowings, fixed rate, as of September 30, 2014 of 0.05%, payable on October 1, 2014 | \$ 12,665             | \$ 6,335             |
| Total other borrowings   | \$ 12,665             | \$ 6,335             |

The Company did not enter into any repurchase agreements during the nine months ended September 30, 2014 or the year ended December 31, 2013.

The Company had \$12,665,000 and \$6,335,000 of other collateralized borrowings at September 30, 2014 and December 31, 2013, respectively. Other collateralized borrowings are generally overnight maturity borrowings from non-financial institutions that are collateralized by securities owned by the Company. As of September 30, 2014, the Company has pledged as collateral and sold under agreements to repurchase investment securities with fair value of \$12,665,000 under these other collateralized borrowings.

The Company maintains a collateralized line of credit with the Federal Home Loan Bank of San Francisco ( FHLB ). Based on the FHLB stock requirements at September 30, 2014, this line provided for maximum borrowings of \$671,242,000 of which none was outstanding, leaving \$671,242,000 available. As of September 30, 2014, the Company has designated loans totaling \$1,161,114,000 as potential collateral under this collateralized line of credit with the FHLB.



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The Company maintains a collateralized line of credit with the San Francisco Federal Reserve Bank. As of September 30, 2014, this line provided for maximum borrowings of \$110,305,000 of which none was outstanding, leaving \$110,305,000 available. As of September 30, 2014, the Company has designated investment securities with fair value of \$37,000 and loans totaling \$145,763,000 as potential collateral under this collateralized line of credit with the San Francisco Federal Reserve Bank.

The Company has available unused correspondent banking lines of credit from commercial banks totaling \$15,000,000 for federal funds transactions at September 30, 2014.

**Note 17 - Junior Subordinated Debt**

On July 31, 2003, the Company formed a subsidiary business trust, TriCo Capital Trust I, to issue trust preferred securities. Concurrently with the issuance of the trust preferred securities, the trust issued 619 shares of common stock to the Company for \$1,000 per share or an aggregate of \$619,000. In addition, the Company issued a Junior Subordinated Debenture to the Trust in the amount of \$20,619,000. The terms of the Junior Subordinated Debenture are materially consistent with the terms of the trust preferred securities issued by TriCo Capital Trust I. Also on July 31, 2003, TriCo Capital Trust I completed an offering of 20,000 shares of cumulative trust preferred securities for cash in an aggregate amount of \$20,000,000. The trust preferred securities are mandatorily redeemable upon maturity on October 7, 2033 with an interest rate that resets quarterly at three-month LIBOR plus 3.05%. TriCo Capital Trust I has the right to redeem the trust preferred securities on or after October 7, 2008. The trust preferred securities were issued through an underwriting syndicate to which the Company paid underwriting fees of \$7.50 per trust preferred security or an aggregate of \$150,000. The net proceeds of \$19,850,000 were used to finance the opening of new branches, improve bank services and technology, repurchase shares of the Company's common stock under its repurchase plan and increase the Company's capital.

The \$20,619,000 of junior subordinated debentures issued by TriCo Capital Trust I are reflected as junior subordinated debt in the consolidated balance sheets. The common stock issued by TriCo Capital Trust I are recorded in other assets in the consolidated balance sheets. As of September 30, 2014, The TriCo Capital Trust I debentures carried an interest rate of 3.28%.

On June 22, 2004, the Company formed a second subsidiary business trust, TriCo Capital Trust II, to issue trust preferred securities. Concurrently with the issuance of the trust preferred securities, the trust issued 619 shares of common stock to the Company for \$1,000 per share or an aggregate of \$619,000. In addition, the Company issued a Junior Subordinated Debenture to the Trust in the amount of \$20,619,000. The terms of the Junior Subordinated Debenture are materially consistent with the terms of the trust preferred securities issued by TriCo Capital Trust II. Also on June 22, 2004, TriCo Capital Trust II completed an offering of 20,000 shares of cumulative trust preferred securities for cash in an aggregate amount of \$20,000,000. The trust preferred securities are mandatorily redeemable upon maturity on July 23, 2034 with an interest rate that resets quarterly at three-month LIBOR plus 2.55%. TriCo Capital Trust II has the right to redeem the trust preferred securities on or after July 23, 2009. The trust preferred securities were issued through an underwriting syndicate to which the Company paid underwriting fees of \$2.50 per trust preferred security or an aggregate of \$50,000. The net proceeds of \$19,950,000 were used to finance the opening of new branches, improve bank services and technology, repurchase shares of the Company's common stock under its repurchase plan and increase the Company's capital.

The \$20,619,000 of junior subordinated debentures issued by TriCo Capital Trust II are reflected as junior subordinated debt in the consolidated balance sheets. The common stock issued by TriCo Capital Trust II is recorded in other assets in the consolidated balance sheets. As of September 30, 2014, The TriCo Capital Trust II debentures carried an interest rate of 2.78%.

The debentures issued by TriCo Capital Trust I and TriCo Capital Trust II, less the common securities of TriCo Capital Trust I and TriCo Capital Trust II, continue to qualify as Tier 1 or Tier 2 capital under interim guidance issued by the Board of Governors of the Federal Reserve System.

**Note 18 - Commitments and Contingencies**

*Restricted Cash Balances* Reserves (in the form of deposits with the San Francisco Federal Reserve Bank) of \$45,146,000 and \$38,359,000 were maintained to satisfy Federal regulatory requirements at September 30, 2014 and December 31, 2013. These reserves are included in cash and due from banks in the accompanying consolidated balance sheets.

*Lease Commitments* The Company leases 40 sites under non-cancelable operating leases as of September 30, 2014. The leases contain various provisions for increases in rental rates, based either on changes in the published Consumer Price Index or a predetermined escalation schedule. Substantially all of the leases provide the Company with the option to extend the lease term one or more times following expiration of the initial term. The Company currently does not have any capital leases.

**Table of Contents****Note 18 - Commitments and Contingencies (continued)**

At December 31, 2013, future minimum commitments under non-cancelable operating leases with initial or remaining terms of one year or more are as follows:

|                                      | Operating<br>Leases<br>(in thousands) |
|--------------------------------------|---------------------------------------|
| 2014                                 | \$ 2,452                              |
| 2015                                 | 1,706                                 |
| 2016                                 | 1,154                                 |
| 2017                                 | 791                                   |
| 2018                                 | 429                                   |
| Thereafter                           | 1,235                                 |
| <b>Future minimum lease payments</b> | <b>\$ 7,767</b>                       |

Rent expense under operating leases was \$1,008,000 and \$1,071,000 during the three months ended September 30, 2014 and 2013, respectively. Rent expense was offset by rent income of \$54,000 and \$54,000 during the three months ended September 30, 2014 and 2013, respectively. Rent expense under operating leases was \$3,103,000 and \$3,257,000 during the nine months ended September 30, 2014 and 2013, respectively. Rent expense was offset by rent income of \$164,000 and \$162,000 during the nine months ended September 30, 2014 and 2013, respectively.

*Financial Instruments with Off-Balance-Sheet Risk* The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit, and deposit account overdraft privilege. Those instruments involve, to varying degrees, elements of risk in excess of the amount recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit written is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company's exposure to loss in the event of nonperformance by the other party to the financial instrument for deposit account overdraft privilege is represented by the overdraft privilege amount disclosed to the deposit account holder.

The following table presents a summary of the Bank's commitments and contingent liabilities:

| (in thousands) | September 30,<br>2014 | December 31,<br>2013 |
|----------------|-----------------------|----------------------|
|                |                       |                      |



|   |            |            |
|---|------------|------------|
| Financial instruments whose amounts represent risk: |            |            |
| Commitments to extend credit:                       |            |            |
| Commercial loans                                    | \$ 138,181 | \$ 136,986 |
| Consumer loans                                      | 362,996    | 360,194    |
| Real estate mortgage loans                          | 40,811     | 35,309     |
| Real estate construction loans                      | 39,757     | 22,897     |
| Standby letters of credit                           | 3,566      | 2,601      |
| Deposit account overdraft privilege                 | 70,677     | 68,932     |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates of one year or less or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on Management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, residential properties, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements. Most standby letters of credit are issued for one year or less. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral requirements vary, but in general follow the requirements for other loan facilities.

Deposit account overdraft privilege amount represents the unused overdraft privilege balance available to the Company's deposit account holders who have deposit accounts covered by an overdraft privilege. The Company has established an overdraft privilege for certain of its deposit account products whereby all holders of such accounts who bring their accounts to a positive balance at least once every thirty days receive the overdraft privilege. The overdraft privilege allows depositors to overdraft their deposit account up to a predetermined level. The predetermined overdraft limit is set by the Company based on account type.

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*Legal Proceedings* The Bank owns 10,214 shares of Class B common stock of Visa Inc. which are convertible into Class A common stock at a conversion ratio of 0.4206 per Class A share. As of September 30, 2014, the value of the Class A shares was \$213.37 per share. Utilizing the conversion ratio, the value of unredeemed Class A equivalent shares owned by the Bank was \$917,000 as of September 30, 2014, and has not been reflected in the accompanying financial statements. The shares of Visa Class B common stock are restricted and may not be transferred. Visa Member Banks are required to fund an escrow account to cover settlements, resolution of pending litigation and related claims. If the funds in the escrow account are insufficient to settle all the covered litigation, Visa may sell additional Class A shares, use the proceeds to settle litigation, and further reduce the conversion ratio. If funds remain in the escrow account after all litigation is settled, the Class B conversion ratio will be increased to reflect that surplus.

On January 24, 2014, a putative shareholder class action lawsuit was filed against TriCo, North Valley Bancorp and certain other defendants in connection with TriCo entering into the merger agreement with North Valley Bancorp. The lawsuit, which was filed in the Shasta County, California Superior Court, alleges that the members of the North Valley Bancorp board of directors breached their fiduciary duties to North Valley Bancorp shareholders by approving the proposed merger for inadequate consideration; approving the transaction in order receive benefits not equally shared by other North Valley Bancorp shareholders; entering into the merger agreement containing preclusive deal protection devices; and failing to take steps to maximize the value to be paid to the North Valley Bancorp shareholders. The lawsuit alleges claims against TriCo for aiding and abetting these alleged breaches of fiduciary duties. The plaintiff seeks, among other things, declaratory and injunctive relief concerning the alleged breaches of fiduciary duties injunctive relief prohibiting consummation of the merger, rescission, attorneys' fees and costs, and other and further relief. On July 31, 2014 the defendants entered into a memorandum of understanding with the plaintiffs regarding the settlement of this lawsuit. In connection with the settlement contemplated by the memorandum of understanding and in consideration for the full settlement and release of all claims, TriCo and North Valley Bancorp agreed to make certain additional disclosures related to the proposed merger, which are contained in a Current Report on Form 8-K filed by each of the companies. The memorandum of understanding contemplates that the parties will negotiate in good faith and use their reasonable best efforts to enter into a stipulation of settlement. The stipulation of settlement will be subject to customary conditions, including court approval following notice to North Valley Bancorp's shareholders. In the event that the parties enter into a stipulation of settlement, a hearing will be scheduled at which the court will consider the settlement. There can be no assurance that the parties will ultimately enter into a stipulation of settlement or that the court will approve the settlement even if the parties were to enter into such stipulation. In such event, the proposed settlement as contemplated by the memorandum of understanding may be terminated.

Neither the Company nor its subsidiaries, are party to any other material pending legal proceeding, nor is their property the subject of any material pending legal proceeding, except routine legal proceedings arising in the ordinary course of their business. None of these proceedings is expected to have a material adverse impact upon the Company's business, consolidated financial position or results of operations.

*Other Commitments and Contingencies* The Company has entered into employment agreements or change of control agreements with certain officers of the Company providing severance payments and accelerated vesting of benefits under supplemental retirement agreements to the officers in the event of a change in control of the Company and termination for other than cause or after a substantial and material change in the officer's title, compensation or responsibilities.

Mortgage loans sold to investors may be sold with servicing rights retained, with only the standard legal representations and warranties regarding recourse to the Bank. Management believes that any liabilities that may result from such recourse provisions are not significant.

## **Note 19 - Shareholders Equity**

### **Dividends Paid**

The Bank paid to the Company cash dividends in the aggregate amounts of \$6,395,000 and \$6,080,000 during the nine months ended September 30, 2014 and 2013 respectively. The Bank is regulated by the Federal Deposit Insurance Corporation (FDIC) and the State of California Department of Business Oversight. Absent approval from the Commissioner of the Department of Business Oversight, California banking laws generally limit the Bank's ability to pay dividends to the lesser of (1) retained earnings or (2) net income for the last three fiscal years, less cash distributions paid during such period. Under this law, at December 31, 2013, the Bank may pay dividends of \$44,548,000.

### **Shareholders Rights Plan**

On June 25, 2001, the Company announced that its Board of Directors adopted and entered into a Shareholder Rights Agreement designed to protect and maximize shareholder value and to assist the Board of Directors in ensuring fair and equitable benefit to all shareholders in the event of a hostile bid to acquire the Company. The Company adopted this Rights Agreement to protect shareholders from coercive or otherwise unfair takeover tactics. In general terms, the Rights Plan would have imposed a significant penalty upon any person or group that acquired 15% or more of the Company's outstanding common stock without approval of the Company's Board of Directors.

On June 4, 2014, the Company entered into an amendment to its Rights Agreement dated June 25, 2001 with Mellon Investor Services LLC, as Rights Agent, as amended. The amendment accelerated the expiration of the Rights from July 10, 2021 to July 1, 2014 and had the effect of terminating the Rights Agreement as of that date. At the time of the termination of the Rights Agreement on July 1, 2014 at 5:00 p.m. California time, all Rights distributed to holders of the Company's common stock pursuant to the Rights Agreement expired.

### **Stock Repurchase Plan**

On August 21, 2007, the Board of Directors adopted a plan to repurchase, as conditions warrant, up to 500,000 shares of the Company's common stock on the open market. The timing of purchases and the exact number of shares to be purchased will depend on market conditions. The 500,000 shares authorized for repurchase under this stock repurchase plan represented approximately 3.2% of the Company's 15,814,662 outstanding common shares as of August 21, 2007. This stock repurchase plan has no expiration date. As of September 30, 2014, the Company had repurchased 166,600 shares under this plan.

**Table of Contents****Stock Repurchased Under Equity Compensation Plans**

During the nine months ended September 30, 2014 and 2013, employees and directors tendered 103,268 and 172,941 shares, respectively, of the Company's common stock with market value of \$2,551,000, and \$3,490,000, respectively, in lieu of cash to exercise options to purchase shares of the Company's stock and to pay income taxes related to such exercises as permitted by the Company's shareholder-approved equity compensation plans. The tendered shares were retired. The market value of tendered shares is the last market trade price at closing on the day an option is exercised. Stock repurchased under equity incentive plans are not included in the total of stock repurchased under the stock repurchase plan announced on August 21, 2007.

**Note 20 - Stock Options and Other Equity-Based Incentive Instruments**

In March 2009, the Company's Board of Directors adopted the TriCo Bancshares 2009 Equity Incentive Plan (2009 Plan) covering officers, employees, directors of, and consultants to, the Company. The 2009 Plan was approved by the Company's shareholders in May 2009. The 2009 Plan allows for the granting of the following types of stock awards (Awards): incentive stock options, nonstatutory stock options, performance awards, restricted stock, restricted stock unit (RSU) awards and stock appreciation rights. RSUs that vest based solely on the grantee remaining in the service of the Company for a certain amount of time, are referred to as service condition vesting RSUs. RSUs that vest based on the grantee remaining in the service of the Company for a certain amount of time and a market condition such as the total return of the Company's common stock versus the total return of an index of bank stocks, are referred to as market plus service condition vesting RSUs. In May 2013, the Company's shareholders approved an amendment to the 2009 Plan increasing the maximum aggregate number of shares of TriCo's common stock which may be issued pursuant to or subject to Awards from 650,000 to 1,650,000. The number of shares available for issuance under the 2009 Plan is reduced by: (i) one share for each share of common stock issued pursuant to a stock option or a Stock Appreciation Right and (ii) two shares for each share of common stock issued pursuant to a Performance Award, a Restricted Stock Award or a Restricted Stock Unit Award. When Awards made under the 2009 Plan expire or are forfeited or cancelled, the underlying shares will become available for future Awards under the 2009 Plan. To the extent that a share of common stock pursuant to an Award that counted as two shares against the number of shares again becomes available for issuance under the 2009 Plan, the number of shares of common stock available for issuance under the 2009 Plan shall increase by two shares. Shares awarded and delivered under the 2009 Plan may be authorized but unissued, or reacquired shares. As of September 30, 2014, 683,500 options for the purchase of common shares, and 42,915 restricted stock units were outstanding, and 851,952 shares remain available for issuance, under the 2009 Plan.

In May 2001, the Company adopted the TriCo Bancshares 2001 Stock Option Plan (2001 Plan) covering officers, employees, directors of, and consultants to, the Company. Under the 2001 Plan, the option exercise price cannot be less than the fair market value of the Common Stock at the date of grant except in the case of substitute options. Options for the 2001 Plan expire on the tenth anniversary of the grant date. Vesting schedules under the 2001 Plan are determined individually for each grant. As of September 30, 2014, 396,850 options for the purchase of common shares were outstanding under the 2001 Plan. As of May 2009, as a result of the shareholder approval of the 2009 Plan, no new options may be granted under the 2001 Plan.

Stock option activity during the nine months ended September 30, 2014 is summarized in the following table:

|          |              |
|----------|--------------|
| Weighted | Weighted     |
| Average  | Average Fair |

|                                   | Number<br>of Shares | Option Price<br>per Share | Exercise<br>Price | Value<br>on<br>Date of Grant |
|-----------------------------------|---------------------|---------------------------|-------------------|------------------------------|
| Outstanding at December 31, 2013  | 1,246,370           | \$ 12.63                  | to \$ 25.91       | \$ 18.04                     |
| Options granted                   |                     |                           | to                |                              |
| Options exercised                 | (166,020)           | \$ 14.54                  | to \$ 20.58       | \$ 17.32                     |
| Options forfeited                 |                     |                           | to                |                              |
| Outstanding at September 30, 2014 | 1,080,350           | \$ 12.63                  | to \$ 25.91       | \$ 18.15                     |

The following table shows the number, weighted-average exercise price, intrinsic value, and weighted average remaining contractual life of options exercisable, options not yet exercisable and total options outstanding as of September 30, 2014:

|  | Currently<br>Exercisable | Currently Not<br>Exercisable | Total<br>Outstanding |
|--|--------------------------|------------------------------|----------------------|
| Number of options                                  | 786,350                  | 294,000                      | 1,080,350            |
| Weighted average exercise price                    | \$ 18.79                 | \$ 16.44                     | \$ 18.15             |
| Intrinsic value (in thousands)                     | \$ 3,519                 | \$ 1,954                     | \$ 5,473             |
| Weighted average remaining contractual term (yrs.) | 4.7                      | 7.6                          | 5.5                  |

The 294,000 options that are currently not exercisable as of September 30, 2014 are expected to vest, on a weighted-average basis, over the next 2.6 years, and the Company is expected to recognize \$1,836,000 of pre-tax compensation costs related to these options as they vest. The Company did not modify any option grants during 2013 or the nine months ended September 30, 2014.

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Restricted stock unit (RSU) activity during the nine months ended September 30, 2014 is summarized in the following table:

|                                     | Service Condition Vesting RSUs               | Market Plus Service Condition Vesting RSUs   |
|-------------------------------------|--|--|
|                                     | Number of RSUs                               | Number of RSUs                               |
|                                     | Weighted Average Fair Value on Date of Grant | Weighted Average Fair Value on Date of Grant |
| Outstanding at December 31, 2013    |  |  |
| RSUs granted                        | 29,025                                       | 13,749                                       |
| RSUs added through dividend credits | 141  |  |
| RSUs released                       |  |  |
| RSUs forfeited/expired              |  |  |
| Outstanding at September 30, 2014   | 29,166                                       | 13,749                                       |

The 29,025 of service condition vesting RSUs granted during the quarter ended September 30, 2014 include a feature whereby each RSU outstanding is credited with a dividend amount equal to any common stock cash dividend declared and paid, and the credited amount is divided by the closing price of the Company's stock on the dividend payable date to arrive at an additional amount of RSUs outstanding under the original grant. The 29,166 of service condition vesting RSUs that are currently outstanding as of September 30, 2014 are expected to vest, and be released, on a weighted-average basis, over the next 3.0 years. The Company is expected to recognize \$599,000 of pre-tax compensation costs related to these service condition vesting RSUs between September 30, 2014 and their vesting dates. The Company did not modify any service condition vesting RSUs during the nine months ended September 30, 2014.

The 13,749 of market plus service condition vesting RSUs that are currently outstanding as of September 30, 2014 are expected to vest, and be released, on a weighted-average basis, over the next 2.9 years. The Company is expected to recognize \$272,000 of pre-tax compensation costs related to these RSUs between September 30, 2014 and their vesting dates. As of September 30, 2014, the number of market plus service condition vesting RSUs outstanding that will actually vest, and be released, may be reduced to zero or increased to 20,623 depending on the total return of the Company's common stock versus the total return of an index of bank stocks from the grant date to the vesting date. The Company did not modify any market plus service condition vesting RSUs during the nine months ended September 30, 2014.

**Note 21 - Noninterest Income and Expense**

The components of other noninterest income were as follows (in thousands):

|                                     | Three months ended |          | Nine months ended |          |
|-------------------------------------|--------------------|----------|-------------------|----------|
|                                     | September 30,      |          | September 30,     |          |
|                                     | 2014               | 2013     | 2014              | 2013     |
| Service charges on deposit accounts | \$ 2,885           | \$ 3,353 | \$ 8,299          | \$ 9,770 |
| ATM and interchange fees            | 2,329              | 2,132    | 6,534             | 6,240    |

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|   |          |          |           |           |
|---|----------|----------|-----------|-----------|
| Other service fees  | 545      | 562      | 1,598     | 1,683     |
| Mortgage banking service fees   | 419      | 434      | 1,260     | 1,280     |
| Change in value of mortgage servicing rights  | (88)     | 181      | (620)     | 311       |
| Total service charges and fees  | 6,090    | 6,662    | 17,071    | 19,284    |
| Gain on sale of loans   | 509      | 1,083    | 1,487     | 4,967     |
| Commissions on sale of non-deposit investment products                                      | 703      | 692      | 2,317     | 2,294     |
| Increase in cash value of life insurance  | 490      | 531      | 1,287     | 1,337     |
| Change in indemnification asset   | 14       | (461)    | (491)     | (876)     |
| Gain (loss) on sale of foreclosed assets  | 385      | 313      | 1,853     | 1,479     |
| Sale of customer checks   | 97       | 97       | 296       | 280       |
| Lease brokerage income  | 167      | 75       | 385       | 273       |
| Gain (loss) on disposal of fixed assets   | (10)     | 2        | 60        | (12)      |
| Other   | 144      | 133      | 496       | 450       |
| Total other noninterest income  | 2,499    | 2,465    | 7,690     | 10,192    |
| Total noninterest income  | \$ 8,589 | \$ 9,127 | \$ 24,761 | \$ 29,476 |
| Mortgage loan servicing fees, net of change in fair value of mortgage loan servicing rights | \$ 331   | \$ 615   | \$ 640    | \$ 1,591  |
| Mortgage banking revenue  | \$ 840   | \$ 1,698 | \$ 2,127  | \$ 6,558  |

**Table of Contents****Note 21 - Noninterest Income and Expense (continued)**

The components of noninterest expense were as follows (in thousands):

|   | Three months ended<br>September 30, |                  | Nine months ended<br>September 30, |                  |
|---|-------------------------------------|------------------|------------------------------------|------------------|
|   | 2014                                | 2013             | 2014                               | 2013             |
| Base salaries, net of deferred loan origination costs | \$ 9,066                            | \$ 8,716         | \$ 26,940                          | \$ 25,572        |
| Incentive compensation                                | 1,265                               | 1,166            | 3,593                              | 3,751            |
| Benefits and other compensation costs                 | 3,038                               | 2,979            | 9,456                              | 9,389            |
| <b>Total salaries and benefits expense</b>            | <b>13,369</b>                       | <b>12,861</b>    | <b>39,989</b>                      | <b>38,712</b>    |
| Occupancy   | 1,971                               | 1,925            | 5,735                              | 5,337            |
| Equipment   | 995                                 | 1,089            | 3,091                              | 3,036            |
| Data processing and software                          | 1,637                               | 1,184            | 4,165                              | 3,542            |
| ATM network charges                                   | 657                                 | 626              | 2,010                              | 1,801            |
| Telecommunications                                    | 648                                 | 629              | 1,941                              | 1,741            |
| Postage   | 179                                 | 269              | 627                                | 633              |
| Courier service                                       | 269                                 | 217              | 727                                | 639              |
| Advertising   | 581                                 | 492              | 1,264                              | 1,232            |
| Assessments   | 493                                 | 572              | 1,495                              | 1,721            |
| Operational losses                                    | 138                                 | 137              | 465                                | 376              |
| Professional fees                                     | 1,468                               | 776              | 3,825                              | 1,982            |
| Foreclosed assets expense                             | 94                                  | 48               | 403                                | 310              |
| Provision for foreclosed asset losses                 | 98                                  | 47               | 138                                | 620              |
| Change in reserve for unfunded commitments            | 175                                 | (335)            | (195)                              | (740)            |
| Intangible amortization                               | 53                                  | 53               | 157                                | 157              |
| Other   | 2,555                               | 3,026            | 7,976                              | 7,627            |
| <b>Total other noninterest expense</b>                | <b>12,011</b>                       | <b>10,755</b>    | <b>33,824</b>                      | <b>30,014</b>    |
| <b>Total noninterest income</b>                       | <b>\$ 25,380</b>                    | <b>\$ 23,616</b> | <b>\$ 73,813</b>                   | <b>\$ 68,726</b> |

**Note 22 - Income Taxes**

The provisions for income taxes applicable to income before taxes differ from amounts computed by applying the statutory Federal income tax rates to income before taxes. The effective tax rate and the statutory federal income tax rate are reconciled for the periods indicated as follows:

|  | Three months ended<br>September 30, | Nine months ended<br>September 30, |
|--|-------------------------------------|------------------------------------|
|--|-------------------------------------|------------------------------------|



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|  | 2014         | 2013         | 2014         | 2013         |
|--|--------------|--------------|--------------|--------------|
| Federal statutory income tax rate              | 35.0%        | 35.0%        | 35.0%        | 35.0%        |
| State income taxes, net of federal tax benefit | 7.1          | 6.7          | 7.0          | 6.7          |
| Tax-exempt interest on municipal obligations   | (0.3)        | (0.5)        | (0.4)        | (0.4)        |
| Increase in cash value of insurance policies   | (1.2)        | (1.5)        | (1.3)        | (1.3)        |
| Nondeductible merger expenses                  | 1.3          |              | 0.9          |              |
| Other  | 0.3          | 0.3          | 0.4%         | 0.4          |
| <b>Effective Tax Rate</b>                      | <b>42.2%</b> | <b>40.0%</b> | <b>41.6%</b> | <b>40.4%</b> |

**Note 23 - Earnings Per Share**

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustments to income that would result from assumed issuance. Potential common shares that may be issued by the Company relate solely from outstanding stock options, and are determined using the treasury stock method. Earnings per share have been computed based on the following:

| (in thousands)  | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |           |
|---|-------------------------------------|----------|------------------------------------|-----------|
|   | 2014                                | 2013     | 2014                               | 2013      |
| Net income  | \$ 8,234                            | \$ 7,361 | \$ 20,458                          | \$ 22,163 |
| Average number of common shares outstanding   | 16,137                              | 16,074   | 16,121                             | 16,035    |
| Effect of dilutive stock options and restricted stock units   | 194                                 | 156      | 200                                | 117       |
| Average number of common shares outstanding used to calculate diluted earnings per share              | 16,331                              | 16,230   | 16,321                             | 16,152    |
| Options excluded from diluted earnings per share because the effect of these options was antidilutive | 127                                 | 171      | 110                                | 544       |

**Table of Contents****Note 24 - Comprehensive Income**

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

The components of accumulated other comprehensive income, included in shareholders' equity, are as follows:

|   | September 30,<br>2014 | December 31,<br>2013 |
|---|-----------------------|----------------------|
|   | (in thousands)        |                      |
| Net unrealized gains on available for sale securities                 | \$ 4,069              | \$ 4,202             |
| Tax effect  | (1,711)               | (1,767)              |
| Unrealized holding gains on available for sale securities, net of tax | 2,358                 | 2,435                |
| Unfunded status of the supplemental retirement plans                  | (760)                 | (787)                |
| Tax effect  | 320                   | 331                  |
| Unfunded status of the supplemental retirement plans, net of tax      | (440)                 | (456)                |
| Joint beneficiary agreement liability                                 | (122)                 | (122)                |
| Tax effect  |                       |                      |
| Joint beneficiary agreement liability, net of tax                     | (122)                 | (122)                |
| Accumulated other comprehensive income                                | \$ 1,796              | \$ 1,857             |

The components of other comprehensive income and related tax effects are as follows:

| (in thousands)  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|--------|------------------------------------|------------|
|   | 2014                                | 2013   | 2014                               | 2013       |
| Unrealized holding gains (losses) on available for sale securities before reclassifications | \$ (686)                            | \$ 144 | \$ (133)                           | \$ (3,498) |
| Amounts reclassified out of accumulated other comprehensive income                          |                                     |        |                                    |            |
| Unrealized holding gains (losses) on available for sale securities after reclassifications  | \$ (686)                            | \$ 144 | \$ (133)                           | \$ (3,498) |
| Tax effect  | 288                                 | (61)   | 56                                 | 1,471      |

|   |          |       |         |            |
|---|----------|-------|---------|------------|
| Unrealized holding gains (losses) on available for sale securities, net of tax          | \$ (398) | \$ 83 | \$ (77) | \$ (2,027) |
| Change in unfunded status of the supplemental retirement plans before reclassifications |          |       |         |            |
| Amounts reclassified out of accumulated other comprehensive income:                     |          |       |         |            |
| Amortization of prior service cost  | 5        |       | 15      |            |
| Amortization of actuarial losses  | 4        |       | 12      |            |
| Total amounts reclassified out of accumulated other comprehensive income                | 9        |       | 27      |            |
| Change in unfunded status of the supplemental retirement plans after reclassifications  | 9        |       | 27      |            |
| Tax effect  | (3)      |       | (11)    |            |
| Change in unfunded status of the supplemental retirement plans, net of tax              | 6        |       | 16      |            |
| Change in joint beneficiary agreement liability before reclassifications                |          |       |         |            |
| Amounts reclassified out of accumulated other comprehensive income                      |          |       |         |            |
| Change in joint beneficiary agreement liability after reclassifications                 |          |       |         |            |
| Tax effect  |          |       |         |            |
| Change in joint beneficiary agreement liability, net of tax                             |          |       |         |            |
| Total other comprehensive income (loss)   | \$ (392) | \$ 83 | \$ (61) | \$ (2,027) |

**Table of Contents****Note 25 - Retirement Plans****401(k) Plan**

The Company sponsors a 401(k) Plan whereby substantially all employees age 21 and over with 90 days of service may participate. Participants may contribute a portion of their compensation subject to certain limits based on federal tax laws. The Company does not contribute to the 401(k) Plan. The Company did not incur any material expenses attributable to the 401(k) Plan during 2013 or the nine months ended September 30, 2014.

**Employee Stock Ownership Plan**

Substantially all employees with at least one year of service are covered by a discretionary employee stock ownership plan (ESOP). Contributions are made to the plan at the discretion of the Board of Directors. Contributions to the plan totaling \$366,000 and \$0 were made during the three months ended September 30, 2014 and 2013, respectively. Contributions to the plan totaling \$926,806 and \$961,695 were made during the nine months ended June 30, 2014 and 2013, respectively. Expenses related to the Company's ESOP, are included in benefits and other compensation costs under salaries and benefits expense, and were \$382,000 and \$355,000 for the three months ended September 30, 2014 and 2013, respectively, and \$1,142,000 and \$1,047,000 for the nine months ended September 30, 2014 and 2013, respectively. Company shares owned by the ESOP are paid dividends and included in the calculation of earnings per share exactly as other common shares outstanding.

**Deferred Compensation Plans**

The Company has deferred compensation plans for certain directors and key executives, which allow certain directors and key executives designated by the Board of Directors of the Company to defer a portion of their compensation. The Company has purchased insurance on the lives of the participants and intends to hold these policies until death as a cost recovery of the Company's deferred compensation obligations of \$6,718,000 and \$7,357,000 at September 30, 2014 and December 31, 2013, respectively. Earnings credits on deferred balances totaling \$124,000 and \$135,000 during the three months ended September 30, 2014 and 2013, respectively, are included in noninterest expense. Earnings credits on deferred balances totaling \$415,000 and \$429,000 during the nine months ended September 30, 2014 and 2013, respectively, are included in noninterest expense.

**Supplemental Retirement Plans**

The Company has supplemental retirement plans for current and former directors and key executives. These plans are non-qualified defined benefit plans and are unsecured and unfunded. The Company has purchased insurance on the lives of the participants and intends (but is not required) to use the cash values of these policies to pay the retirement obligations. The following table sets forth the net periodic benefit cost recognized for the plans:

| (in thousands)   | Three months ended<br>September 30, |        | Nine months<br>ended<br>September 30, |        |
|--|-------------------------------------|--------|---------------------------------------|--------|
|  | 2014                                | 2013   | 2014                                  | 2013   |
| <b>Net pension cost included the following components:</b> |                                     |        |                                       |        |
| Service cost-benefits earned during the period             | \$ 163                              | \$ 187 | \$ 489                                | \$ 557 |
| Interest cost on projected benefit obligation              | 174                                 | 161    | 522                                   | 482    |

|  |        |        |          |          |
|--|--------|--------|----------|----------|
| Amortization of net obligation at transition |        |        | 1        | 1        |
| Amortization of prior service cost           | 35     | 39     | 104      | 115      |
| Recognized net actuarial loss                | 4      | 73     | 12       | 218      |
| Net periodic pension cost                    | \$ 376 | \$ 460 | \$ 1,128 | \$ 1,373 |
| Company contributions to pension plans       | \$ 125 | \$ 151 | \$ 444   | \$ 411   |
| Pension plan payouts to participants         | \$ 125 | \$ 151 | \$ 444   | \$ 411   |

For the year ending December 31, 2014, the Company expects to contribute and pay out as benefits \$569,000 to participants under the plans.

#### Note 26 - Related Party Transactions

Certain directors, officers, and companies with which they are associated were customers of, and had banking transactions with, the Company or the Bank in the ordinary course of business.

The following table summarizes the activity in these loans for 2014 and 2013 (in thousands):

|                            |          |
|----------------------------|----------|
| Balance December 31, 2012  | \$ 2,368 |
| Advances/new loans         | 1,154    |
| Removed/payments           | (886)    |
| Balance December 31, 2013  | \$ 2,636 |
| Advances/new loans         | 297      |
| Removed/payments           | (1,379)  |
| Balance September 30, 2014 | \$ 1,554 |

Director Chrysler is a principal owner and CEO of Modern Building Inc. Modern Building Inc. provided construction services to the Company related to new and existing Bank facilities for aggregate payments of \$1,112,000 during the nine months ended September 30, 2014 and \$4,261,000 during the year ended December 31, 2013.

**Table of Contents****Note 27 - Fair Value Measurement**

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, income approach, and/or the cost approach. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability including assumptions about the risk inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset and the risk of nonperformance. Securities available-for-sale and mortgage servicing rights are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or impairment write-downs of individual assets.

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the observable nature of the assumptions used to determine fair value. These levels are:

- Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

*Securities available for sale* Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. The Company had no securities classified as Level 3 during any of the periods covered in these financial statements.

*Loans held for sale* Loans held for sale are carried at the lower of cost or fair value. The fair value of loans held for sale is based on what secondary markets are currently offering for loans with similar characteristics. As such, we classify those loans subjected to nonrecurring fair value adjustments as Level 2.

*Impaired originated and PNCI loans* Originated and PNCI loans are not recorded at fair value on a recurring basis. However, from time to time, an originated or PNCI loan is considered impaired and an allowance for loan losses is established. Originated and PNCI loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. The fair value of an impaired originated or PNCI loan is estimated using one of several methods, including collateral value, fair value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired originated and PNCI loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the

recorded investments in such loans. Impaired originated and PNCI loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value which uses substantially observable data, the Company records the impaired originated or PNCI loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value, or the appraised value contains a significant unobservable assumption, such as deviations from comparable sales, and there is no observable market price, the Company records the impaired originated or PNCI loan as nonrecurring Level 3.

*Foreclosed assets* Foreclosed assets include assets acquired through, or in lieu of, loan foreclosure. Foreclosed assets are held for sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, management periodically performs valuations and the assets are carried at the lower of carrying amount or fair value less cost to sell. When the fair value of foreclosed assets is based on an observable market price or a current appraised value which uses substantially observable data, the Company records the impaired originated loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value, or the appraised value contains a significant unobservable assumption, such as deviations from comparable sales, and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3. Revenue and expenses from operations and changes in the valuation allowance are included in other noninterest expense.

*Mortgage servicing rights* Mortgage servicing rights are carried at fair value. A valuation model, which utilizes a discounted cash flow analysis using a discount rate and prepayment speed assumptions is used in the computation of the fair value measurement. While the prepayment speed assumption is currently quoted for comparable instruments, the discount rate assumption currently requires a significant degree of management judgment and is therefore considered an unobservable input. As such, the Company classifies mortgage servicing rights subjected to recurring fair value adjustments as Level 3. Additional information regarding mortgage servicing rights can be found in Note 10 in the consolidated financial statements at Item 1 of this report.

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The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis (in thousands):

| Fair value at September 30, 2014                         | Total            | Level 1 | Level 2          | Level 3         |
|--|------------------|---------|------------------|-----------------|
| <b>Securities available for sale:</b>                    |                  |         |                  |                 |
| Obligations of U.S. government corporations and agencies | \$ 79,860        |         | \$ 79,860        |                 |
| Obligations of states and political subdivisions         | 3,190            |         | 3,190            |                 |
| Corporate debt securities                                | 1,912            |         | 1,912            |                 |
| Mortgage servicing rights                                | 5,985            |         |                  | \$ 5,985        |
| <b>Total assets measured at fair value</b>               | <b>\$ 90,947</b> |         | <b>\$ 84,962</b> | <b>\$ 5,985</b> |

| Fair value at December 31, 2013                          | Total             | Level 1 | Level 2           | Level 3         |
|--|-------------------|---------|-------------------|-----------------|
| <b>Securities available for sale:</b>                    |                   |         |                   |                 |
| Obligations of U.S. government corporations and agencies | \$ 97,143         |         | \$ 97,143         |                 |
| Obligations of states and political subdivisions         | 5,589             |         | 5,589             |                 |
| Corporate debt securities                                | 1,915             |         | 1,915             |                 |
| Mortgage servicing rights                                | 6,165             |         |                   | \$ 6,165        |
| <b>Total assets measured at fair value</b>               | <b>\$ 110,812</b> |         | <b>\$ 104,647</b> | <b>\$ 6,165</b> |

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally corresponds with the Company's quarterly valuation process. There were no transfers between any levels during the three months ended September 30, 2014 or the year ended December 31, 2013.

The following table provides a reconciliation of assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the time periods indicated. Had there been any transfer into or out of Level 3 during the time periods indicated, the amount included in the Transfers into (out of) Level 3 column would represent the beginning balance of an item in the period (interim quarter) during which it was transferred (in thousands):

|                                   | Three months ended September 30, |                 | Nine months ended September 30, |                 |
|-----------------------------------|----------------------------------|-----------------|---------------------------------|-----------------|
|                                   | 2014                             | 2013            | 2014                            | 2013            |
| <b>Mortgage servicing rights:</b> |                                  |                 |                                 |                 |
| Balance at beginning of period    | \$ 5,909                         | \$ 5,571        | \$ 6,165                        | \$ 4,552        |
| Issuances                         | 164                              | 297             | 440                             | 1,186           |
| Change included in earnings       | (88)                             | 181             | (620)                           | 311             |
| <b>Balance at end of period</b>   | <b>\$ 5,985</b>                  | <b>\$ 6,049</b> | <b>\$ 5,985</b>                 | <b>\$ 6,049</b> |



The Company's method for determining the fair value of mortgage servicing rights is described in Note 1. The key unobservable inputs used in determining the fair value of mortgage servicing rights are mortgage prepayment speeds and the discount rate used to discount cash projected cash flows. Generally, any significant increases in the mortgage prepayment speed and discount rate utilized in the fair value measurement of the mortgage servicing rights will result in a negative fair value adjustments (and decrease in the fair value measurement). Conversely, a decrease in the mortgage prepayment speed and discount rate will result in a positive fair value adjustment (and increase in the fair value measurement). Note 10 contains additional information regarding mortgage servicing rights.

The following table presents quantitative information about recurring Level 3 fair value measurements at September 30, 2014:

|                           | Fair Value<br>(in thousands) | Valuation<br>Technique | Unobservable<br>Inputs                    | Range,<br>Weighted Average              |
|---------------------------|------------------------------|------------------------|---|---|
| Mortgage Servicing Rights | \$ 5,985                     | Discounted cash flow   | Constant prepayment rate<br>Discount rate | 6.0%-22.4%, 10.4%<br>10.0%-12.0%, 10.0% |

The following table presents quantitative information about recurring Level 3 fair value measurements at December 31, 2013:

|                           | Fair Value<br>(in thousands) | Valuation<br>Technique | Unobservable<br>Inputs                    | Range,<br>Weighted Average              |
|---------------------------|------------------------------|------------------------|---|---|
| Mortgage Servicing Rights | \$ 6,165                     | Discounted cash flow   | Constant prepayment rate<br>Discount rate | 6.3%-33.0%, 10.3%<br>10.0%-12.0%, 10.0% |

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The tables below present the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis, as of the dates indicated, that had a write-down or an additional allowance provided during the periods indicated; and the losses from nonrecurring fair value adjustments that occurred in the periods indicated (in thousands):

| Nine months ended September 30, 2014 | Total    | Level 1 | Level 2 | Level 3  | Total Losses |
|--------------------------------------|----------|---------|---------|----------|--------------|
| Fair value:                          |          |         |         |          |              |
| Impaired Originated & PNCI loans     | \$ 3,090 |         |         | \$ 3,090 | \$ 617       |
| Foreclosed assets                    | 3,012    |         |         | 3,012    | 110          |
| Total assets measured at fair value  | \$ 6,102 |         |         | \$ 6,102 | \$ 727       |

| Year ended December 31, 2013        | Total     | Level 1 | Level 2 | Level 3   | Total Losses |
|-------------------------------------|-----------|---------|---------|-----------|--------------|
| Fair value:                         |           |         |         |           |              |
| Impaired Originated & PNCI loans    | \$ 20,334 |         |         | \$ 20,334 | \$ 2,539     |
| Foreclosed assets                   | 948       |         |         | 948       | 397          |
| Total assets measured at fair value | \$ 21,282 |         |         | \$ 21,282 | \$ 2,936     |

| Nine months ended September 30, 2013 | Total     | Level 1 | Level 2 | Level 3   | Total Losses |
|--------------------------------------|-----------|---------|---------|-----------|--------------|
| Fair value:                          |           |         |         |           |              |
| Impaired Originated & PNCI loans     | \$ 22,638 |         |         | \$ 22,638 | \$ 2,836     |
| Foreclosed assets                    | 2,049     |         |         | 2,049     | 531          |
| Total assets measured at fair value  | \$ 24,687 |         |         | \$ 24,687 | \$ 3,367     |

The table below presents the losses from nonrecurring fair value adjustments that occurred in the periods indicated (in thousands):

| Losses from nonrecurring fair value adjustments:      | Three months ended September 30, |        |
|---|----------------------------------|--------|
|   | 2014                             | 2013   |
| Impaired Originated & PNCI loans                      | \$ 211                           | \$ 258 |
| Foreclosed assets                                     | 98                               |        |
| Total losses from nonrecurring fair value adjustments | \$ 309                           | \$ 258 |

The impaired Originated and PNCI loan amount above represents impaired, collateral dependent loans that have been adjusted to fair value. When we identify a collateral dependent loan as impaired, we measure the impairment using the

current fair value of the collateral, less selling costs. Depending on the characteristics of a loan, the fair value of collateral is generally estimated by obtaining external appraisals. If we determine that the value of the impaired loan is less than the recorded investment in the loan, we recognize this impairment and adjust the carrying value of the loan to fair value through the allowance for loan and lease losses. The loss represents charge-offs or impairments on collateral dependent loans for fair value adjustments based on the fair value of collateral. The carrying value of loans fully charged-off is zero.

The foreclosed assets amount above represents impaired real estate that has been adjusted to fair value. Foreclosed assets represent real estate which the Bank has taken control of in partial or full satisfaction of loans. At the time of foreclosure, other real estate owned is recorded at the lower of the carrying amount of the loan or fair value less costs to sell, which becomes the property's new basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan and lease losses. After foreclosure, management periodically performs valuations such that the real estate is carried at the lower of its new cost basis or fair value, net of estimated costs to sell. Fair value adjustments on other real estate owned are recognized within net loss on real estate owned. The loss represents impairments on non-covered other real estate owned for fair value adjustments based on the fair value of the real estate.

The Company's property appraisals are primarily based on the sales comparison approach and income approach methodologies, which consider recent sales of comparable properties, including their income generating characteristics, and then make adjustments to reflect the general assumptions that a market participant would make when analyzing the property for purchase. These adjustments may increase or decrease an appraised value and can vary significantly depending on the location, physical characteristics and income producing potential of each property. Additionally, the quality and volume of market information available at the time of the appraisal can vary from period to period and cause significant changes to the nature and magnitude of comparable sale adjustments. Given these variations, comparable sale adjustments are generally not a reliable indicator for how fair value will increase or decrease from period to period. Under certain circumstances, management discounts are applied based on specific characteristics of an individual property.

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The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at September 30, 2014:

|                                  | Fair Value<br>(in thousands) | Valuation<br>Technique    | Unobservable<br>Inputs                              | Range,<br>Weighted Average |
|----------------------------------|------------------------------|---------------------------|---|----------------------------|
| Impaired Originated & PNCI loans | \$ 3,090                     | Sales comparison approach | Adjustment for differences between comparable sales | (5.0)%-(39.0)%, (9.0)%     |
|                                  |                              | Income approach           | Capitalization rate                                 | 9.09%-9.25 %, 9.23%        |
| Foreclosed assets                | \$ 3,012                     | Sales comparison approach | Adjustment for differences between comparable sales | (5.0)%-(28.6)%, (7.7)%     |

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at December 31, 2013:

|                                  | Fair Value<br>(in thousands) | Valuation<br>Technique    | Unobservable<br>Inputs                              | Range,<br>Weighted Average |
|----------------------------------|------------------------------|---------------------------|---|----------------------------|
| Impaired Originated & PNCI loans | \$ 20,334                    | Sales comparison approach | Adjustment for differences between comparable sales | (5.0)%-(56.4)%, (10.4)%    |
|                                  |                              | Income approach           | Capitalization rate                                 | 7.75%-9.25 %, 8.91%        |
| Foreclosed assets                | \$ 948                       | Sales comparison approach | Adjustment for differences between comparable sales | (6.5)%-(16.7)%, (8.9)%     |

In addition to the methods and assumptions used to estimate the fair value of each class of financial instrument noted above, the following methods and assumptions were used to estimate the fair value of other classes of financial instruments for which it is practical to estimate the fair value.

*Short-term Instruments* Cash and due from banks, fed funds purchased and sold, interest receivable and payable, and short-term borrowings are considered short-term instruments. For these short-term instruments their carrying amount approximates their fair value.

*Securities held to maturity* The fair value of securities held to maturity is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. The Company had no securities held to maturity classified as Level 3 during any of the periods covered in these financial statements.

*Restricted Equity Securities* The carrying value of restricted equity securities approximates fair value as the shares can only be redeemed by the issuing institution at par.

*Originated and PNCI loans* The fair value of variable rate originated and PNCI loans is the current carrying value. The interest rates on these originated and PNCI loans are regularly adjusted to market rates. The fair value of other

types of fixed rate originated and PNCI loans is estimated by discounting the future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings for the same remaining maturities. The allowance for loan losses is a reasonable estimate of the valuation allowance needed to adjust computed fair values for credit quality of certain originated and PNCI loans in the portfolio.

*PCI Loans* PCI loans are measured at estimated fair value on the date of acquisition. Carrying value is calculated as the present value of expected cash flows and approximates fair value.

*Deposit Liabilities* The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. These values do not consider the estimated fair value of the Company's core deposit intangible, which is a significant unrecognized asset of the Company. The fair value of time deposits and other borrowings is based on the discounted value of contractual cash flows.

*Other Borrowings* The fair value of other borrowings is calculated based on the discounted value of the contractual cash flows using current rates at which such borrowings can currently be obtained.

*Junior Subordinated Debentures* The fair value of junior subordinated debentures is estimated using a discounted cash flow model. The future cash flows of these instruments are extended to the next available redemption date or maturity date as appropriate based upon the spreads of recent issuances or quotes from brokers for comparable bank holding companies compared to the contractual spread of each junior subordinated debenture measured at fair value.

*Commitments to Extend Credit and Standby Letters of Credit* The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present credit worthiness of the counter parties. For fixed rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligation with the counter parties at the reporting date.

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Fair values for financial instruments are management's estimates of the values at which the instruments could be exchanged in a transaction between willing parties. These estimates are subjective and may vary significantly from amounts that would be realized in actual transactions. In addition, other significant assets are not considered financial assets including, any mortgage banking operations, deferred tax assets, and premises and equipment. Further, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered in any of these estimates.

The estimated fair values of financial instruments that are reported at amortized cost in the Corporation's consolidated balance sheets, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value, were as follows (in thousands):

|   | September 30, 2014 |               | December 31, 2013  |               |
|---|--------------------|---------------|--------------------|---------------|
|   | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
| <b>Financial assets:</b>                |                    |               |                    |               |
| <b>Level 1 inputs:</b>                  |                    |               |                    |               |
| Cash and due from banks                 | \$ 74,476          | \$ 74,476     | \$ 76,915          | \$ 76,915     |
| Cash at Federal Reserve and other banks | 295,203            | 295,203       | 521,453            | 521,453       |
| <b>Level 2 inputs:</b>                  |                    |               |                    |               |
| Securities held to maturity             | 443,509            | 446,804       | 240,504            | 233,807       |
| Restricted equity securities            | 11,582             | 11,582        | 9,163              | 9,163         |
| Loans held for sale                     | 2,724              | 2,724         | 2,270              | 2,270         |
| <b>Level 3 inputs:</b>                  |                    |               |                    |               |
| Loans, net                              | 1,727,951          | 1,799,884     | 1,672,007          | 1,760,274     |
| <b>Financial liabilities:</b>           |                    |               |                    |               |
| <b>Level 2 inputs:</b>                  |                    |               |                    |               |
| Deposits                                | 2,437,356          | 2,437,687     | 2,410,483          | 2,411,402     |
| Other borrowings                        | 12,665             | 12,665        | 6,335              | 6,335         |
| Junior subordinated debt                | 41,238             | 29,279        | 41,238             | 25,774        |
|   | Contract<br>Amount | Fair<br>Value | Contract<br>Amount | Fair<br>Value |
| <b>Off-balance sheet:</b>               |                    |               |                    |               |
| <b>Level 3 inputs:</b>                  |                    |               |                    |               |
| Commitments                             | \$ 581,745         | \$ 5,817      | \$ 555,386         | \$ 5,554      |
| Standby letters of credit               | 3,566              | 36            | 2,601              | 26            |
| Overdraft privilege commitments         | 70,677             | 707           | 68,932             | 689           |

**Table of Contents****Note 28 - TriCo Bancshares Condensed Financial Statements (Parent Only)**

| <b>Condensed Balance Sheets</b>   | September 30,     | December 31,      |
|---|-------------------|-------------------|
|   | 2014              | 2013              |
|   | (In thousands)    |                   |
| <b>Assets</b>   |                   |                   |
| Cash and Cash equivalents   | \$ 2,022          | \$ 2,520          |
| Investment in Tri Counties Bank   | 305,543           | 288,746           |
| Other assets  | 1,465             | 1,280             |
| <b>Total assets</b>   | <b>\$ 309,030</b> | <b>\$ 292,546</b> |
| <b>Liabilities and shareholders equity</b>  |                   |                   |
| Other liabilities   | 412               | 362               |
| Junior subordinated debt  | 41,238            | 41,238            |
| <b>Total liabilities</b>  | <b>41,650</b>     | <b>41,600</b>     |
| <b>Shareholders equity:</b>   |                   |                   |
| Common stock, no par value: authorized 50,000,000 shares; issued and outstanding 16,139,414 and 16,076,662 shares, respectively | 92,692            | 89,356            |
| Retained earnings   | 172,892           | 159,733           |
| Accumulated other comprehensive income, net   | 1,796             | 1,857             |
| <b>Total shareholders equity</b>  | <b>267,380</b>    | <b>250,946</b>    |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 309,030</b> | <b>\$ 292,546</b> |

| <b>Statements of Income</b><br>(In thousands)         | Three months ended |                    | Nine months ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2014 | September 30, 2013 | September 30, 2014 | September 30, 2013 |
| Interest expense                                      | \$ 310             | \$ 314             | \$ 920             | \$ 936             |
| Administration expense                                | 722                | 191                | 1,512              | 568                |
| Loss before equity in net income of Tri Counties Bank | (1,032)            | (505)              | (2,432)            | (1,504)            |
| Equity in net income of Tri Counties Bank:            |                    |                    |                    |                    |
| Distributed   | 2,295              | 2,300              | 6,395              | 6,080              |
| (Over) under distributed                              | 6,744              | 5,354              | 15,823             | 16,955             |
| Income tax benefit                                    | 227                | 212                | 672                | 632                |
| <b>Net income</b>                                     | <b>\$ 8,234</b>    | <b>\$ 7,361</b>    | <b>\$ 20,458</b>   | <b>\$ 22,163</b>   |

| <b>Statements of Comprehensive Income</b><br>(In thousands)                                  | Three months ended    |                       | Nine months ended     |                       |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
|  | September 30,<br>2014 | September 30,<br>2013 | September 30,<br>2014 | September 30,<br>2013 |
| Net income   | \$ 8,234              | \$ 7,361              | \$ 20,458             | \$ 22,163             |
| Other comprehensive income (loss), net of tax:   |                       |                       |                       |                       |
| Unrealized holding gains (losses) on available for sale securities arising during the period | (398)                 | 83                    | (77)                  | (2,027)               |
| Change in minimum pension liability  | 6                     |                       | 16                    |                       |
| Other comprehensive income (loss)  | (392)                 | 83                    | (61)                  | (2,027)               |
| Comprehensive income   | \$ 7,842              | \$ 7,444              | \$ 20,397             | \$ 20,136             |

| <b>Statements of Cash Flows</b><br>(In thousands)                                 | Nine months ended September 30, |          |
|---|---------------------------------|----------|
|   | 2014                            | 2013     |
| <b>Operating activities:</b>  |                                 |          |
| Net income  | 20,458                          | 22,163   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |          |
| Over (under) distributed equity in earnings of Tri Counties Bank                  | (15,823)                        | (16,955) |
| Stock option vesting expense  | 810                             | 849      |
| Stock option excess tax benefits  | (225)                           | (356)    |
| Net change in other assets and liabilities  | (945)                           | (853)    |
| Net cash provided by operating activities   | 4,275                           | 4,848    |
| <b>Investing activities: None</b>   |                                 |          |
| <b>Financing activities:</b>  |                                 |          |
| Issuance of common stock through option exercise                                  | 616                             | 251      |
| Stock option excess tax benefits  | 225                             | 356      |
| Repurchase of common stock  | (292)                           | (501)    |
| Cash dividends paid common  | (5,322)                         | (4,976)  |
| Net cash used for financing activities  | (4,773)                         | (4,870)  |
| (Decrease) increase in cash and cash equivalents                                  | (498)                           | (22)     |
| Cash and cash equivalents at beginning of year                                    | 2,520                           | 2,511    |
| Cash and cash equivalents at end of year  | \$ 2,022                        | \$ 2,489 |



**Table of Contents****Note 29 - Regulatory Matters**

The Company is subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of September 30, 2014, that the Company meets all capital adequacy requirements to which it is subject.

As of September 30, 2014, the Bank was well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since that date that Management believes have changed the institution's category. The Bank's actual capital amounts and ratios are also presented in the table.

|  | Actual     |        | Minimum Capital Requirement |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|--|------------|--------|-----------------------------|-------|--|-------|
|  | Amount     | Ratio  | Amount                      | Ratio | Amount   | Ratio |
| (dollars in thousands)                           |            |        |                             |       |  |       |
| <b>As of September 30, 2014:</b>                 |            |        |                             |       |  |       |
| <b>Total Capital (to Risk Weighted Assets):</b>  |            |        |                             |       |  |       |
| Consolidated                                     | \$ 315,581 | 14.79% | \$ 170,716                  | 8.0%  | N/A  | N/A   |
| Tri Counties Bank                                | \$ 313,725 | 14.71% | \$ 170,597                  | 8.0%  | \$ 213,247   | 10.0% |
| <b>Tier 1 Capital (to Risk Weighted Assets):</b> |            |        |                             |       |  |       |
| Consolidated                                     | \$ 288,740 | 13.53% | \$ 85,358                   | 4.0%  | N/A  | N/A   |
| Tri Counties Bank                                | \$ 286,903 | 13.45% | \$ 85,299                   | 4.0%  | \$ 127,948   | 6.0%  |
| <b>Tier 1 Capital (to Average Assets):</b>       |            |        |                             |       |  |       |
| Consolidated                                     | \$ 288,740 | 10.48% | \$ 110,197                  | 4.0%  | N/A  | N/A   |
| Tri Counties Bank                                | \$ 286,903 | 10.42% | \$ 110,148                  | 4.0%  | \$ 137,685   | 5.0%  |
| <b>As of December 31, 2013:</b>                  |            |        |                             |       |  |       |
| <b>Total Capital (to Risk Weighted Assets):</b>  |            |        |                             |       |  |       |
| Consolidated                                     | \$ 297,429 | 14.77% | \$ 161,064                  | 8.0%  | N/A  | N/A   |
| Tri Counties Bank                                | \$ 295,212 | 14.67% | \$ 160,961                  | 8.0%  | \$ 201,201   | 10.0% |
| <b>Tier 1 Capital (to Risk Weighted Assets):</b> |            |        |                             |       |  |       |
| Consolidated                                     | \$ 272,071 | 13.51% | \$ 80,532                   | 4.0%  | N/A  | N/A   |
| Tri Counties Bank                                | \$ 269,870 | 13.41% | \$ 80,480                   | 4.0%  | \$ 120,720   | 6.0%  |

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Tier 1 Capital (to Average Assets):

|                   |            |        |            |      |            |      |
|-------------------|------------|--------|------------|------|------------|------|
| Consolidated      | \$ 272,071 | 10.17% | \$ 107,017 | 4.0% | N/A        | N/A  |
| Tri Counties Bank | \$ 269,870 | 10.09% | \$ 106,965 | 4.0% | \$ 133,706 | 5.0% |

**Table of Contents****Note 30 - Summary of Quarterly Results of Operations (unaudited)**

The following table sets forth the results of operations for the periods indicated, and is unaudited; however, in the opinion of Management, it reflects all adjustments (which include only normal recurring adjustments) necessary to present fairly the summarized results for such periods.

|   | 2014 Quarters Ended                           |                 |                 |           |
|---|---|-----------------|-----------------|-----------|
|   | December 31,                                  | September 30,   | June 30,        | March 31, |
|   | (dollars in thousands, except per share data) |                 |                 |           |
| <b>Interest and dividend income:</b>                                    |   |                 |                 |           |
| <b>Loans:</b>   |   |                 |                 |           |
| Discount accretion PCI cash basis                                       | \$ 290  | \$ 69           | \$ 203          |           |
| Discount accretion PCI other  | 822   | 811             | 984             |           |
| Discount accretion PNCI   | 402   | 624             | 379             |           |
| All other loan interest income  | 23,466  | 22,929          | 22,172          |           |
| <b>Total loan interest income</b>                                       | <b>24,980</b>                                 | <b>24,433</b>   | <b>23,738</b>   |           |
| Debt securities, dividends and interest bearing cash at Banks (not FTE) | 4,151   | 3,985           | 3,421           |           |
| <b>Total interest income</b>  | <b>29,131</b>                                 | <b>28,418</b>   | <b>27,159</b>   |           |
| Interest expense  | 1,082   | 1,075           | 1,087           |           |
| <b>Net interest income</b>  | <b>28,049</b>                                 | <b>27,343</b>   | <b>26,072</b>   |           |
| (Benefit from) provision for loan losses                                | (2,977)                                       | 1,708           | (1,355)         |           |
| <b>Net interest income after provision for loan losses</b>              | <b>31,026</b>                                 | <b>25,635</b>   | <b>27,427</b>   |           |
| Noninterest income  | 8,589   | 7,877           | 8,295           |           |
| Noninterest expense   | 25,380  | 25,116          | 23,317          |           |
| <b>Income before income taxes</b>                                       | <b>14,235</b>                                 | <b>8,396</b>    | <b>12,405</b>   |           |
| Income tax expense  | 6,001   | 3,537           | 5,040           |           |
| <b>Net income</b>   | <b>\$ 8,234</b>                               | <b>\$ 4,859</b> | <b>\$ 7,365</b> |           |
| <b>Per common share:</b>  |   |                 |                 |           |
| Net income (diluted)  | \$ 0.50                                       | \$ 0.30         | \$ 0.45         |           |
| Dividends   | \$ 0.11                                       | \$ 0.11         | \$ 0.11         |           |

2013 Quarters Ended  
December 31, September 30, June 30, March 31,  
(dollars in thousands, except per share data)

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|   |                 |                 |                 |                 |
|---|-----------------|-----------------|-----------------|-----------------|
| Interest and dividend income:   |                 |                 |                 |                 |
| Loans:  |                 |                 |                 |                 |
| Discount accretion PCI cash basis                                       | \$ 255          | \$ 140          | \$ 129          | \$ 167          |
| Discount accretion PCI other  | 893             | 898             | 732             | 597             |
| Discount accretion PNCI   | 568             | 1,115           | 815             | 766             |
| All other loan interest income  | 22,754          | 22,970          | 22,207          | 22,542          |
| <b>Total loan interest income</b>                                       | <b>24,470</b>   | <b>25,123</b>   | <b>23,883</b>   | <b>24,072</b>   |
| Debt securities, dividends and interest bearing cash at Banks (not FTE) | 2,992           | 2,413           | 1,873           | 1,734           |
| <b>Total interest income</b>  | <b>27,462</b>   | <b>27,536</b>   | <b>25,756</b>   | <b>25,806</b>   |
| Interest expense  | 1,123           | 1,169           | 1,167           | 1,237           |
| <b>Net interest income</b>  | <b>26,339</b>   | <b>26,367</b>   | <b>24,589</b>   | <b>24,569</b>   |
| Provision for (benefit from) loan losses                                | 172             | (393)           | 614             | (1,108)         |
| <b>Net interest income after provision for loan losses</b>              | <b>26,167</b>   | <b>26,760</b>   | <b>23,975</b>   | <b>25,677</b>   |
| Noninterest income  | 7,353           | 9,127           | 10,131          | 10,218          |
| Noninterest expense   | 24,878          | 23,616          | 23,509          | 21,601          |
| <b>Income before income taxes</b>                                       | <b>8,642</b>    | <b>12,271</b>   | <b>10,597</b>   | <b>14,294</b>   |
| Income tax expense  | 3,406           | 4,910           | 4,272           | 5,817           |
| <b>Net income</b>   | <b>\$ 5,236</b> | <b>\$ 7,361</b> | <b>\$ 6,325</b> | <b>\$ 8,477</b> |
| Per common share:   |                 |                 |                 |                 |
| Net income (diluted)  | \$ 0.32         | \$ 0.45         | \$ 0.39         | \$ 0.53         |
| Dividends   | \$ 0.11         | \$ 0.11         | \$ 0.11         | \$ 0.09         |

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**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****General**

As TriCo Bancshares (referred to in this report as we, our or the Company) has not commenced any business operations independent of Tri Counties Bank (the Bank), the following discussion pertains primarily to the Bank. Average balances, including such balances used in calculating certain financial ratios, are generally comprised of average daily balances for the Company. Within Management's Discussion and Analysis of Financial Condition and Results of Operations, interest income, net interest income, net interest yield, and efficiency ratio are generally presented on a fully tax-equivalent (FTE) basis. The Company believes the use of these non-generally accepted accounting principles (non-GAAP) measures provides additional clarity in assessing its results, and the presentation of these measures on a FTE basis is a common practice within the banking industry. Interest income and net interest income are shown on a non-FTE basis in the Part I Financial Information section of this Form 10-Q, and a reconciliation of the FTE and non-FTE presentations is provided below in the discussion of net interest income.

**Critical Accounting Policies and Estimates**

There have been no changes to the Company's critical accounting policies during the nine months ended September 30, 2014, except for the changes in the Company's accounting policies related to its allowance for loan losses noted under the heading *Loans and Allowance for Loan Losses* in Note 1 in Item 1 of Part I of this report.

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those that materially affect the financial statements and are related to the adequacy of the allowance for loan losses, investments, mortgage servicing rights, fair value measurements, retirement plans and intangible assets. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company's policies related to estimates on the allowance for loan losses, other than temporary impairment of investments and impairment of intangible assets, can be found in Note 1 in Item 1 of Part I of this report.

On September 23, 2011, the California Department of Financial Institutions closed Citizens Bank of Northern California (Citizens), Nevada City, California and appointed the FDIC as receiver. That same date, the Bank assumed the banking operations of Citizens from the FDIC under a whole bank purchase and assumption agreement without loss sharing.

On May 28, 2010, the Office of the Comptroller of the Currency closed Granite Community Bank, N.A. (Granite), Granite Bay, California and appointed the FDIC as receiver. That same date, the Bank assumed the banking operations of Granite from the FDIC under a whole bank purchase and assumption agreement with loss sharing. Under the terms of the loss sharing agreement, the FDIC will cover a substantial portion of any future losses on loans, related unfunded loan commitments, other real estate owned (OREO)/foreclosed assets and accrued interest on loans for up to 90 days. The FDIC will absorb 80% of losses and share in 80% of loss recoveries on the covered assets acquired from Granite. The loss sharing arrangements for non-single family residential and single family residential loans are in effect for 5 years and 10 years, respectively, and the loss recovery provisions are in effect for 8 years and

10 years, respectively, from the acquisition date.

The Company refers to loans and foreclosed assets that are covered by loss sharing agreements as covered loans and covered foreclosed assets, respectively. In addition, the Company refers to loans purchased or obtained in a business combination as purchased credit impaired (PCI) loans, or purchased non-credit impaired (PNCI) loans. The Company refers to loans that it originates as originated loans. Additional information regarding the Citizens and Granite Bank acquisitions can be found in Note 2 in Item 1 of Part I of this report. Additional information regarding the definitions and accounting for originated, PNCI and PCI loans can be found in Notes 1, 2, 4 and 5 in Item 1 of Part I of this report, and under the heading *Asset Quality and Non-Performing Assets* below.

### **Geographical Descriptions**

For the purpose of describing the geographical location of the Company's loans, the Company has defined northern California as that area of California north of, and including, Stockton; central California as that area of the State south of Stockton, to and including, Bakersfield; and southern California as that area of the State south of Bakersfield.

**Table of Contents****TRICO BANCSHARES**

## Financial Summary

(dollars in thousands, except per share amounts; unaudited)

|   | Three months ended<br>September 30, |              | Nine months ended<br>September 30, |           |
|---|-------------------------------------|--------------|------------------------------------|-----------|
|   | 2014                                | 2013         | 2014                               | 2013      |
| Net Interest Income (FTE)                             | \$ 28,118                           | \$ 26,470    | \$ 81,685                          | \$ 75,779 |
| Benefit from reversal of provision for<br>loan losses | 2,977                               | 393          | 2,624                              | 887       |
| Noninterest income                                    | 8,589                               | 9,127        | 24,761                             | 29,476    |
| Noninterest expense                                   | (25,380)                            | (23,616)     | (73,813)                           | (68,726)  |
| Provision for income taxes (FTE)                      | (6,070)                             | (5,013)      | (14,799)                           | (15,253)  |
| Net income  | \$ 8,234                            | \$ 7,361     | \$ 20,458                          | \$ 22,163 |
| <b>Earnings per share:</b>                            |                                     |              |                                    |           |
| Basic   | \$ 0.51                             | \$ 0.46      | \$ 1.27                            | \$ 1.38   |
| Diluted   | \$ 0.50                             | \$ 0.45      | \$ 1.25                            | \$ 1.37   |
| <b>Per share:</b>                                     |                                     |              |                                    |           |
| Dividends paid  | \$ 0.11                             | \$ 0.11      | \$ 0.33                            | \$ 0.31   |
| Book value at period end                              | \$ 16.57                            | \$ 15.27     |                                    |           |
| Average common shares outstanding                     | 16,137                              | 16,074       | 16,121                             | 16,035    |
| Average diluted common shares<br>outstanding          | 16,331                              | 16,230       | 16,321                             | 16,152    |
| Shares outstanding at period end                      | 16,139                              | 16,077       |                                    |           |
| <b>At period end:</b>                                 |                                     |              |                                    |           |
| Loans, net  | \$ 1,727,951                        | \$ 1,617,711 |                                    |           |
| Total assets  | 2,794,943                           | 2,632,106    |                                    |           |
| Total deposits  | 2,437,356                           | 2,293,311    |                                    |           |
| Other borrowings                                      | 12,665                              | 14,626       |                                    |           |
| Junior subordinated debt                              | 41,238                              | 41,238       |                                    |           |
| Shareholders' equity                                  | \$ 267,380                          | \$ 245,452   |                                    |           |
| <b>Financial Ratios:</b>                              |                                     |              |                                    |           |
| <b>During the period (annualized):</b>                |                                     |              |                                    |           |
| Return on assets                                      | 1.19%                               | 1.13%        | 0.99%                              | 1.14%     |
| Return on equity                                      | 12.39%                              | 12.08%       | 10.47%                             | 12.36%    |
| Net interest margin <sup>1</sup>                      | 4.39%                               | 4.40%        | 4.26%                              | 4.17%     |
| Efficiency ratio <sup>1</sup>                         | 69.1%                               | 66.3%        | 69.3%                              | 65.3%     |
| Average equity to average assets                      | 9.59%                               | 9.36%        | 9.48%                              | 9.20%     |
| <b>At period end:</b>                                 |                                     |              |                                    |           |
| Equity to assets                                      | 9.57%                               | 9.33%        |                                    |           |
| Total capital to risk-adjusted assets                 | 14.79%                              | 14.88%       |                                    |           |

<sup>1</sup> Fully taxable equivalent (FTE)

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**Table of Contents****Results of Operations****Overview**

The following discussion and analysis is designed to provide a better understanding of the significant changes and trends related to the Company and the Bank's financial condition, operating results, asset and liability management, liquidity and capital resources and should be read in conjunction with the Condensed Consolidated Financial Statements of the Company and the Notes thereto located at Item 1 of this report.

Following is a summary of the components of FTE net income for the periods indicated (dollars in thousands):

|  | Three months ended<br>September 30, |           | Nine months ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2014                                | 2013      | 2014                               | 2013      |
| Net Interest Income (FTE)                          | \$ 28,118                           | \$ 26,470 | \$ 81,685                          | \$ 75,779 |
| Benefit from reversal of provision for loan losses | 2,977                               | 393       | 2,624                              | 887       |
| Noninterest income                                 | 8,589                               | 9,127     | 24,761                             | 29,476    |
| Noninterest expense                                | (25,380)                            | (23,616)  | (73,813)                           | (68,726)  |
| Provision for income taxes (FTE)                   | (6,070)                             | (5,013)   | (14,799)                           | (15,253)  |
| Net income   | \$ 8,234                            | \$ 7,361  | \$ 20,458                          | \$ 22,163 |

**Net Interest Income**

The Company's primary source of revenue is net interest income, or the difference between interest income on interest-earning assets and interest expense on interest-bearing liabilities. Following is a summary of the components of net interest income for the periods indicated (dollars in thousands):

|                           | Three months ended<br>September 30, |           | Nine month ended<br>September 30, |           |
|---------------------------|-------------------------------------|-----------|-----------------------------------|-----------|
|                           | 2014                                | 2013      | 2014                              | 2013      |
| Interest income           | \$ 29,131                           | \$ 27,536 | \$ 84,708                         | \$ 79,098 |
| Interest expense          | (1,082)                             | (1,169)   | (3,244)                           | (3,573)   |
| FTE adjustment            | 69                                  | 103       | 221                               | 254       |
| Net interest income (FTE) | \$ 28,118                           | \$ 26,470 | \$ 81,685                         | \$ 75,779 |
| Net interest margin (FTE) | 4.39%                               | 4.40%     | 4.26%                             | 4.17%     |

Net interest income (FTE) during the third quarter of 2014 increased \$1,648,000 (6.2%) from the same period in 2013 to \$28,118,000. The increase in net interest income (FTE) was due primarily to a \$223,394,000 (83%) increase in the average balance of investments to \$494,104,000, and a \$116,520,000 (7.1%) increase in the average balance of loans to \$1,752,026,000 that were partially offset by a 44 basis point decrease in the average yield on loans from 6.14% during the three months ended September 30, 2013 to 5.70% during the three months ended September 30, 2014.

During much of 2013 and the nine months ended September 30, 2014, the Company used a portion of its Fed funds sold to buy investments. The increase in average loan balances was due to organic loan growth and the purchase of \$19,690,000 and \$12,327,000 of single family residential real estate loans during the second and third quarters of 2014, respectively. The decrease in average loan yields is due primarily to declines in market yields on new and renewed loans compared to yields on repricing, maturing, and paid off loans. The increases in average investment and loan balances added \$1,636,000 and \$1,789,000 to net interest income (FTE) while the decrease in average loan yields reduced net interest income (FTE) by \$1,932,000 when compared to the year-ago quarter. For more information related to loan interest income, including loan purchase discount accretion, see Note 30 to the consolidated financial statements at Part I, Item 1 of this report. As noted above, during much of 2013 and the nine months ended September 30, 2014, the Company deployed some of its excess cash previously held as Federal funds sold into some higher yielding investments while maintaining an appropriate level of interest rate risk. In addition, during the three and nine months ended September 30, 2014 and some of 2013, the Company noted some increase in loan demand albeit at lower yields than existing loans.

Net interest income (FTE) during the nine months ended September 30, 2014 increased \$5,906,000 (7.8%) from the same period in 2013 to \$81,685,000. The increase in net interest income (FTE) was due primarily to a \$259,564,000 (126%) increase in the average balance of investments to \$465,809,000, and a \$114,921,000 (7.2%) increase in the average balance of loans to \$1,712,657,000 that were partially offset by a 41 basis point decrease in the average yield on loans from 6.10% during the nine months ended September 30, 2013 to 5.69% during the nine months ended September 30, 2014. During much of 2013 and the nine months ended September 30, 2014, the Company used a portion of its Fed funds sold to buy investments. The increase in average loan balances was due to organic loan growth and the purchase of \$19,690,000 and \$12,327,000 of single family residential real estate loans during the second and third quarters of 2014, respectively. The decrease in average loan yields is due primarily to declines in market yields on new and renewed loans compared to yields on repricing, maturing, and paid off loans. The increases in average investment and loan balances added \$5,840,000 and \$5,258,000 to net interest income (FTE) while the decrease in average loan yields reduced net interest income (FTE) by \$5,185,000 when compared to the nine months ended September 30, 2013.

**Table of Contents****Summary of Average Balances, Yields/Rates and Interest Differential**

The following table presents, for the periods indicated, information regarding the Company's consolidated average assets, liabilities and shareholders' equity, the amounts of interest income from average interest-earning assets and resulting yields, and the amount of interest expense paid on interest-bearing liabilities. Average loan balances include nonperforming loans. Interest income includes proceeds from loans on nonaccrual loans only to the extent cash payments have been received and applied to interest income. Yields on securities and certain loans have been adjusted upward to reflect the effect of income thereon exempt from federal income taxation at the current statutory tax rate (dollars in thousands).

|  | For the three months ended |                         |                    |                    |                         |                    |
|--|----------------------------|-------------------------|--------------------|--------------------|-------------------------|--------------------|
|  | September 30, 2014         |                         |                    | September 30, 2013 |                         |                    |
|  | Average Balance            | Interest Income/Expense | Rates Earned /Paid | Average Balance    | Interest Income/Expense | Rates Earned /Paid |
| <b>Assets:</b>   |                            |                         |                    |                    |                         |                    |
| Loans  | \$ 1,752,026               | \$ 24,980               | 5.70%              | \$ 1,635,506       | \$ 25,123               | 6.14%              |
| Investment securities - taxable                        | 478,223                    | 3,823                   | 3.20%              | 249,901            | 1,863                   | 2.98%              |
| Investment securities - nontaxable                     | 15,881                     | 184                     | 4.63%              | 20,809             | 275                     | 5.29%              |
| Cash at Federal Reserve and other banks                | 315,267                    | 213                     | 0.27%              | 498,978            | 378                     | 0.30%              |
| Total interest-earning assets                          | 2,561,397                  | 29,200                  | 4.56%              | 2,405,194          | 27,639                  | 4.60%              |
| Other assets   | 210,575                    |                         |                    | 198,049            |                         |                    |
| Total assets   | \$ 2,771,972               |                         |                    | \$ 2,603,243       |                         |                    |
| <b>Liabilities and shareholders' equity:</b>           |                            |                         |                    |                    |                         |                    |
| Interest-bearing demand deposits                       | \$ 556,406                 | 111                     | 0.08%              | \$ 522,784         | 145                     | 0.11%              |
| Savings deposits                                       | 870,615                    | 273                     | 0.13%              | 800,126            | 249                     | 0.12%              |
| Time deposits  | 256,155                    | 388                     | 0.61%              | 307,957            | 460                     | 0.60%              |
| Other borrowings                                       | 6,829                      |                         | 0.05%              | 7,693              | 1                       | 0.05%              |
| Junior subordinated debt                               | 41,238                     | 310                     | 3.01%              | 41,238             | 314                     | 3.05%              |
| Total interest-bearing liabilities                     | 1,731,243                  | 1,082                   | 0.25%              | 1,679,798          | 1,169                   | 0.28%              |
| Noninterest-bearing deposits                           | 741,792                    |                         |                    | 643,175            |                         |                    |
| Other liabilities                                      | 33,089                     |                         |                    | 36,494             |                         |                    |
| Shareholders' equity                                   | 265,848                    |                         |                    | 243,776            |                         |                    |
| Total liabilities and shareholders' equity             | \$ 2,771,972               |                         |                    | \$ 2,603,243       |                         |                    |
| Net interest spread <sup>(1)</sup>                     |                            |                         | 4.31%              |                    |                         | 4.32%              |
| Net interest income and interest margin <sup>(2)</sup> |                            | \$ 28,118               | 4.39%              |                    | \$ 26,470               | 4.40%              |

For the nine months ended  
September 30, 2014                      September 30, 2013

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|  | Average<br>Balance  | Interest<br>Income/<br>Expense | Rates<br>Earned<br>/Paid | Average<br>Balance  | Interest<br>Income/<br>Expense | Rates<br>Earned<br>/Paid |
|--|---------------------|--------------------------------|--------------------------|---------------------|--------------------------------|--------------------------|
| <b>Assets:</b>   |                     |                                |                          |                     |                                |                          |
| Loans  | \$ 1,712,657        | \$ 73,151                      | 5.69%                    | \$ 1,597,736        | \$ 73,078                      | 6.10%                    |
| Investment securities - taxable                        | 449,279             | 10,393                         | 3.08%                    | 190,616             | 4,279                          | 2.99%                    |
| Investment securities - nontaxable                     | 16,530              | 589                            | 4.75%                    | 15,629              | 677                            | 5.78%                    |
| Cash at Federal Reserve and other banks                | 379,422             | 796                            | 0.28%                    | 616,913             | 1,318                          | 0.28%                    |
| <b>Total interest-earning assets</b>                   | <b>2,557,888</b>    | <b>84,929</b>                  | <b>4.43%</b>             | <b>2,420,894</b>    | <b>79,352</b>                  | <b>4.37%</b>             |
| Other assets   | 191,361             |                                |                          | 178,385             |                                |                          |
| <b>Total assets</b>                                    | <b>\$ 2,749,249</b> |                                |                          | <b>\$ 2,599,279</b> |                                |                          |
| <b>Liabilities and shareholders equity:</b>            |                     |                                |                          |                     |                                |                          |
| Interest-bearing demand deposits                       | \$ 551,287          | 347                            | 0.08%                    | \$ 520,762          | 411                            | 0.11%                    |
| Savings deposits                                       | 854,913             | 793                            | 0.12%                    | 788,278             | 766                            | 0.13%                    |
| Time deposits  | 268,424             | 1,182                          | 0.59%                    | 321,320             | 1,457                          | 0.60%                    |
| Other borrowings                                       | 6,504               | 2                              | 0.05%                    | 7,825               | 3                              | 0.05%                    |
| Junior subordinated debt                               | 41,238              | 920                            | 2.97%                    | 41,238              | 936                            | 3.03%                    |
| <b>Total interest-bearing liabilities</b>              | <b>1,722,366</b>    | <b>3,244</b>                   | <b>0.25%</b>             | <b>1,679,423</b>    | <b>3,573</b>                   | <b>0.28%</b>             |
| Noninterest-bearing deposits                           | 732,154             |                                |                          | 643,326             |                                |                          |
| Other liabilities                                      | 34,183              |                                |                          | 37,358              |                                |                          |
| Shareholders equity                                    | 260,546             |                                |                          | 239,172             |                                |                          |
| <b>Total liabilities and shareholders equity</b>       | <b>\$ 2,749,249</b> |                                |                          | <b>\$ 2,599,279</b> |                                |                          |
| Net interest spread <sup>(1)</sup>                     |                     |                                | 4.18%                    |                     |                                | 4.09%                    |
| Net interest income and interest margin <sup>(2)</sup> |                     | \$ 81,685                      | 4.26%                    |                     | \$ 75,779                      | 4.17%                    |

(1) Net interest spread represents the average yield earned on interest-earning assets minus the average rate paid on interest-bearing liabilities.

(2) Net interest margin is computed by calculating the difference between interest income and interest expense, divided by the average balance of interest-earning assets.

**Table of Contents****Summary of Changes in Interest Income and Expense due to Changes in Average Asset and Liability Balances and Yields Earned and Rates Paid**

The following table sets forth a summary of the changes in interest income and interest expense from changes in average asset and liability balances (volume) and changes in average interest rates for the periods indicated. Changes not solely attributable to volume or rates have been allocated in proportion to the respective volume and rate components (in thousands).

|   | Three months ended September 30, 2014<br>compared with three months ended<br>September 30, 2013 |                   |                 |
|---|---|-------------------|-----------------|
|   | Volume  | Rate              | Total           |
| Increase (decrease) in interest income:           |   |                   |                 |
| Loans   | \$ 1,789  | \$ (1,932)        | \$ (143)        |
| Investment securities                             | 1,636   | 233               | 1,869           |
| Cash at Federal Reserve and other banks           | (138)   | (27)              | (165)           |
| <b>Total interest-earning assets</b>              | <b>3,287</b>  | <b>(1,726)</b>    | <b>1,561</b>    |
| Increase (decrease) in interest expense:          |   |                   |                 |
| Interest-bearing demand deposits                  | 9   | (43)              | (34)            |
| Savings deposits                                  | 21  | 3                 | 24              |
| Time deposits                                     | (78)  | 6                 | (72)            |
| Other borrowings                                  |   | (1)               | (1)             |
| Junior subordinated debt                          |   | (4)               | (4)             |
| <b>Total interest-bearing liabilities</b>         | <b>(48)</b>   | <b>(39)</b>       | <b>(87)</b>     |
| <b>Increase (decrease) in Net Interest Income</b> | <b>\$ 3,335</b>   | <b>\$ (1,687)</b> | <b>\$ 1,648</b> |

|  | Nine months ended September 30, 2014<br>compared with six months ended<br>September 30, 2013 |                |              |
|--|--|----------------|--------------|
|  | Volume   | Rate           | Total        |
| Increase (decrease) in interest income:  |  |                |              |
| Loans                                    | \$ 5,258   | \$ (5,185)     | \$ 73        |
| Investment securities                    | 5,840  | 186            | 6,026        |
| Cash at Federal Reserve and other banks  | (499)  | (23)           | (522)        |
| <b>Total interest-earning assets</b>     | <b>10,599</b>  | <b>(5,022)</b> | <b>5,577</b> |
| Increase (decrease) in interest expense: |  |                |              |
| Interest-bearing demand deposits         | 25   | (89)           | (64)         |
| Savings deposits                         | 65   | (38)           | 27           |
| Time deposits                            | (238)  | (37)           | (275)        |

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|  |           |            |          |
|--|-----------|------------|----------|
| Other borrowings                           |           | (1)        | (1)      |
| Junior subordinated debt                   |           | (16)       | (16)     |
| Total interest-bearing liabilities         | (148)     | (181)      | (329)    |
| Increase (decrease) in Net Interest Income | \$ 10,747 | \$ (4,841) | \$ 5,906 |

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**Table of Contents****Provision for Loan Losses**

The provision for loan losses during any period is the sum of the allowance for loan losses required at the end of the period and any loan charge offs during the period, less the allowance for loan losses required at the beginning of the period, and less any loan recoveries during the period. See the Tables labeled *Allowance for loan losses three and nine months ended September 30, 2014 and 2013* at Note 5 in Item 1 of Part I of this report for the components that make up the provision for loan losses for the three and nine months ended September 30, 2014 and 2013.

The Company benefited from a \$2,977,000 reversal of provision for loan losses during the three months ended September 30, 2014 versus a benefit of \$393,000 during the three months ended September 30, 2013. During the three months ended September 30, 2014, the Company recovered \$769,000 related to an originated residential construction loan that was previously charged off that resulted in a reversal of provision for loan losses of \$769,000, and received \$2,500,000 representing the complete payoff of all principal and interest due on a purchased credit impaired commercial real estate loan that was accounted for as part of a pool of loans that resulted in a reversal of provision for loan losses of \$670,000. Excluding these items, the benefit from reversal of provision for loan losses would have been \$1,538,000 for the three months ended September 30, 2014. In general, the credit quality of the Company's loans continued to improve during the quarter ended September 30, 2014 due to improvements in collateral values and estimated cash flows related to nonperforming originated loans and purchased credit impaired loans, reductions in nonperforming originated loans and purchased credit impaired loans, and decreases in loss histories for performing originated loans compared to year-ago levels. As shown in the Table labeled *Allowance for Loan Losses - three months ended September 30, 2014* at Note 5 in Item 1 of Part I of this report, residential real estate mortgage loans, home equity loans and other consumer loans experienced a provision for loan losses during the three months ended September 30, 2014. All other categories of loans experienced a reversal of provision for loan losses during the three months ended September 30, 2014. The level of provision, or reversal of provision, for loan losses of each loan category during the three months ended September 30, 2014 was due primarily to a decrease in the required allowance for loan losses as of September 30, 2014 when compared to the required allowance for loan losses as of June 30, 2014 plus net recoveries during the three months ended September 30, 2014. All categories of loans except residential real estate mortgage loans, home equity loans, other consumer loans, and residential construction loans experienced a decrease in the required allowance for loan losses during the three months ended September 30, 2014. These decreases in required allowance for loan losses were due primarily to reduced impaired loans, improvements in estimated cash flows and collateral values for the remaining and newly impaired loans, and reductions in historical loss factors that, in part, determine the required loan loss allowance for performing loans in accordance with the Company's allowance for loan losses methodology as described under the heading *Loans and Allowance for Loan Losses* at Note 1 in Item 1 of Part I of this report. These same factors were also present, to some extent, for residential real estate mortgage loans, home equity loans, other consumer loans, and residential construction loans, but were more than offset by the effect of increased loan balances, changes in credit quality within the pass category of these loan categories, resulting in net provisions for loan losses in these categories during the three months ended September 30, 2014. For details of the change in nonperforming loans during the three months ended September 30, 2014 see the Tables, and associated narratives, labeled *Changes in nonperforming assets during the three months ended September 30, 2014* under the heading *Asset Quality and Non-Performing Assets* below.

The Company benefited from a \$2,624,000 reversal of provision for loan losses during the nine months ended September 30, 2014 versus a benefit of \$887,000 during the nine months ended September 30, 2013. During the three months ended September 30, 2014, the Company recovered \$769,000 related to an originated residential construction loan that was previously charged off that resulted in a reversal of provision for loan losses of \$769,000, and received \$2,500,000 representing the complete payoff of all principal and interest due on a purchased credit impaired commercial real estate loan that was accounted for as part of a pool of loans that resulted in a reversal of provision for loan losses of \$670,000. Excluding these items, the benefit from reversal of provision for loan losses would have been

\$1,185,000 for the nine months ended September 30, 2014. As shown in the Table labeled *Allowance for Loan Losses - nine months ended September 30, 2014* at Note 5 in Item 1 of Part I of this report, home equity lines of credit, home equity loans, and other consumer loans experienced a provision for loan losses during the nine months ended September 30, 2014. All other categories of loans experienced a reversal of provision for loan losses during the nine months ended September 30, 2014. The level of provision, or reversal of provision, for loan losses of each loan category during the nine months ended September 30, 2014 was due primarily to a decrease in the required allowance for loan losses as of September 30, 2014 when compared to the required allowance for loan losses as of December 31, 2013 plus net recoveries during the nine months ended September 30, 2014, and the effect of the changes in the allowance methodology during the six months ended June 30, 2014 as described under the heading *Loans and Allowance for Loan Losses* at Note 1 in Item 1 of Part I of this report. All categories of loans except commercial real estate mortgage loans, home equity lines of credit, home equity loans, other consumer loans, and residential construction loans experienced a decrease in the required allowance for loan losses during the nine months ended September 30, 2014. These decreases in required allowance for loan losses were due primarily to reduced impaired loans, improvements in estimated cash flows and collateral values for the remaining and newly impaired loans, and reductions in historical loss factors that, in part, determine the required loan loss allowance for performing loans in accordance with the Company's allowance for loan losses methodology as described under the heading *Loans and Allowance for Loan Losses* at Note 1 in Item 1 of Part I of this report. These same factors were also present, to some extent, for commercial real estate mortgage loans, home equity lines of credit, home equity loans, other consumer loans, and residential construction loans, but were more than offset by the effect of increased loan balances, changes in credit quality within the *pass* category of these loan categories, or in the case of home equity lines of credit, the refinement in the allowance methodology, resulting in net provisions for loan losses in these categories during the nine months ended September 30, 2014. For details of the change in nonperforming loans during the nine months ended September 30, 2014 see the Tables, and associated narratives, labeled *Changes in nonperforming assets during the three months ended September 30, 2014, June 30, 2014 and March 31, 2014* under the heading *Asset Quality and Non-Performing Assets* below.

The provision for loan losses related to originated and PNCI loans is based on management's evaluation of inherent risks in these loan portfolios and a corresponding analysis of the allowance for loan losses. The provision for loan losses related to PCI loan portfolio is based on changes in estimated cash flows expected to be collected on PCI loans. Additional discussion on loan quality, our procedures to measure loan impairment, and the allowance for loan losses is provided under the heading *Asset Quality and Non-Performing Assets* below.



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Management re-evaluates the loss ratios and other assumptions used in its calculation of the allowance for loan losses for its originated and PNCI loan portfolios on a quarterly basis and makes changes as appropriate based upon, among other things, changes in loss rates experienced, collateral support for underlying loans, changes and trends in the economy, and changes in the loan mix. Management also re-evaluates expected cash flows used in its accounting for its PCI loan portfolio, including any required allowance for loan losses, on a quarterly basis and makes changes as appropriate based upon, among other things, changes in loan repayment experience, changes in loss rates experienced, and collateral support for underlying loans.

**Noninterest Income**

The following table summarizes the Company's noninterest income for the periods indicated (in thousands):

|   | Three months ended |                    | Nine months ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2014 | September 30, 2013 | September 30, 2014 | September 30, 2013 |
| Service charges on deposit accounts   | \$ 2,885           | \$ 3,353           | \$ 8,299           | \$ 9,770           |
| ATM and interchange fees  | 2,329              | 2,132              | 6,534              | 6,240              |
| Other service fees  | 545                | 562                | 1,598              | 1,683              |
| Mortgage banking service fees   | 419                | 434                | 1,260              | 1,280              |
| Change in value of mortgage servicing rights  | (88)               | 181                | (620)              | 311                |
| <b>Total service charges and fees</b>   | <b>6,090</b>       | <b>6,662</b>       | <b>17,071</b>      | <b>19,284</b>      |
| Gain on sale of loans   | 509                | 1,083              | 1,487              | 4,967              |
| Commissions on sale of non-deposit investment products                                      | 703                | 692                | 2,317              | 2,294              |
| Increase in cash value of life insurance  | 490                | 531                | 1,287              | 1,337              |
| Change in indemnification asset   | 14                 | (461)              | (491)              | (876)              |
| Gain (loss) on sale of foreclosed assets  | 385                | 313                | 1,853              | 1,479              |
| Sale of customer checks   | 97                 | 97                 | 296                | 280                |
| Lease brokerage income  | 167                | 75                 | 385                | 273                |
| Gain (loss) on disposal of fixed assets   | (10)               | 2                  | 60                 | (12)               |
| Other   | 144                | 133                | 496                | 450                |
| <b>Total other noninterest income</b>   | <b>2,499</b>       | <b>2,465</b>       | <b>7,690</b>       | <b>10,192</b>      |
| <b>Total noninterest income</b>   | <b>\$ 8,589</b>    | <b>\$ 9,127</b>    | <b>\$ 24,761</b>   | <b>\$ 29,476</b>   |
| Mortgage loan servicing fees, net of change in fair value of mortgage loan servicing rights | \$ 331             | \$ 615             | \$ 640             | \$ 1,591           |
| Mortgage banking revenue  | \$ 840             | \$ 1,698           | \$ 2,127           | \$ 6,558           |

Noninterest income decreased \$538,000 (5.9%) to \$8,589,000 during the three months ended September 30, 2014 compared to the three months ended September 30, 2013. The decrease in noninterest income was due primarily to a \$574,000 (53.0%) decrease in gain on sale of loans to \$509,000, a \$468,000 (14.0%) decrease in service charges on deposit accounts, and a \$269,000 decrease in change in value of mortgage servicing rights, that were partially offset by a \$475,000 improvement in change in indemnification asset and a \$197,000 (9.2%) increase in ATM fees and

interchange revenue. The decrease in gain on sale of loans was primarily due to the increase in residential real estate mortgage rates that occurred in May 2013 that resulted in a significant decrease in mortgage refinance activity, and thus a significant decrease in newly originated mortgages for the Company to sell. The decrease in service charges on deposit accounts was primarily due to reduced customer overdrafts and a resulting decrease in non-sufficient funds fees. The decrease in the change in value of mortgage servicing rights was due primarily to a decrease in the balance of mortgages serviced during the quarter ended September 30, 2014 compared to an increase in such balances during the quarter ended September 30, 2013, and a slight decrease in estimated prepayment speeds of such mortgages during the three months ended September 30, 2014 versus a larger decrease in estimated prepayment speeds during the three months ended September 30, 2013. An increase in prepayment speed decreases the value of mortgage servicing rights and a decrease in mortgage prepayment speed increases the value of mortgage servicing rights. Mortgage prepayment speed generally increases when market rates for mortgages decrease, and vice versa. The improvement in change in indemnification asset was primarily due to stable and low expectations of future covered losses when compared to changes in the year-ago quarter. The increase in ATM fees and interchange revenue was primarily due to increased interchange revenue from the negotiation of a more favorable agreement with the Company's interchange service provider and increased sales efforts in this area.

Noninterest income decreased \$4,715,000 (16.0%) to \$24,761,000 during the nine months ended September 30, 2014 when compared to the nine months ended September 30, 2013. The decrease in noninterest income was due primarily to a \$3,480,000 (70.1%) decrease in gain on sale of loans to \$1,487,000, a \$1,471,000 (15.1%) decrease in service charges on deposit accounts, and a \$931,000 decrease in change in value of mortgage servicing rights that were partially offset by a \$374,000 (25.3%) increase in gain on sale of foreclosed assets, a \$385,000 improvement in the change in indemnification asset, and a \$294,000 (4.7%) increase in ATM fees and interchange revenue. The decrease in gain on sale of loans was primarily due to the increase in residential real estate mortgage rates that occurred in May 2013 that resulted in a significant decrease in mortgage refinance activity, and thus a significant decrease in newly originated mortgages for the Company to sell. The decrease in service charges on deposit accounts was primarily due to reduced customer overdrafts and a resulting decrease in non-sufficient funds fees. The decrease in the change in value of mortgage servicing rights was due primarily to a decrease in the balance of mortgages serviced during the nine months ended September 30, 2014 compared to an increase in such balances during the nine months ended September 30, 2013, and a large decrease in estimated prepayment speeds of such mortgages during the nine months ended September 30, 2013 versus a slight increase in estimated mortgage prepayment speeds during the nine months ended September 30, 2014. An increase in prepayment speed decreases the value of mortgage servicing rights and a decrease in mortgage prepayment speed increases the value of mortgage servicing rights. Mortgage prepayment speed generally increases when market rates for mortgages decrease, and vice versa. The

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increase in gain on sale of foreclosed assets was due to a relatively large reduction in the balance of foreclosed assets and the resulting gain on sale during the nine months ended March 31, 2014. The improvement in change in indemnification asset was primarily due to stable and low expectations of future covered losses when compared to changes in the year-ago quarter. The increase in ATM fees and interchange revenue was primarily due to increased interchange revenue from the negotiation of a more favorable agreement with the Company's interchange service provider and increased sales efforts in this area.

**Noninterest Expense**

The following table summarizes the Company's noninterest expense for the periods indicated (dollars in thousands):

|   | Three months ended<br>September 30, |                  | Nine months ended<br>September 30, |                  |
|---|-------------------------------------|------------------|------------------------------------|------------------|
|   | 2014                                | 2013             | 2014                               | 2013             |
| Base salaries, net of deferred loan origination costs | \$ 9,066                            | \$ 8,716         | \$ 26,940                          | \$ 25,572        |
| Incentive compensation                                | 1,265                               | 1,166            | 3,593                              | 3,751            |
| Benefits and other compensation costs                 | 3,038                               | 2,979            | 9,456                              | 9,389            |
| <b>Total salaries and benefits expense</b>            | <b>13,369</b>                       | <b>12,861</b>    | <b>39,989</b>                      | <b>38,712</b>    |
| Occupancy   | 1,971                               | 1,925            | 5,735                              | 5,337            |
| Equipment   | 995                                 | 1,089            | 3,091                              | 3,036            |
| Data processing and software                          | 1,637                               | 1,184            | 4,165                              | 3,542            |
| ATM network charges                                   | 657                                 | 626              | 2,010                              | 1,801            |
| Telecommunications                                    | 648                                 | 629              | 1,941                              | 1,741            |
| Postage   | 179                                 | 269              | 627                                | 633              |
| Courier service                                       | 269                                 | 217              | 727                                | 639              |
| Advertising   | 581                                 | 492              | 1,264                              | 1,232            |
| Assessments   | 493                                 | 572              | 1,495                              | 1,721            |
| Operational losses                                    | 138                                 | 137              | 465                                | 376              |
| Professional fees                                     | 1,468                               | 776              | 3,825                              | 1,982            |
| Foreclosed assets expense                             | 94                                  | 48               | 403                                | 310              |
| Provision for foreclosed asset losses                 | 98                                  | 47               | 138                                | 620              |
| Change in reserve for unfunded commitments            | 175                                 | (335)            | (195)                              | (740)            |
| Intangible amortization                               | 53                                  | 53               | 157                                | 157              |
| Other   | 2,555                               | 3,026            | 7,976                              | 7,627            |
| <b>Total other noninterest expense</b>                | <b>12,011</b>                       | <b>10,755</b>    | <b>33,824</b>                      | <b>30,014</b>    |
| <b>Total noninterest income</b>                       | <b>\$ 25,380</b>                    | <b>\$ 23,616</b> | <b>\$ 73,813</b>                   | <b>\$ 68,726</b> |
| Average full time equivalent staff                    | 717                                 | 732              | 725                                | 734              |
| Noninterest expense to revenue (FTE)                  | 69.1%                               | 66.3%            | 69.3%                              | 65.3%            |

Salary and benefit expenses increased \$508,000 (3.9%) to \$13,369,000 during the three months ended September 30, 2014 compared to the three months ended September 30, 2013. Base salaries increased \$350,000 (4.0%) to \$9,066,000 during the three months ended September 30, 2014 versus the year ago period despite a 2.0% decrease in

the average number of full time equivalent employees from 732 to 717. The average number of full time equivalent employees decreased primarily due to the reductions in staff from the closing of six branches since December 31, 2012 that was partially offset by increases in full time equivalent back office staff and management. The salary expense attributable to the newly added back office staff and management outweighed the reduction in salary expense attributable to the branch closings. Annual salary merit increases of approximately 2.5% also contributed to the increase in base salary expense. Incentive and commission related salary expenses increased \$99,000 (8.5%) to \$1,265,000 during three months ended September 30, 2014. Benefits expense, including retirement, medical and workers compensation insurance, and taxes, increased \$59,000 (2.0%) to \$3,038,000 during the three months ended September 30, 2014.

Salary and benefit expenses increased \$1,277,000 (3.3%) to \$39,989,000 during the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. Base salaries increased \$1,368,000 (5.3%) to \$26,940,000 during the nine months ended September 30, 2014 versus the year ago period despite a 1.2% decrease in the average number of full time equivalent employees from 734 to 725. The average number of full time equivalent employees decreased primarily due to the reductions in staff from the closing of six branches since December 31, 2012 that was partially offset by increases in full time equivalent back office staff and management. The salary expense attributable to the newly added back office staff and management outweighed the reduction in salary expense attributable to the branch closings. Annual salary merit increases of approximately 2.5% also contributed to the increase in base salary expense. Incentive and commission related salary expenses decreased \$158,000 (4.2%) to \$3,593,000 during nine months ended September 30, 2014. Benefits expense, including retirement, medical and workers compensation insurance, and taxes, increased \$67,000 (0.7%) to \$9,456,000 during the nine months ended September 30, 2014.

Other noninterest expense increased \$1,256,000 (11.7%) to \$12,011,000 during the three months ended September 30, 2014 compared to the three months ended September 30, 2013. The increase in other noninterest expense was due primarily a \$692,000 (89.2%) increase in professional fees to \$1,637,000, a \$510,000 increase in provision for losses for unfunded commitments to \$175,000, and a \$453,000 (38.3%) increase in data processing and software expenses to \$1,637,000 that were partially offset by a \$471,000 (15.6%) decrease in other noninterest expenses. The increase in professional fees was mainly due to \$492,000 of legal and consulting expenses related to the proposed North Valley Bancorp merger. The increase in provision for losses for unfunded commitments was due to increased unfunded commitments during the three months ended September 30, 2014 compared to a decrease in unfunded commitments in the year-ago quarter. The increase in data

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processing and software expenses was due primarily to \$307,000 of system conversion planning expenses related to the North Valley Bancorp merger, which was completed on October 3, 2014. The decrease in other noninterest expense was due primarily to \$339,000 of legal settlement expense during the three months ended September 30, 2013 compared to no legal settlement expenses during the three months ended September 30, 2014. During the three months ended September 30, 2014, the Company incurred \$799,000 of noninterest expense related to the North Valley Bancorp merger.

Other noninterest expense increased \$3,810,000 (12.7%) to \$33,824,000 during the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. The increase in other noninterest expense was due primarily to a \$1,843,000 (93.0%) increase in professional fees to \$3,825,000, a \$453,000 (5.4%) increase in occupancy and equipment expenses to \$8,826,000, a \$623,000 (17.6%) increase in data processing and software expenses to \$4,165,000, and a \$545,000 (73.6%) decrease in reversal of provision for losses for unfunded commitments that were partially offset by a \$482,000 (77.7%) decrease in provision for foreclosed assets. The increase in professional fees was mainly due to \$948,000 of legal and consulting expenses related to the North Valley Bancorp merger. The increase in occupancy and equipment expenses was due primarily to leasehold improvement removal expenses related to two branches closed at the end of the quarter ended March 31, 2014 and one branch closed at the end of the quarter ended September 30, 2014. The increase in data processing and software expenses was due primarily to \$482,000 of system conversion planning expenses related to the North Valley Bancorp merger. The increase in provision for losses for unfunded commitments was due to a relatively smaller decrease in unfunded commitments during the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. During the nine months ended September 30, 2014, the Company incurred \$1,430,000 of noninterest expense related to the North Valley Bancorp merger.

**Income Taxes**

The effective combined Federal and State income tax rate on income was 42.2% and 40.0% for the three months ended September 30, 2014 and 2013, respectively. The effective combined Federal and State income tax rate was greater than the Federal statutory tax rate of 35.0% due to State income tax expense of \$1,558,000 and \$1,261,000, respectively, in these periods. Tax-exempt income of \$115,000 and \$172,000, respectively, from investment securities, and \$489,000 and \$531,000, respectively, from increase in cash value of life insurance in these periods helped to reduce the effective combined Federal and State income tax rate from the combined Federal and State statutory income tax rate of approximately 42.0%, and were partially offset by nondeductible merger expenses of \$534,000 and \$0, respectively, and other nondeductible expenses of \$85,000 and \$116,000, respectively.

The effective combined Federal and State income tax rate on income was 41.6% and 40.4% for the nine months ended September 30, 2014 and 2013, respectively. The effective combined Federal and State income tax rate was greater than the Federal statutory tax rate of 35.0% due to State income tax expense of \$3,792,000 and \$3,843,000, respectively, in these periods. Tax-exempt income of \$368,000 and \$423,000, respectively, from investment securities, and \$1,287,000 and \$1,337,000, respectively, from increase in cash value of life insurance in these periods helped to reduce the effective combined Federal and State income tax rate from the combined Federal and State statutory income tax rate of approximately 42.0%, and were partially offset by nondeductible merger expenses of \$875,000 and \$0, respectively, and other nondeductible expenses of \$350,000 and \$311,000, respectively.

**Financial Condition****Investment Securities**

Investment securities available for sale decreased \$19,685,000 to \$84,962,000 as of September 30, 2014, as compared to December 31, 2013. This decrease is attributable to maturities of \$19,226,000, a decrease in fair value of investments securities available for sale of \$133,000, and amortization of net purchase price premiums of \$326,000. The following table presents the available for sale investment securities portfolio by major type as of September 30, 2014 and December 31, 2013:

| (In thousands)   | September 30,<br>2014 |        | December 31, 2013 |        |
|--|-----------------------|--------|-------------------|--------|
|  | Fair Value            | %      | Fair Value        | %      |
| Securities available for sale:                           |                       |        |                   |        |
| Obligations of U.S. government corporations and agencies | \$ 79,860             | 94.0%  | \$ 97,143         | 92.8%  |
| Obligations of states and political subdivisions         | 3,190                 | 3.8%   | 5,589             | 5.3%   |
| Corporate debt securities                                | 1,912                 | 2.2%   | 1,915             | 1.9%   |
| Total securities available for sale                      | \$ 84,962             | 100.0% | \$ 104,647        | 100.0% |

Investment securities held to maturity increased \$203,005,000 to \$443,509,000 as of September 30, 2014, as compared to December 31, 2013. This increase is attributable to purchases of \$221,984,000, maturities of \$18,727,000, and amortization of net purchase price premiums of \$252,000.

The following table presents the held to maturity investment securities portfolio by major type as of September 30, 2014 and December 31, 2013:

| (In thousands)   | September 30, 2014 |        | December 31, 2013 |        |
|--|--------------------|--------|-------------------|--------|
|  | Cost Basis         | %      | Cost Basis        | %      |
| Securities held to maturity:                             |                    |        |                   |        |
| Obligations of U.S. government corporations and agencies | \$ 430,899         | 97.2%  | \$ 227,864        | 94.7%  |
| Obligations of states and political subdivisions         | 12,610             | 2.8%   | 12,640            | 5.3%   |
| Total securities held to maturity                        | \$ 443,509         | 100.0% | \$ 240,504        | 100.0% |

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Additional information about the investment portfolio is provided in Note 3 of the Notes to Unaudited Condensed Consolidated Financial Statements at Item 1 of Part I of this report.

**Restricted Equity Securities**

Restricted equity securities were \$11,582,000 at September 30, 2014 and \$9,163,000 at December 31, 2013. The entire balance of restricted equity securities at September 30, 2014 and December 31, 2013 represent the Bank's investment in the Federal Home Loan Bank of San Francisco ( FHLB ). Additional information about the restricted equity securities is provided in Note 1 of the Notes to Unaudited Condensed Consolidated Financial Statements at Item 1 of Part I of this report.

**Loans**

The Bank concentrates its lending activities in four principal areas: real estate mortgage loans (residential and commercial loans), consumer loans, commercial loans (including agricultural loans), and real estate construction loans. The interest rates charged for the loans made by the Bank vary with the degree of risk, the size and maturity of the loans, the borrower's relationship with the Bank and prevailing money market rates indicative of the Bank's cost of funds.

The majority of the Bank's loans are direct loans made to individuals, farmers and local businesses. The Bank relies substantially on local promotional activity and personal contacts by bank officers, directors and employees to compete with other financial institutions. The Bank makes loans to borrowers whose applications include a sound purpose, a viable repayment source and a plan of repayment established at inception and generally backed by a secondary source of repayment.

The following table shows the Company's loan balances, including net deferred loan costs, as of the dates indicated:

| (In thousands)           | September 30,<br>2014 | December 31,<br>2013 |
|--------------------------|-----------------------|----------------------|
| Real estate mortgage     | \$ 1,214,153          | \$ 1,107,863         |
| Consumer                 | 373,620               | 383,163              |
| Commercial               | 135,085               | 131,878              |
| Real estate construction | 43,013                | 49,103               |
| <b>Total loans</b>       | <b>\$ 1,765,871</b>   | <b>\$ 1,672,007</b>  |

At September 30, 2014 loans, including net deferred loan costs, totaled \$1,765,871,000 which was a \$93,864,000 (5.6%) increase over the balances at December 31, 2013. Included in the \$93,864,000 increase in loans during the nine months ended September 30, 2014 was the purchase of residential real estate mortgage loans totaling \$19,690,000 and \$12,327,000 during the three months ended June 30, 2014 and September 30, 2014, respectively. Demand for all categories of loans was moderate during the nine months ended September 30, 2014.

The following table shows the Company's loan balances, including net deferred loan costs, as a percentage of total loans for the periods indicated:

|                          | September 30,<br>2014 | December 31,<br>2013 |
|--------------------------|-----------------------|----------------------|
| Real estate mortgage     | 68.8%                 | 66.3%                |
| Consumer                 | 21.2%                 | 22.9%                |
| Commercial               | 7.6%                  | 7.9%                 |
| Real estate construction | 2.4%                  | 2.9%                 |
| <b>Total loans</b>       | <b>100.0%</b>         | <b>100.0%</b>        |

## Assets Quality and Nonperforming Assets

### Nonperforming Assets

Loans originated by the Company, i.e., not purchased or acquired in a business combination, are referred to as originated loans. Originated loans are reported at the principal amount outstanding, net of deferred loan fees and costs. Loan origination and commitment fees and certain direct loan origination costs are deferred, and the net amount is amortized as an adjustment of the related loan's yield over the actual life of the loan. Originated loans on which the accrual of interest has been discontinued are designated as nonaccrual loans.

Originated loans are placed in nonaccrual status when reasonable doubt exists as to the full, timely collection of interest or principal, or a loan becomes contractually past due by 90 days or more with respect to interest or principal and is not well secured and in the process of collection. When an originated loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of Management, the loan is estimated to be fully collectible as to both principal and interest.

An allowance for loan losses for originated loans is established through a provision for loan losses charged to expense. Originated loans and deposit related overdrafts are charged against the allowance for loan losses when Management believes that the collectability of the principal is unlikely or, with respect to consumer installment loans, according to an established delinquency schedule. The allowance is an amount that Management believes will be adequate to absorb probable losses inherent in existing loans and leases, based on evaluations of the collectability, impairment and prior loss experience of loans and leases. The evaluations take into consideration such factors as changes in the nature and size of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrower's ability to pay. The Company defines an originated loan as impaired when it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired originated loans are measured based on



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the present value of expected future cash flows discounted at the loan's original effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance.

In situations related to originated loans where, for economic or legal reasons related to a borrower's financial difficulties, the Company grants a concession for other than an insignificant period of time to the borrower that the Company would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). The Company strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where the Company grants the borrower new terms that result in the loan being classified as a TDR, the Company measures any impairment on the restructuring as noted above for impaired loans. TDR loans are classified as impaired until they are fully paid off or charged off. Loans that are in nonaccrual status at the time they become TDR loans, remain in nonaccrual status until the borrower demonstrates a sustained period of performance which the Company generally believes to be six consecutive months of payments, or equivalent. Otherwise, TDR loans are subject to the same nonaccrual and charge-off policies as noted above with respect to their restructured principal balance.

Credit risk is inherent in the business of lending. As a result, the Company maintains an allowance for loan losses to absorb losses inherent in the Company's originated loan portfolio. This is maintained through periodic charges to earnings. These charges are included in the Consolidated Statements of Income as provision for loan losses. All specifically identifiable and quantifiable losses are immediately charged off against the allowance. However, for a variety of reasons, not all losses are immediately known to the Company and, of those that are known, the full extent of the loss may not be quantifiable at that point in time. The balance of the Company's allowance for originated loan losses is meant to be an estimate of these unknown but probable losses inherent in the portfolio.

The Company formally assesses the adequacy of the allowance for originated loan losses on a quarterly basis. Determination of the adequacy is based on ongoing assessments of the probable risk in the outstanding originated loan portfolio, and to a lesser extent the Company's originated loan commitments. These assessments include the periodic re-grading of credits 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, growth of the portfolio as a whole or by segment, and other factors as warranted. Loans are initially graded when originated. They are re-graded as they are renewed, when there is a new loan to the same borrower, when identified facts demonstrate heightened risk of nonpayment, or if they become delinquent. Re-grading of larger problem loans occurs at least quarterly. Confirmation of the quality of the grading process is obtained by independent credit reviews conducted by consultants specifically hired for this purpose and by various bank regulatory agencies.

The Company's method for assessing the appropriateness of the allowance for originated loan losses includes specific allowances for impaired originated loans and leases, formula allowance factors for pools of credits, and allowances for changing environmental factors (e.g., interest rates, growth, economic conditions, etc.). Allowance factors for loan pools were based on historical loss experience by product type and prior risk rating.

During the three months ended March 31, 2013, the Company changed the method it uses to estimate net sale proceeds from real estate collateral sales when calculating the allowance for loan losses associated with impaired real estate collateral dependent loans. Previously, the Company used the greater of fifteen percent or actual estimated selling costs. Currently, the Company uses the actual estimated selling costs, and an adjustment to appraised value based on the age of the appraisal. These changes are intended to more accurately reflect the estimated net sale

proceeds from the sale of impaired collateral dependent real estate loans. This change in methodology resulted in the allowance for loan losses as of March 31, 2013 being \$494,000 more than it would have been without this change in methodology.

During the three months ended June 30, 2013, the Company modified its loss migration analysis methodology used to determine the formula allowance factors. When the Company originally established its loss migration analysis methodology during the quarter ended March 31, 2012, it reviewed the loss experience of each rolling twelve month period over the previous three years in order to calculate an annualized loss rate by loan category and risk rating. The use of three years of loss experience data was originally used because that was the extent of the detailed loss data, by loan category and risk rating that was available at the time. This three year historical look-back period was used through the quarter ended March 31, 2013. Starting with the quarter ended June 30, 2013, the Company reviews all available detailed loss experience data, going back to, and including, the twelve month period ended June 30, 2009, and does not limit the look-back period to the most recent three years of historical loss data. Using this data, the Company calculates loss factors for each quarter from the quarter ended June 30, 2009 to the most recent quarter. The Company then calculates a weighted average formula allowance factor for each loan category and risk rating with the most recent quarterly loss factor being weighted 125%, the quarter ended June 30, 2009 loss factor being weighted 75%, and the loss factors for all the quarters between the most recent quarter and the quarter ended June 30, 2009, being weighted on a linear scale from 75% to 125%. This change is intended to more accurately reflect the risk inherent in the loan portfolio by considering historical loss data for all years as the data for new periods becomes available. This change in methodology resulted in the allowance for loan losses as of June 30, 2013 being \$1,314,000 more than it would have been without this change in methodology.

During the three months ended September 30, 2013, the Company modified its methodology used to determine the allowance for changing environmental factors. Previously, the Company compared the current value of each environmental factor to a fixed baseline value. The deviation of the current value from the baseline value was then multiplied by a conversion factor to determine the required allowance related to each environmental factor. As of September 30, 2013, the Company replaced the fixed baseline values with average baseline values derived from historical averages, and adjusted the conversion factors. This change is intended to more accurately reflect the risk inherent in the portfolio by recognizing that baseline, or normal, levels for environmental factors may change over time. This change in methodology resulted in the allowance for loan losses as of September 30, 2013 being \$1,665,000 more than it would have been without this change in methodology.

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During the three months ended March 31, 2014, the Company modified its methodology used to determine the allowance for changing environmental factors by adding a new environmental factor based on the California Home Affordability Index ( CHAI ). The CHAI measures the percentage of households in California that can afford to purchase the median priced home in California based on current home prices and mortgage interest rates. The use of the CHAI environmental factor consists of comparing the current CHAI to its historical baseline, and allows management to consider the adverse impact that a lower than historical CHAI may have on general economic activity and the performance of our borrowers. Based on an analysis of historical data, management believes this environmental factor gives a better estimate of current economic activity compared to other environmental factors that may lag current economic activity to some extent. This change in methodology resulted in no change to the allowance for loan losses as of March 31, 2014 compared to what it would have been without this change in methodology.

During the three months ended June 30, 2014, the Company refined the method it uses to evaluate historical losses for the purpose of estimating the pool allowance for unimpaired loans. In the third quarter of 2010, the Company moved from a six point grading system (Grades A-F) to a nine point risk rating system (Risk Ratings 1-9), primarily to allow for more distinction within the Pass risk rating. Initially, there was not sufficient loss experience within the nine point scale to complete a migration analysis for all nine risk ratings, all loans risk rated Pass or 2-5 were grouped together, a loss rate was calculated for that group, and that loss rate was established as the loss rate for risk rating 4. The reserve ratios for risk ratings 2, 3 & 5 were then interpolated from that figure. As of June 30, 2014, the Company was able to compile twelve quarters of historical loss information for all risk ratings, and use that information to calculate the loss rates for each of the nine risk ratings without interpolation. This refinement led to an increase of \$1,438,000 in the reserve requirement for unimpaired loans, driven primarily by home equity lines of credit with a risk rating of 5 or Pass-Watch.

Loans purchased or acquired in a business combination are referred to as acquired loans. Acquired loans are valued as of acquisition date in accordance with Financial Accounting Standards Board Accounting Standards Codification ( FASB ASC ) Topic 805, *Business Combinations*. Loans acquired with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are referred to as purchased credit impaired (PCI) loans. PCI loans are accounted for under FASB ASC Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. Under FASB ASC Topic 805 and FASB ASC Topic 310-30, PCI loans are recorded at fair value 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 as of the acquisition date. Fair value is defined as the present value of the future estimated principal and interest payments of the loan, with the discount rate used in the present value calculation representing the estimated effective yield of the loan. Default rates, loss severity, and prepayment speed assumptions are periodically reassessed and our estimate of future payments is adjusted accordingly. The difference between contractual future payments and estimated future payments is referred to as the nonaccretable difference. The difference between estimated future payments and the present value of the estimated future payments is referred to as the accretable yield. The accretable yield represents the amount that is expected to be recorded as interest income over the remaining life of the loan. If after acquisition, the Company determines that the estimated future cash flows of a PCI loan are expected to be more than the originally estimated, an increase in the discount rate (effective yield) would be made such that the newly increased accretable yield would be recognized, on a level yield basis, over the remaining estimated life of the loan. If, after acquisition, the Company determines that the estimated future cash flows of a PCI loan are expected to be less than the previously estimated, the discount rate would first be reduced until the present value of the reduced cash flow estimate equals the previous present value however, the discount rate may not be lowered below its original level at acquisition. If the discount rate has been lowered to its original level and the present value has not been sufficiently lowered, an allowance for loan loss would be established through a provision for loan losses charged to expense to decrease the present value to the required level. If the estimated cash flows improve after an allowance has been established for a loan, the allowance may be partially or fully reversed depending on the improvement in the estimated cash flows. Only after the allowance

has been fully reversed may the discount rate be increased. PCI loans are put on nonaccrual status when cash flows cannot be reasonably estimated. PCI loans on nonaccrual status are accounted for using the cost recovery method or cash basis method of income recognition. PCI loans are charged off when evidence suggests cash flows are not recoverable. Foreclosed assets from PCI loans are recorded in foreclosed assets at fair value with the fair value at time of foreclosure representing cash flow from the loan. ASC 310-30 allows PCI loans with similar risk characteristics and acquisition time frame to be pooled and have their cash flows aggregated as if they were one loan. The Company elected to use the pooled method of ASC 310-30 for PCI other loans in the acquisition of certain assets and liabilities of Granite and Citizens.

Acquired loans that are not PCI loans are referred to as purchased not credit impaired (PNCI) loans. PNCI loans are accounted for under FASB ASC Topic 310-20, *Receivables - Nonrefundable Fees and Other Costs*, in which interest income is accrued on a level-yield basis for performing loans. For income recognition purposes, this method assumes that all contractual cash flows will be collected, and no allowance for loan losses is established at the time of acquisition. Post-acquisition date, an allowance for loan losses may need to be established for acquired loans through a provision charged to earnings for credit losses incurred subsequent to acquisition. Under ASC 310-20, the loss would be measured based on the probable shortfall in relation to the contractual note requirements, consistent with our allowance for loan loss policy for similar loans.

When referring to PNCI and PCI loans we use the terms nonaccretable difference, accretable yield, or purchase discount. Nonaccretable difference is the difference between undiscounted contractual cash flows due and undiscounted cash flows we expect to collect, or put another way, it is the undiscounted contractual cash flows we do not expect to collect. Accretable yield is the difference between undiscounted cash flows we expect to collect and the value at which we have recorded the loan on our financial statements. On the date of acquisition, all purchased loans are recorded on our consolidated financial statements at estimated fair value. Purchase discount is the difference between the estimated fair value of loans on the date of acquisition and the principal amount owed by the borrower, net of charge offs, on the date of acquisition. We may also refer to discounts to principal balance of loans owed, net of charge-offs. Discounts to principal balance of loans owed, net of charge-offs is the difference between principal balance of loans owed, net of charge-offs, and loans as recorded on our financial statements. Discounts to principal balance of loans owed, net of charge-offs arise from purchase discounts, and equal the purchase discount on the acquisition date.

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Loans are also categorized as covered or noncovered. Covered loans refer to loans covered by a FDIC loss sharing agreement. Noncovered loans refer to loans not covered by a FDIC loss sharing agreement.

Originated loans and PNCI loans are reviewed on an individual basis for reclassification to nonaccrual status when any one of the following occurs: the loan becomes 90 days past due as to interest or principal, the full and timely collection of additional interest or principal becomes uncertain, the loan is classified as doubtful by internal credit review or bank regulatory agencies, a portion of the principal balance has been charged off, or the Company takes possession of the collateral. Loans that are placed on nonaccrual even though the borrowers continue to repay the loans as scheduled are classified as performing nonaccrual and are included in total nonperforming loans. The reclassification of loans as nonaccrual does not necessarily reflect Management's judgment as to whether they are collectible.

Interest income on originated nonaccrual loans that would have been recognized during the three months ended September 30, 2014 and 2013, if all such loans had been current in accordance with their original terms, totaled \$634,000 and \$1,238,000, respectively. Interest income actually recognized on these originated loans during the three months ended September 30, 2014 and 2013 was \$26,000 and \$120,000, respectively. Interest income on PNCI nonaccrual loans that would have been recognized during the three months ended September 30, 2014 and 2013, if all such loans had been current in accordance with their original terms, totaled \$65,000 and \$72,000. Interest income actually recognized on these PNCI loans during the three months ended September 30, 2014 and 2013 was \$4,000 and \$8,000.

Interest income on originated nonaccrual loans that would have been recognized during the nine months ended September 30, 2014 and 2013, if all such loans had been current in accordance with their original terms, totaled \$2,092,000 and \$3,673,000, respectively. Interest income actually recognized on these originated loans during the nine months ended September 30, 2014 and 2013 was \$26,000 and \$226,000, respectively. Interest income on PNCI nonaccrual loans that would have been recognized during the nine months ended September 30, 2014 and 2013, if all such loans had been current in accordance with their original terms, totaled \$183,000 and \$202,000. Interest income actually recognized on these PNCI loans during the nine months ended September 30, 2014 and 2013 was \$3,000 and \$15,000.

The Company's policy is to place originated loans and PNCI loans 90 days or more past due on nonaccrual status. In some instances when an originated loan is 90 days past due Management does not place it on nonaccrual status because the loan is well secured and in the process of collection. A loan is considered to be in the process of collection if, based on a probable specific event, it is expected that the loan will be repaid or brought current. Generally, this collection period would not exceed 30 days. Loans where the collateral has been repossessed are classified as foreclosed assets. Management considers both the adequacy of the collateral and the other resources of the borrower in determining the steps to be taken to collect nonaccrual loans. Alternatives that are considered are foreclosure, collecting on guarantees, restructuring the loan or collection lawsuits.

The following table sets forth the amount of the Bank's nonperforming assets as of the dates indicated. For purposes of the following table, PCI other loans that are 90 days past due and still accruing are not considered nonperforming loans. Performing nonaccrual loans are loans that may be current for both principal and interest payments, or are less than 90 days past due, but for which payment in full of both principal and interest is not expected, and are not well secured and in the process of collection:

September 30,                      December 31,

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| (In thousands)   | 2014             | 2013             |
|--|------------------|------------------|
| Performing nonaccrual loans  | \$ 37,645        | \$ 48,112        |
| Nonperforming nonaccrual loans   | 2,637            | 5,104            |
| <b>Total nonaccrual loans</b>  | <b>40,282</b>    | <b>53,216</b>    |
| Originated and PNCI loans 90 days past due and still accruing  | 360              |                  |
| <b>Total nonperforming loans</b>   | <b>40,642</b>    | <b>53,216</b>    |
| Noncovered foreclosed assets   | 4,576            | 5,588            |
| Covered foreclosed assets  | 520              | 674              |
| <b>Total nonperforming assets</b>  | <b>\$ 45,738</b> | <b>\$ 59,478</b> |
| U.S. government, including its agencies and its government-sponsored agencies, guaranteed portion of nonperforming loans | \$ 124           | \$ 101           |
| Indemnified portion of covered foreclosed assets   | \$ 416           | \$ 539           |
| Nonperforming assets to total assets   | 1.64%            | 2.17%            |
| Nonperforming loans to total loans   | 2.30%            | 3.18%            |
| Allowance for loan losses to nonperforming loans   | 93%              | 72%              |
| Allowance for loan losses, unamortized loan fees, and discounts to loan principal balances owed                          | 3.65%            | 4.09%            |

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The following table set forth the amount of the Bank's nonperforming assets as of the dates indicated. For purposes of the following table, PCI other loans that are 90 days past due and still accruing are not considered nonperforming loans. Performing nonaccrual loans are loans that may be current for both principal and interest payments, or are less than 90 days past due, but for which payment in full of both principal and interest is not expected, and are not well secured and in the process of collection:

| (dollars in thousands)   | September 30, 2014 |                 |           |                |               | Total            |
|--|--------------------|-----------------|-----------|----------------|---------------|------------------|
|  | Originated         | PNCI            | PCI       | cash basis     | PCI - other   |                  |
| Performing nonaccrual loans  | \$ 30,888          | \$ 1,077        | \$        | 5,680          |               | \$ 37,645        |
| Nonperforming nonaccrual loans   | 2,601              | 36              |           |                |               | 2,637            |
| <b>Total nonaccrual loans</b>  | <b>33,489</b>      | <b>1,113</b>    |           | <b>5,680</b>   |               | <b>40,282</b>    |
| Originated and PNCI loans 90 days past due and still accruing  | 360                |                 |           |                |               | 360              |
| <b>Total nonperforming loans</b>   | <b>33,849</b>      | <b>1,113</b>    |           | <b>5,680</b>   |               | <b>40,642</b>    |
| Noncovered foreclosed assets   | 4,118              |                 |           |                | 458           | 4,576            |
| Covered foreclosed assets  |                    |                 |           |                | 520           | 520              |
| <b>Total nonperforming assets</b>  | <b>\$ 37,967</b>   | <b>\$ 1,113</b> | <b>\$</b> | <b>5,680</b>   | <b>\$ 978</b> | <b>\$ 45,738</b> |
| U.S. government, including its agencies and its government-sponsored agencies, guaranteed portion of nonperforming loans | \$ 124             |                 |           |                |               | \$ 124           |
| Indemnified portion of covered foreclosed assets   |                    |                 |           |                | \$ 416        | \$ 416           |
| <b>Nonperforming assets to total assets</b>  |                    |                 |           |                |               | <b>1.64%</b>     |
| <b>Nonperforming loans to total loans</b>  | <b>2.16%</b>       | <b>0.75%</b>    |           | <b>100.00%</b> | <b>0.00%</b>  | <b>2.30%</b>     |
| <b>Allowance for loan losses to nonperforming loans</b>  | <b>92%</b>         | <b>293%</b>     |           | <b>7%</b>      | <b>n/m</b>    | <b>93%</b>       |
| Allowance for loan losses, unamortized loan fees, and discounts to loan principal balances owed                          | 2.28%              | 5.79%           |           | 64.74%         | 21.68%        | 3.65%            |
| n/m not meaningful   |                    |                 |           |                |               |                  |

The following table set forth the amount of the Bank's nonperforming assets as of the dates indicated. For purposes of the following table, PCI other loans that are 90 days past due and still accruing are not considered nonperforming loans. Performing nonaccrual loans are loans that may be current for both principal and interest payments, or are less than 90 days past due, but for which payment in full of both principal and interest is not expected, and are not well secured and in the process of collection:

| (dollars in thousands)      | December 31, 2013 |          |     |            |             | Total     |
|-----------------------------|-------------------|----------|-----|------------|-------------|-----------|
|                             | Originated        | PNCI     | PCI | cash basis | PCI - other |           |
| Performing nonaccrual loans | \$ 40,294         | \$ 1,649 | \$  | 6,169      |             | \$ 48,112 |

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|  |           |          |          |        |           |
|--|-----------|----------|----------|--------|-----------|
| Nonperforming nonaccrual loans   | 4,837     | 217      | 50       |        | 5,104     |
| Total nonaccrual loans   | 45,131    | 1,866    | 6,219    |        | 53,216    |
| Originated and PNCI loans 90 days past due and still accruing  |           |          |          |        |           |
| Total nonperforming loans  | 45,131    | 1,866    | 6,219    |        | 53,216    |
| Noncovered foreclosed assets   | 5,479     |          |          | \$ 109 | 5,588     |
| Covered foreclosed assets  |           |          |          | 674    | 674       |
| Total nonperforming assets   | \$ 50,610 | \$ 1,866 | \$ 6,219 | \$ 783 | \$ 59,478 |
| U.S. government, including its agencies and its government-sponsored agencies, guaranteed portion of nonperforming loans | \$ 101    |          |          |        | \$ 101    |
| Indemnified portion of covered foreclosed assets   |           |          |          | \$ 539 | \$ 539    |
| Nonperforming assets to total assets   |           |          |          |        | 2.30%     |
| Nonperforming loans to total loans   | 3.04%     | 1.38%    | 100.0%   |        | 3.18%     |
| Allowance for loan losses to nonperforming loans   | 69%       | 153%     | 6%       | n/m    | 72%       |
| Allowance for loan losses, unamortized loan fees, and discounts to loan principal balances owed                          | 2.36%     | 7.62%    | 64.5%    | 22.93% | 4.09%     |
| n/m not meaningful   |           |          |          |        |           |



**Table of Contents****Changes in nonperforming assets during the three months ended September 30, 2014**

| (In thousands):                         | Balance<br>at<br>September 30,<br>2014 | New<br>NPA      | Advances/<br>Capitalized<br>Costs | Pay-downs<br>/Sales<br>/Upgrades | Charge-offs/<br>Write-downs | Transfers to<br>Foreclosed<br>Assets | Category<br>Changes | Balance at<br>June 30,<br>2014 |
|---|--|-----------------|-----------------------------------|----------------------------------|-----------------------------|--------------------------------------|---------------------|--------------------------------|
| <b>Real estate mortgage:</b>            |  |                 |                                   |                                  |                             |                                      |                     |                                |
| Residential                             | \$ 4,367                               | \$ 188          | 1                                 | \$ (441)                         | \$ (31)                     | \$ (106)                             |                     | \$ 4,756                       |
| Commercial                              | 22,250                                 | 861             |                                   | (3,299)                          | (50)                        | (47)                                 |                     | 24,785                         |
| <b>Consumer</b>                         |  |                 |                                   |                                  |                             |                                      |                     |                                |
| Home equity lines                       | 10,242                                 | 345             | 34                                | (552)                            | (137)                       | (205)                                | (77)                | 10,834                         |
| Home equity loans                       | 838                                    |                 | 1                                 | (53)                             |                             |                                      | 77                  | 813                            |
| Auto indirect                           | 23                                     |                 |                                   | (13)                             |                             |                                      |                     | 36                             |
| Other consumer                          | 50                                     | 18              |                                   | (4)                              | (13)                        |                                      |                     | 49                             |
| Commercial                              | 321                                    | 61              |                                   | (173)                            | (10)                        |                                      |                     | 443                            |
| <b>Construction:</b>                    |  |                 |                                   |                                  |                             |                                      |                     |                                |
| Residential                             | 2,437                                  |                 |                                   | (31)                             |                             |                                      |                     | 2,468                          |
| Commercial                              | 114                                    | 102             |                                   | (4)                              |                             |                                      |                     | 16                             |
| <b>Total nonperforming<br/>loans</b>    | <b>40,642</b>                          | <b>1,575</b>    | <b>36</b>                         | <b>(4,570)</b>                   | <b>(241)</b>                | <b>(358)</b>                         |                     | <b>44,200</b>                  |
| <b>Noncovered foreclosed<br/>assets</b> | <b>4,576</b>                           |                 |                                   | <b>(949)</b>                     | <b>(97)</b>                 | <b>\$ 358</b>                        |                     | <b>5,264</b>                   |
| <b>Covered foreclosed<br/>assets</b>    | <b>520</b>                             |                 |                                   |                                  | <b>(1)</b>                  |                                      |                     | <b>521</b>                     |
| <b>Total nonperforming<br/>assets</b>   | <b>\$ 45,738</b>                       | <b>\$ 1,575</b> | <b>\$ 36</b>                      | <b>\$ (5,519)</b>                | <b>\$ (339)</b>             |                                      |                     | <b>\$ 49,985</b>               |

Nonperforming assets decreased during the third quarter of 2014 by \$4,247,000 (8.50%) to \$45,738,000 at September 30, 2014 compared to \$49,985,000 at June 30, 2014. The decrease in nonperforming assets during the third quarter of 2014 was primarily the result of new nonperforming loans of \$1,575,000, advances on existing nonperforming loans and capitalized costs on foreclosed assets of \$36,000, less pay-downs, sales or upgrades of nonperforming loans to performing status totaling \$4,570,000, less dispositions of foreclosed assets totaling \$949,000, less loan charge-offs of \$241,000, and less write-downs of foreclosed assets of \$98,000.

The \$1,575,000 in new nonperforming loans during the third quarter of 2014 was comprised of increases of \$188,000 on two residential real estate loans, \$861,000 on five commercial real estate loans, \$345,000 on seven home equity lines and loans, \$18,000 on 13 consumer loans, \$61,000 on four C&I loans, and \$102,000 on a single commercial construction loan. The \$861,000 in new nonperforming commercial real estate loans was primarily made up of one loan in the amount of \$360,000 secured by a multi-family investment property in northern California. Related charge-offs are discussed below.

**Loan charge-offs during the three months ended September 30, 2014**

In the third quarter of 2014, the Company recorded \$241,000 in loan charge-offs and \$105,000 in deposit overdraft charge-offs less \$1,211,000 in loan recoveries and \$64,000 in deposit overdraft recoveries resulting in \$929,000 of net loan recoveries. Primary causes of the loan charges taken in the third quarter of 2014 were gross charge-offs of \$31,000 on a single residential real estate loan, \$50,000 on three commercial real estate loans, \$137,000 on four home equity lines and loans, \$13,000 on 12 other consumer loans, and \$10,000 on three C&I loans. During the third quarter of 2014, there were no individual charges greater than \$250,000.

Differences between the amounts explained in this section and the total charge-offs listed for a particular category are generally made up of individual charges of less than \$250,000 each. Generally losses are triggered by non-performance by the borrower and calculated based on any difference between the current loan amount and the current value of the underlying collateral less any estimated costs associated with the disposition of the collateral.

#### Changes in nonperforming assets during the three months ended June 30, 2014

|                                     | Balance at<br>June 30,<br>2014 | New<br>NPA      | Advances/<br>Capitalized<br>Costs | Pay-downs<br>/Sales<br>/Upgrades | Charge-offs/<br>Write-downs | Transfers to<br>Foreclosed<br>Assets | Category<br>Changes | Balance at<br>March 31,<br>2014 |
|-------------------------------------|--------------------------------|-----------------|-----------------------------------|----------------------------------|-----------------------------|--------------------------------------|---------------------|---------------------------------|
| (In thousands):                     |                                |                 |                                   |                                  |                             |                                      |                     |                                 |
| <b>Real estate mortgage:</b>        |                                |                 |                                   |                                  |                             |                                      |                     |                                 |
| Residential                         | \$ 4,756                       | \$ 186          | \$ 24                             | \$ (182)                         |                             |                                      |                     | \$ 4,728                        |
| Commercial                          | 24,785                         | 71              | 1,045                             | (4,643)                          | \$ (44)                     | \$ (3,287)                           |                     | 31,643                          |
| <b>Consumer</b>                     |                                |                 |                                   |                                  |                             |                                      |                     |                                 |
| Home equity lines                   | 10,834                         | 785             | 19                                | (485)                            | (677)                       | (116)                                | \$ (126)            | 11,434                          |
| Home equity loans                   | 813                            | 46              |                                   | (64)                             | (11)                        |                                      | 126                 | 716                             |
| Auto indirect                       | 36                             |                 |                                   | (8)                              |                             |                                      |                     | 44                              |
| Other consumer                      | 49                             | 29              |                                   | (13)                             | (39)                        |                                      |                     | 72                              |
| Commercial                          | 443                            | 170             |                                   | (377)                            | (152)                       |                                      |                     | 802                             |
| <b>Construction:</b>                |                                |                 |                                   |                                  |                             |                                      |                     |                                 |
| Residential                         | 2,468                          |                 |                                   | (42)                             |                             |                                      |                     | 2,510                           |
| Commercial                          | 16                             |                 |                                   | (3)                              |                             |                                      |                     | 19                              |
| <b>Total nonperforming loans</b>    | <b>44,200</b>                  | <b>1,287</b>    | <b>1,088</b>                      | <b>(5,817)</b>                   | <b>(923)</b>                | <b>(3,403)</b>                       |                     | <b>51,968</b>                   |
| <b>Noncovered foreclosed assets</b> | <b>5,264</b>                   |                 |                                   | <b>(687)</b>                     | <b>(3)</b>                  | <b>3,403</b>                         |                     | <b>2,551</b>                    |
| <b>Covered foreclosed assets</b>    | <b>521</b>                     |                 |                                   | <b>(142)</b>                     | <b>(1)</b>                  |                                      |                     | <b>664</b>                      |
| <b>Total nonperforming assets</b>   | <b>\$ 49,985</b>               | <b>\$ 1,287</b> | <b>\$ 1,088</b>                   | <b>\$ (6,646)</b>                | <b>\$ (927)</b>             |                                      |                     | <b>\$ 55,183</b>                |

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Nonperforming assets decreased during the second quarter of 2014 by \$5,198,000 (9.42%) to \$49,985,000 at June 30, 2014 compared to \$55,183,000 at March 31, 2014. The decrease in nonperforming assets during the second quarter of 2014 was primarily the result of new nonperforming loans of \$1,287,000, advances on existing nonperforming loans and capitalized costs on foreclosed assets of \$1,088,000, less pay-downs, sales or upgrades of nonperforming loans to performing status totaling \$5,817,000, less dispositions of foreclosed assets totaling \$829,000, less loan charge-offs of \$923,000, and less write-downs of foreclosed assets of \$4,000.

The \$1,287,000 in new nonperforming loans during the second quarter of 2014 was comprised of increases of \$186,000 on three residential real estate loans, \$71,000 on two commercial real estate loans, \$831,000 on 10 home equity lines and loans, \$29,000 on eight consumer loans, and \$170,000 on eight C&I loans.

**Loan charge-offs during the three months ended June 30, 2014**

In the second quarter of 2014, the Company recorded \$923,000 in loan charge-offs and \$105,000 in deposit overdraft charge-offs less \$878,000 in loan recoveries and \$88,000 in deposit overdraft recoveries resulting in \$62,000 of net loan charge-offs. Primary causes of the loan charges taken in the second quarter of 2014 were gross charge-offs of \$44,000 on four commercial real estate loans, \$688,000 on 11 home equity lines and loans, \$39,000 on nine other consumer loans, and \$170,000 on seven C&I loans. During the second quarter of 2014, there were no individual charges greater than \$250,000.

Differences between the amounts explained in this section and the total charge-offs listed for a particular category are generally made up of individual charges of less than \$250,000 each. Generally losses are triggered by non-performance by the borrower and calculated based on any difference between the current loan amount and the current value of the underlying collateral less any estimated costs associated with the disposition of the collateral.

**Changes in nonperforming assets during the three months ended March 31, 2014**

| (In thousands):                      | Balance at        | New          | Advances/<br>Capitalized<br>Costs | Pay-downs           | Transfers to<br>Foreclosed<br>Assets | Charge-offs<br>Write-downs | Category<br>Changes | Balance at           |
|--------------------------------------|-------------------|--------------|-----------------------------------|---------------------|--------------------------------------|----------------------------|---------------------|----------------------|
|                                      | March 31,<br>2014 |              |                                   | /Sales<br>/Upgrades |                                      |                            |                     | December 31,<br>2013 |
| <b>Real estate mortgage:</b>         |                   |              |                                   |                     |                                      |                            |                     |                      |
| Residential                          | \$ 4,728          | \$ 72        |                                   | \$ (167)            | \$ (136)                             |                            |                     | \$ 4,959             |
| Commercial                           | 31,643            | 860          | \$ 4                              | (1,721)             | (13)                                 | \$ (325)                   | \$ 967              | 31,871               |
| <b>Consumer</b>                      |                   |              |                                   |                     |                                      |                            |                     |                      |
| Home equity lines                    | 11,434            | 1,232        | 434                               | (1,351)             | (178)                                | (221)                      | (83)                | 11,601               |
| Home equity loans                    | 716               | 100          | 1                                 | (20)                |                                      | (167)                      | 83                  | 719                  |
| Auto indirect                        | 44                |              |                                   | (10)                |                                      |                            |                     | 54                   |
| Other consumer                       | 72                | 48           |                                   | (7)                 | (31)                                 |                            |                     | 62                   |
| Commercial                           | 802               | 401          | 417                               | (109)               | (239)                                |                            | (967)               | 1,299                |
| <b>Construction:</b>                 |                   |              |                                   |                     |                                      |                            |                     |                      |
| Residential                          | 2,510             | 4            |                                   | (9)                 | (4)                                  |                            | 46                  | 2,473                |
| Commercial                           | 19                | 69           |                                   | (113)               | (69)                                 |                            | \$ (46)             | 178                  |
| <b>Total nonperforming<br/>loans</b> | <b>51,968</b>     | <b>2,786</b> | <b>856</b>                        | <b>(3,507)</b>      | <b>(670)</b>                         | <b>(713)</b>               |                     | <b>53,216</b>        |

|                              |           |          |          |            |          |           |
|------------------------------|-----------|----------|----------|------------|----------|-----------|
| Noncovered foreclosed assets | 2,551     | 462      | (4,186)  | (26)       | \$ 713   | 5,588     |
| Covered foreclosed assets    | 664       |          |          | (10)       |          | 674       |
| Total nonperforming assets   | \$ 55,183 | \$ 2,786 | \$ 1,318 | \$ (7,693) | \$ (706) | \$ 59,478 |

Nonperforming assets decreased during the first quarter of 2014 by \$4,295,000 (7.22%) to \$55,183,000 at March 31, 2014 compared to \$59,478,000 at December 31, 2013. The decrease in nonperforming assets during the first quarter of 2014 was primarily the result of new nonperforming loans of \$2,786,000, advances on existing nonperforming loans and capitalized costs on foreclosed assets of \$1,318,000, less pay-downs, sales or upgrades of nonperforming loans to performing status totaling \$3,045,000, less dispositions of foreclosed assets totaling \$4,187,000, less loan charge-offs of \$670,000, and less write-downs of foreclosed assets of \$36,000.

The \$2,786,000 in new nonperforming loans during the first quarter of 2014 was comprised of increases of \$72,000 on one residential real estate loan, \$860,000 on six commercial real estate loans, \$1,332,000 on 17 home equity lines and loans, \$48,000 on 14 consumer loans, \$401,000 on nine C&I loans, \$4,000 on one residential construction loan, and \$69,000 on one commercial construction loan.

The \$860,000 in new nonperforming commercial real estate loans was primarily made up of two loans totaling \$514,000 secured by agricultural production land in central California. Related charge-offs are discussed below.

#### **Loan charge-offs during the three months ended March 31, 2014**

In the first quarter of 2014, the Company recorded \$670,000 in loan charge-offs and \$96,000 in deposit overdraft charge-offs less \$2,068,000 in loan recoveries and \$130,000 in deposit overdraft recoveries resulting in \$1,432,000 of net loan recoveries. Primary causes of the loan charges taken in the first quarter of 2014 were gross charge-offs of \$136,000 on one residential real estate loan, \$13,000 on one commercial real estate loan, \$178,000 on 7 home equity lines and loans, \$31,000 on 14 other consumer loans, \$239,000 on eight C&I loans, \$4,000 on one residential construction loan, and \$69,000 on one commercial construction loan. During the first quarter of 2014, there were no individual charges greater than \$250,000.

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Differences between the amounts explained in this section and the total charge-offs listed for a particular category are generally made up of individual charges of less than \$250,000 each. Generally losses are triggered by non-performance by the borrower and calculated based on any difference between the current loan amount and the current value of the underlying collateral less any estimated costs associated with the disposition of the collateral.

**Allowance for Loan Losses**

The Company's allowance for loan losses is comprised of allowances for originated, PNCI and PCI loans. All such allowances are established through a provision for loan losses charged to expense.

Originated and PNCI loans, and deposit related overdrafts are charged against the allowance for originated loan losses when Management believes that the collectability of the principal is unlikely or, with respect to consumer installment loans, according to an established delinquency schedule. The allowances for originated and PNCI loan losses are amounts that Management believes will be adequate to absorb probable losses inherent in existing originated loans, based on evaluations of the collectability, impairment and prior loss experience of those loans and leases. The evaluations take into consideration such factors as changes in the nature and size of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrower's ability to pay. The Company defines an originated or PNCI loan as impaired when it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired originated and PNCI loans are measured based on the present value of expected future cash flows discounted at the loan's original effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance.

In situations related to originated and PNCI loans where, for economic or legal reasons related to a borrower's financial difficulties, the Company grants a concession for other than an insignificant period of time to the borrower that the Company would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). The Company strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where the Company grants the borrower new terms that provide for a reduction of either interest or principal, the Company measures any impairment on the restructuring as noted above for impaired loans. TDR loans are classified as impaired until they are fully paid off or charged off. Loans that are in nonaccrual status at the time they become TDR loans, remain in nonaccrual status until the borrower demonstrates a sustained period of performance which the Company generally believes to be six consecutive months of payments, or equivalent. Otherwise, TDR loans are subject to the same nonaccrual and charge-off policies as noted above with respect to their restructured principal balance.

Credit risk is inherent in the business of lending. As a result, the Company maintains an allowance for loan losses to absorb losses inherent in the Company's originated and PNCI loan portfolios. These are maintained through periodic charges to earnings. These charges are included in the Consolidated Income Statements as provision for loan losses. All specifically identifiable and quantifiable losses are immediately charged off against the allowance. However, for a variety of reasons, not all losses are immediately known to the Company and, of those that are known, the full extent of the loss may not be quantifiable at that point in time. The balance of the Company's allowances for originated and PNCI loan losses are meant to be an estimate of these unknown but probable losses inherent in these portfolios.

The Company formally assesses the adequacy of the allowance for originated and PNCI loan losses on a quarterly basis. Determination of the adequacy is based on ongoing assessments of the probable risk in the outstanding

originated and PNCI loan portfolios, and to a lesser extent the Company's originated and PNCI loan commitments. These assessments include the periodic re-grading of credits 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, growth of the portfolio as a whole or by segment, and other factors as warranted. Loans are initially graded when originated or acquired. They are re-graded as they are renewed, when there is a new loan to the same borrower, when identified facts demonstrate heightened risk of nonpayment, or if they become delinquent. Re-grading of larger problem loans occurs at least quarterly. Confirmation of the quality of the grading process is obtained by independent credit reviews conducted by consultants specifically hired for this purpose and by various bank regulatory agencies.

The Company's method for assessing the appropriateness of the allowance for originated and PNCI loan losses includes specific allowances for impaired loans and leases, formula allowance factors for pools of credits, and allowances for changing environmental factors (e.g., interest rates, growth, economic conditions, etc.). Allowance factors for loan pools are based on historical loss experience by product type and prior risk rating. Allowances for impaired loans are based on analysis of individual credits. Allowances for changing environmental factors are Management's best estimate of the probable impact these changes have had on the originated or PNCI loan portfolio as a whole. The allowances for originated and PNCI loans are included in the allowance for loan losses.

As noted above, the allowances for originated and PNCI loan losses consists of a specific allowance, a formula allowance, and an allowance for environmental factors. The first component, the specific allowance, results from the analysis of identified credits that meet management's criteria for specific evaluation. These loans are reviewed individually to determine if such loans are considered impaired. Impaired loans are those where management has concluded that it is probable that the borrower will be unable to pay all amounts due under the contractual terms. Impaired loans are specifically reviewed and evaluated individually by management for loss potential by evaluating sources of repayment, including collateral as applicable, and a specified allowance for loan losses is established where necessary.

During the three months ended March 31, 2013, the Company changed the method it uses to estimate net sale proceeds from real estate collateral sales when calculating the allowance for loan losses associated with impaired real estate collateral dependent loans. Previously, the Company used the greater of fifteen percent or actual estimated selling costs. Currently, the Company uses the actual estimated selling costs,

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and an adjustment to appraised value based on the age of the appraisal. These changes are intended to more accurately reflect the estimated net sale proceeds from the sale of impaired collateral dependent real estate loans. This change in methodology resulted in the allowance for loan losses as of March 31, 2013 being \$494,000 more than it would have been without this change in methodology.

The second component of the allowance for originated and PNCI loan losses, the formula allowance, is an estimate of the probable losses that have occurred across the major loan categories in the Company's originated and PNCI loan portfolios. This analysis is based on loan grades by pool and the loss history of these pools. This analysis covers the Company's entire originated and PNCI loan portfolios including unused commitments but excludes any loans that were analyzed individually and assigned a specific allowance as discussed above. The total amount allocated for this component is determined by applying loss estimation factors to outstanding loans and loan commitments. The loss factors were previously based primarily on the Company's historical loss experience tracked over a five-year period and adjusted as appropriate for the input of current trends and events. Because historical loss experience varies for the different categories of originated loans, the loss factors applied to each category also differed. In addition, there is a greater chance that the Company would suffer a loss from a loan that was risk rated less than satisfactory than if the loan was last graded satisfactory. Therefore, for any given category, a larger loss estimation factor was applied to less than satisfactory loans than to those that the Company last graded as satisfactory. The resulting formula allowance was the sum of the allocations determined in this manner.

During the three months ended June 30, 2013, the Company modified its loss migration analysis methodology used to determine the formula allowance factors. When the Company originally established its loss migration analysis methodology during the quarter ended March 31, 2012, it reviewed the loss experience of each quarter over the previous three years in order to calculate an annualized loss rate by loan category and risk rating. The use of three years of loss experience data was originally used because that was the extent of the detailed loss data, by loan category and risk rating that was available at the time. This three year historical look-back period was used through the quarter ended March 31, 2013. Starting with the quarter ended June 30, 2013, the Company reviews all available detailed loss experience data, going back to, and including, the quarter end June 30, 2008, and does not limit the look-back period to the most recent three years of historical loss data. Using this data, the Company calculates loss factors for each quarter from the quarter ended June 30, 2009 to the most recent quarter. The Company then calculates a weighted average formula allowance factor for each loan category and risk rating with the most recent quarterly loss factor being weighted 125%, the quarter ended June 30, 2009 loss factor being weighted 75%, and the loss factors for all the quarters between the most recent quarter and the quarter ended June 30, 2009, being weighted on a linear scale from 75% to 125%. This change is intended to more accurately reflect the risk inherent in the loan portfolio by considering historical loss data for all years as the data for new periods becomes available. This change in methodology resulted in the allowance for loan losses as of June 30, 2013 being \$1,314,000 more than it would have been without this change in methodology.

During the three months ended June 30, 2014, the Company refined the method it uses to evaluate historical losses for the purpose of estimating the pool allowance for unimpaired loans. In the third quarter of 2010, the Company moved from a six point grading system (Grades A-F) to a nine point risk rating system (Risk Ratings 1-9), primarily to allow for more distinction within the Pass risk rating. As there was not initially sufficient loss experience within the nine point scale to complete a migration analysis for all nine risk ratings, all loans risk rated Pass or 2-5 were grouped together, a loss rate was calculated for that group, and that loss rate was established as the rate for risk rating 4. The reserve ratios for risk ratings 2, 3 & 5 were then interpolated from that figure. As of June 30, 2014, the Company was able to compile twelve quarters of historical loss information for all risk ratings, and use that information to calculate the loss rates for each of the nine risk ratings without interpolation. This refinement led to an increase of \$1,438,000 in the reserve requirement for unimpaired loans, driven primarily by Consumer loans with a risk rating of 5 or Pass-Watch.

The third component of the allowances for originated and PNCI loan losses, the environmental factor allowance, is a component that is not allocated to specific loans or groups of loans, but rather is intended to absorb losses that may not be provided for by the other components.

There are several primary reasons that the other components discussed above might not be sufficient to absorb the losses present in the originated and PNCI loan portfolios, and the environmental factor allowance is used to provide for the losses that have occurred because of them.

The first reason is that there are limitations to any credit risk grading process. The volume of originated and PNCI loans makes it impractical to re-grade every loan every quarter. Therefore, it is possible that some currently performing originated or PNCI 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 second reason is that the loss estimation factors are based primarily on historical loss totals. As such, the factors may not give sufficient weight to such considerations as the current general economic and business conditions that affect the Company's borrowers and specific industry conditions that affect borrowers in that industry. The factors might also not give sufficient weight to other environmental factors such as changing economic conditions and interest rates, portfolio growth, entrance into new markets or products, and other characteristics as may be determined by Management.

Specifically, in assessing how much environmental factor allowance needed to be provided, management considered the following:

with respect to the economy, management considered the effects of changes in GDP, unemployment, CPI, debt statistics, housing starts, housing sales, auto sales, agricultural prices, home affordability, and other economic factors which serve as indicators of economic health and trends and which may have an impact on the performance of our borrowers, and

with respect to changes in the interest rate environment, management considered the recent changes in interest rates and the resultant economic impact it may have had on borrowers with high leverage and/or low profitability; and



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with respect to changes in energy prices, management considered the effect that increases, decreases or volatility may have on the performance of our borrowers, and

with respect to loans to borrowers in new markets and growth in general, management considered the relatively short seasoning of such loans and the lack of experience with such borrowers, and

with respect to loans that have not yet been identified as impaired, management considered the volume and severity of past due loans.

Each of these considerations was assigned a factor and applied to a portion or the entire originated and PNCI loan portfolios. Since these factors are not derived from experience and are applied to large non-homogeneous groups of loans, they are available for use across the portfolio as a whole.

During the three months ended September 30, 2013, the Company modified its methodology used to determine the allowance for changing environmental factors. Previously, the Company compared the current value of each environmental factor to a fixed baseline value. The deviation of the current value from the baseline value was then multiplied by a conversion factor to determine the required allowance related to each environmental factor. As of September 30, 2013, the Company replaced the fixed baseline values with average baseline values derived from historical averages, and adjusted the conversion factors. This change is intended to more accurately reflect the risk inherent in the portfolio by recognizing that baseline, or normal, levels for environmental factors may change over time. This change in methodology resulted in the allowance for loan losses as of September 30, 2013 being \$1,665,000 more than it would have been without this change in methodology.

During the three months ended March 31, 2014, the Company modified its methodology used to determine the allowance for changing environmental factors by adding a new environmental factor based on the California Home Affordability Index ( CHAI ). The CHAI measures the percentage of households in California that can afford to purchase the median priced home in California based on current home prices and mortgage interest rates. The use of the CHAI environmental factor consists of comparing the current CHAI to its historical baseline, and allows management to consider the adverse impact that a lower than historical CHAI may have on general economic activity and the performance of our borrowers. Based on an analysis of historical data, management believes this environmental factor gives a better estimate of current economic activity compared to other environmental factors that may lag current economic activity to some extent. This change in methodology resulted in no change to the allowance for loan losses as of March 31, 2014 compared to what it would have been without this change in methodology.

Acquired loans are valued as of acquisition date in accordance with FASB ASC Topic 805, *Business Combinations*. Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are referred to as purchased credit impaired (PCI) loans. PCI loans are accounted for under FASB ASC Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. In addition, because of the significant credit discounts associated with the loans acquired in the Granite acquisition, the Company elected to account for all loans acquired in the Granite acquisition under FASB ASC Topic 310-30, and classify them all as PCI loans. Under FASB ASC Topic 805 and FASB ASC Topic 310-30, PCI loans are recorded at fair value 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 as of the acquisition date. Fair value is defined as the present value of the future estimated principal and interest payments of the loan, with the discount rate used in the present value calculation representing the estimated effective yield of the loan. The difference between contractual future payments and estimated future payments is referred to as the nonaccretable difference. The difference between estimated future payments and the present value of the estimated future payments is referred to as the accretable yield.

The accretable yield represents the amount that is expected to be recorded as interest income over the remaining life of the loan. If after acquisition, the Company determines that the future cash flows of a PCI loan are expected to be more than the originally estimated, an increase in the discount rate (effective yield) would be made such that the newly increased accretable yield would be recognized, on a level yield basis, over the remaining estimated life of the loan. If after acquisition, the Company determines that the future cash flows of a PCI loan are expected to be less than the previously estimated, the discount rate would first be reduced until the present value of the reduced cash flow estimate equals the previous present value however, the discount rate may not be lowered below its original level. If the discount rate has been lowered to its original level and the present value has not been sufficiently lowered, an allowance for loan loss would be established through a provision for loan losses charged to expense to decrease the present value to the required level. If the estimated cash flows improve after an allowance has been established for a loan, the allowance may be partially or fully reversed depending on the improvement in the estimated cash flows. Only after the allowance has been fully reversed may the discount rate be increased. PCI loans are put on nonaccrual status when cash flows cannot be reasonably estimated. PCI loans are charged off when evidence suggests cash flows are not recoverable. Foreclosed assets from PCI loans are recorded in foreclosed assets at fair value with the fair value at time of foreclosure representing cash flow from the loan. ASC 310-30 allows PCI loans with similar risk characteristics and acquisition time frame to be pooled and have their cash flows aggregated as if they were one loan.

### The Components of the Allowance for Loan Losses

The following table sets forth the allowance for loan losses as of the dates indicated:

| (In thousands)                                 | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| Allowance for originated and PNCI loan losses: |                       |                      |
| Specific allowance                             | \$ 4,091              | \$ 3,975             |
| Formula allowance                              | 24,701                | 24,611               |
| Environmental factors allowance                | 5,719                 | 5,619                |
| Allowance for originated and PNCI loan losses  | 34,511                | 34,205               |
| Allowance for PCI loan losses                  | 3,409                 | 4,040                |
| Allowance for loan losses                      | \$ 37,920             | \$ 38,245            |
| Allowance for loan losses to loans             | 2.15%                 | 2.29%                |

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For additional information regarding the allowance for loan losses, including changes in specific, formula, and environmental factors allowance categories, see *Provision for Loan Losses* at *Results of Operations* and *Allowance for Loan Losses* above. Based on the current conditions of the loan portfolio, management believes that the \$37,920,000 allowance for loan losses at September 30, 2014 is adequate to absorb probable losses inherent in the Bank's 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 following table summarizes the allocation of the allowance for loan losses between loan types as of the dates indicated:

| (In thousands)                         | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| Real estate mortgage                   | \$ 12,623             | \$ 12,854            |
| Consumer                               | 19,258                | 18,238               |
| Commercial                             | 4,062                 | 4,331                |
| Real estate construction               | 1,977                 | 2,822                |
| <b>Total allowance for loan losses</b> | <b>\$ 37,920</b>      | <b>\$ 38,245</b>     |

The following table summarizes the allocation of the allowance for loan losses between loan types as a percentage of the total allowance for loan losses as of the dates indicated:

| (In thousands)                         | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| Real estate mortgage                   | 33.3%                 | 33.6%                |
| Consumer                               | 50.8%                 | 47.7%                |
| Commercial                             | 10.7%                 | 11.3%                |
| Real estate construction               | 5.2%                  | 7.4%                 |
| <b>Total allowance for loan losses</b> | <b>100.0%</b>         | <b>100.0%</b>        |

The following table summarizes the allocation of the allowance for loan losses as a percentage of the total loans for each loan category as of the dates indicated:

| (In thousands)                         | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| Real estate mortgage                   | 1.04%                 | 1.16%                |
| Consumer                               | 5.15%                 | 4.76%                |
| Commercial                             | 3.01%                 | 3.28%                |
| Real estate construction               | 4.60%                 | 5.75%                |
| <b>Total allowance for loan losses</b> | <b>2.15%</b>          | <b>2.29%</b>         |



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The following tables summarize the activity in the allowance for loan losses, reserve for unfunded commitments, and allowance for losses (which is comprised of the allowance for loan losses and the reserve for unfunded commitments) for the periods indicated (in thousands):

|   | Three months ended September 30, |                  | Nine months ended September 30, |                  |
|---|----------------------------------|------------------|---------------------------------|------------------|
|   | 2014                             | 2013             | 2014                            | 2013             |
| <b>Allowance for loan losses:</b>                       |                                  |                  |                                 |                  |
| Balance at beginning of period                          | \$ 39,968                        | \$ 39,599        | \$ 38,245                       | \$ 42,648        |
| Provision for loan losses                               | (2,977)                          | (393)            | (2,624)                         | (887)            |
| <b>Loans charged off:</b>                               |                                  |                  |                                 |                  |
| <b>Real estate mortgage:</b>                            |                                  |                  |                                 |                  |
| Residential   | (31)                             | (4)              | (167)                           | (46)             |
| Commercial  | (49)                             | (23)             | (107)                           | (1,712)          |
| <b>Consumer:</b>  |                                  |                  |                                 |                  |
| Home equity lines                                       | (136)                            | (331)            | (991)                           | (1,843)          |
| Home equity loans                                       |                                  | (30)             | (11)                            | (56)             |
| Auto indirect   |                                  | (9)              |                                 | (67)             |
| Other consumer  | (118)                            | (239)            | (389)                           | (724)            |
| Commercial  | (11)                             | (318)            | (401)                           | (1,143)          |
| <b>Construction:</b>                                    |                                  |                  |                                 |                  |
| Residential   |                                  |                  | (4)                             | (20)             |
| Commercial  |                                  | (31)             | (69)                            | (92)             |
| <b>Total loans charged off</b>                          | <b>(345)</b>                     | <b>(985)</b>     | <b>(2,139)</b>                  | <b>(5,703)</b>   |
| <b>Recoveries of previously charged-off loans:</b>      |                                  |                  |                                 |                  |
| <b>Real estate mortgage:</b>                            |                                  |                  |                                 |                  |
| Residential   |                                  | 154              |                                 | 345              |
| Commercial  | 42                               | 295              | 513                             | 965              |
| <b>Consumer:</b>  |                                  |                  |                                 |                  |
| Home equity lines                                       | 249                              | 304              | 758                             | 809              |
| Home equity loans                                       | 4                                | 3                | 31                              | 29               |
| Auto indirect   | 19                               | 34               | 70                              | 180              |
| Other consumer  | 71                               | 199              | 373                             | 601              |
| Commercial  | 94                               | 108              | 1,155                           | 244              |
| <b>Construction:</b>                                    |                                  |                  |                                 |                  |
| Residential   | 769                              | 2                | 1,377                           | 63               |
| Commercial  | 26                               | 20               | 161                             | 46               |
| <b>Total recoveries of previously charged off loans</b> | <b>1,274</b>                     | <b>1,119</b>     | <b>4,438</b>                    | <b>3,282</b>     |
| <b>Net charge-offs</b>                                  | <b>929</b>                       | <b>134</b>       | <b>2,299</b>                    | <b>(2,421)</b>   |
| <b>Balance at end of period</b>                         | <b>\$ 37,920</b>                 | <b>\$ 39,340</b> | <b>\$ 37,920</b>                | <b>\$ 39,340</b> |

Three months ended September 30, 2014      Nine months ended September 30, 2013

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|  | 2014         | 2013         | 2014         | 2013         |
|--|--------------|--------------|--------------|--------------|
| <b>Reserve for unfunded commitments:</b>                                 |              |              |              |              |
| Balance at beginning of period   | \$ 2,045     | \$ 3,210     | \$ 2,415     | \$ 3,615     |
| Provision for losses unfunded commitments                                | 175          | (335)        | (1,955)      | (740)        |
| Balance at end of period   | \$ 2,220     | \$ 2,875     | \$ 2,220     | \$ 2,875     |
| <b>Balance at end of period:</b>   |              |              |              |              |
| Allowance for loan losses  |              |              | \$ 37,920    | \$ 39,340    |
| Reserve for unfunded commitments   |              |              | 2,220        | 2,875        |
| Allowance for loan losses and Reserve for unfunded commitments           |              |              | \$ 40,140    | \$ 42,215    |
| <b>As a percentage of total loans at end of period:</b>                  |              |              |              |              |
| Allowance for loan losses  |              |              | 2.15%        | 2.37%        |
| Reserve for unfunded commitments   |              |              | 0.12%        | 0.18%        |
| Allowance for loan losses and Reserve for unfunded commitments           |              |              | 2.27%        | 2.55%        |
| Average total loans  | \$ 1,752,026 | \$ 1,635,506 | \$ 1,712,657 | \$ 1,597,736 |
| <b>Ratios (annualized):</b>  |              |              |              |              |
| Net charge-offs during period to average loans outstanding during period | (0.21)%      | (0.03)%      | (0.18)%      | 0.20%        |
| (Benefit from) provision for loan losses to average loans outstanding    | (0.68)%      | (0.10)%      | (0.20)%      | (0.07)%      |

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The following tables detail the components and summarize the activity in foreclosed assets, net of allowances for losses for the periods indicated (dollars in thousands):

| (dollars in thousands):        | Balance<br>at<br>September 30,<br>2014 | Advances/<br>New<br>NPA | Capitalized<br>Costs | Sales        | Valuation<br>Adjustments | Transfers<br>from Loans | Category<br>Changes | Balance at<br>June 30,<br>2014 |
|--------------------------------|--|-------------------------|----------------------|--------------|--------------------------|-------------------------|---------------------|--------------------------------|
| <b>Noncovered:</b>             |  |                         |                      |              |                          |                         |                     |                                |
| Land & Construction            | \$ 1,945                               |                         |                      |              | \$ (24)                  |                         |                     | \$ 1,969                       |
| Residential real estate        | 1,340                                  |                         |                      | (526)        | (18)                     | \$ 358                  |                     | 1,526                          |
| Commercial real estate         | 1,291                                  |                         |                      | (423)        | (55)                     |                         |                     | 1,769                          |
| <b>Total noncovered</b>        | <b>4,576</b>                           |                         |                      | <b>(949)</b> | <b>(97)</b>              | <b>358</b>              |                     | <b>5,264</b>                   |
| <b>Covered:</b>                |  |                         |                      |              |                          |                         |                     |                                |
| Land & Construction            | 520                                    |                         |                      |              | (1)                      |                         |                     | 521                            |
| Residential real estate        |  |                         |                      |              |                          |                         |                     |                                |
| Commercial real estate         |  |                         |                      |              |                          |                         |                     |                                |
| <b>Total covered</b>           | <b>520</b>                             |                         |                      |              | <b>(1)</b>               |                         |                     | <b>521</b>                     |
| <b>Total foreclosed assets</b> | <b>\$ 5,096</b>                        |                         |                      | <b>(949)</b> | <b>(98)</b>              | <b>\$ 358</b>           |                     | <b>\$ 5,785</b>                |

| (dollars in thousands):        | Balance<br>at<br>June 30,<br>2014 | Advances/<br>New<br>NPA | Capitalized<br>Costs | Sales           | Valuation<br>Adjustments | Transfers<br>from Loans | Category<br>Changes | Balance at<br>March<br>31,<br>2014 |
|--------------------------------|-----------------------------------|-------------------------|----------------------|-----------------|--------------------------|-------------------------|---------------------|------------------------------------|
| <b>Noncovered:</b>             |                                   |                         |                      |                 |                          |                         |                     |                                    |
| Land & Construction            | \$ 1,969                          |                         |                      | \$ (453)        | \$ (1)                   | \$ 1,845                |                     | \$ 578                             |
| Residential real estate        | 1,526                             |                         |                      | (235)           | (1)                      | 116                     |                     | 1,646                              |
| Commercial real estate         | 1,769                             |                         |                      |                 |                          | 1,442                   |                     | 327                                |
| <b>Total noncovered</b>        | <b>5,264</b>                      |                         |                      | <b>(688)</b>    | <b>(2)</b>               | <b>3,403</b>            |                     | <b>2,551</b>                       |
| <b>Covered:</b>                |                                   |                         |                      |                 |                          |                         |                     |                                    |
| Land & Construction            | 521                               |                         |                      | (142)           | (1)                      |                         |                     | 664                                |
| Residential real estate        |                                   |                         |                      |                 |                          |                         |                     |                                    |
| Commercial real estate         |                                   |                         |                      |                 |                          |                         |                     |                                    |
| <b>Total covered</b>           | <b>521</b>                        |                         |                      | <b>(142)</b>    | <b>(1)</b>               |                         |                     | <b>664</b>                         |
| <b>Total foreclosed assets</b> | <b>\$ 5,785</b>                   |                         |                      | <b>\$ (830)</b> | <b>\$ (3)</b>            | <b>\$ 3,403</b>         |                     | <b>\$ 3,215</b>                    |

|                                | Balance<br>at<br>March<br>31,<br>2014 | Advances/<br>New<br>NPA<br>Capitalized<br>Costs | Sales            | Valuation<br>Adjustment | Transfers<br>from Loans<br>Category<br>Changes | Balance<br>at<br>December 31,<br>2013 |
|--------------------------------|---------------------------------------|---|------------------|-------------------------|--|---------------------------------------|
| (dollars in thousands):        |                                       |   |                  |                         |  |                                       |
| <b>Noncovered:</b>             |                                       |   |                  |                         |  |                                       |
| Land & Construction            | \$ 578                                |   |                  |                         |  | \$ 578                                |
| Residential real estate        | 1,646                                 | \$ 462  | \$(1,123)        | \$ (25)                 | \$ 388   | 1,944                                 |
| Commercial real estate         | 327                                   |   | (3,063)          | (1)                     | 325  | 3,066                                 |
| <b>Total noncovered</b>        | <b>2,551</b>                          | <b>462</b>                                      | <b>(4,186)</b>   | <b>(26)</b>             | <b>713</b>                                     | <b>5,588</b>                          |
| <b>Covered:</b>                |                                       |   |                  |                         |  |                                       |
| Land & Construction            | 664                                   |   |                  | (10)                    |  | 674                                   |
| Residential real estate        |                                       |   |                  |                         |  |                                       |
| Commercial real estate         |                                       |   |                  |                         |  |                                       |
| <b>Total covered</b>           | <b>664</b>                            |   |                  | <b>(10)</b>             |  | <b>674</b>                            |
| <b>Total foreclosed assets</b> | <b>\$ 3,215</b>                       | <b>\$ 462</b>                                   | <b>\$(4,186)</b> | <b>\$ (36)</b>          | <b>\$ 713</b>                                  | <b>\$ 6,262</b>                       |

### Premises and Equipment

Premises and equipment were comprised of:

| (In thousands)                      | September 30,<br>2014 | December 31,<br>2013 |
|-------------------------------------|-----------------------|----------------------|
| Land & land improvements            | \$ 5,953              | \$ 5,975             |
| Buildings                           | 30,147                | 30,103               |
| Furniture and equipment             | 28,547                | 27,881               |
|                                     | 64,647                | 63,959               |
| Less: Accumulated depreciation      | (32,466)              | (32,397)             |
|                                     | 32,181                | 31,562               |
| Construction in progress            |                       | 50                   |
| <b>Total premises and equipment</b> | <b>\$ 32,181</b>      | <b>\$ 31,612</b>     |

During the nine months ended September 30, 2014, premises and equipment increased \$569,000 due to purchases of \$3,857,000, that were partially offset by depreciation of \$3,228,000 and disposals of premises and equipment with net book value of \$60,000. Included in the depreciation expense of \$3,228,000 during the nine months ended September 30, 2014 was \$238,000 of accelerated depreciation of leasehold improvements taken on two branches that were closed during the quarter ended March 31, 2014.





**Table of Contents****Intangible Assets**

Intangible assets were comprised of the following as of the dates indicated:

| (In thousands)                 | September 30,<br>2014 | December 31,<br>2013 |
|--------------------------------|-----------------------|----------------------|
| Core-deposit intangible        | \$ 726                | \$ 883               |
| Goodwill                       | 15,519                | 15,519               |
| <b>Total intangible assets</b> | <b>\$ 16,245</b>      | <b>\$ 16,402</b>     |

The core-deposit intangible assets resulted from the Bank's acquisitions of Citizens in 2011 and Granite in 2010. The goodwill intangible asset resulted from the North State National Bank acquisition in 2003. Amortization of core deposit intangible assets amounting to \$53,000 and \$53,000 were recorded during the three months ended September 30, 2014 and 2013, respectively. Amortization of core deposit intangible assets amounting to \$157,000 and \$157,000 were recorded during the nine months ended September 30, 2014 and 2013, respectively.

**Deposits**

Deposits at September 30, 2014 increased \$26,873,000 (1.1%) from the 2013 year-end balances to \$2,437,356,000. Interest-bearing demand and savings deposits were up, while noninterest-bearing demand and time deposits down at September 30, 2014 when compared to December 31, 2013. Included in the September 30, 2014 and December 31, 2013 certificate of deposit balances are \$5,000,000 from the State of California. The Bank participates in a deposit program offered by the State of California whereby the State may make deposits at the Bank's request subject to collateral and creditworthiness constraints. The negotiated rates on these State deposits are generally more favorable than other wholesale funding sources available to the Bank.

**Long-Term Debt**

See Note 16 to the condensed consolidated financial statements at Item 1 of Part I of this report for information about the Company's other borrowings, including long-term debt.

**Junior Subordinated Debt**

See Note 17 to the condensed consolidated financial statements at Item 1 of Part I of this report for information about the Company's junior subordinated debt.

**Off-Balance Sheet Arrangements**

See Note 18 to the condensed consolidated financial statements at Item 1 of Part I of this report for information about the Company's commitments and contingencies including off-balance-sheet arrangements.

**Capital Resources**

The current and projected capital position of the Company and the impact of capital plans and long-term strategies are reviewed regularly by Management.

The Company adopted and announced a stock repurchase plan on August 21, 2007 for the repurchase of up to 500,000 shares of the Company's common stock from time to time as market conditions allow. The 500,000 shares authorized for repurchase under this plan represented approximately 3.2% of the Company's approximately 15,815,000 common shares outstanding as of August 21, 2007. The Company did not repurchase any shares during the six months ended June 30, 2014. This plan has no stated expiration date for the repurchases. As of September 30, 2014, the Company had repurchased 166,600 shares under this plan, which left 333,400 shares available for repurchase under the plan. Shares that are repurchased in accordance with the provisions of a Company stock option plan or equity compensation plan are not counted against the number of shares repurchased under the repurchase plan adopted on August 21, 2007.

The Company's primary capital resource is shareholders' equity, which was \$267,380,000 at September 30, 2014. This amount represents an increase of \$16,434,000 (6.5%) from December 31, 2013, the net result of comprehensive income for the period of \$20,458,000, and the effect of equity compensation vesting and tax benefits of \$1,035,000, and the exercise of stock options of \$2,875,000, that were partially offset by dividends paid of \$5,322,000, and the repurchase of common stock as it was tendered in lieu of cash to exercise stock options and pay related taxes of \$2,551,000. The Company's ratio of equity to total assets was 9.57% and 9.15% as of September 30, 2014 and December 31, 2013, respectively.

The following summarizes the Company's ratios of capital to risk-adjusted assets as of the dates indicated:

|                | As of<br>September 30,<br>2014 | As<br>December 31,<br>2013 | Minimum<br>Regulatory<br>Requirement |
|----------------|--------------------------------|----------------------------|--------------------------------------|
| Total Capital  | 14.79%                         | 14.77%                     | 8.00%                                |
| Tier I Capital | 13.53%                         | 13.51%                     | 4.00%                                |
| Leverage ratio | 10.48%                         | 10.17%                     | 4.00%                                |

See Note 19 and Note 29 to the condensed consolidated financial statements at Item 1 of Part I of this report for additional information about the Company's capital resources.

On July 2, 2013, the Federal Reserve approved final rules that substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The FDIC has subsequently approved these rules. The final rules were adopted following the issuance of proposed rules by the Federal Reserve in June 2012, and implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. Basel III refers to two consultative documents released by the Basel Committee on Banking Supervision in December 2009, the rules text released in December 2010, and loss absorbency rules issued in January 2011, which include significant changes to bank capital, leverage and liquidity requirements.

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The rules include new risk-based capital and leverage ratios, which would be phased in from 2015 to 2019, and would refine the definition of what constitutes capital for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Company and the Bank under the final rules would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The final rules also establish a capital conservation buffer above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The capital conservation buffer will be phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

Basel III provides discretion for regulators to impose an additional buffer, the countercyclical buffer, of up to 2.5% of common equity Tier 1 capital to take into account the macro-financial environment and periods of excessive credit growth. However, the final rules permit the countercyclical buffer to be applied only to advanced approach banks (i.e., banks with \$250 billion or more in total assets or \$10 billion or more in total foreign exposures), which currently excludes the Company and the Bank. The final rules also implement revisions and clarifications consistent with Basel III regarding the various components of Tier 1 capital, including common equity, unrealized gains and losses, as well as certain instruments that will no longer qualify as Tier 1 capital, some of which will be phased out over time. However, the final rules provide that small depository institution holding companies with less than \$15 billion in total assets as of December 31, 2009 (which includes the Company) will be able to permanently include non-qualifying instruments that were issued and included in Tier 1 or Tier 2 capital prior to May 19, 2010 in additional Tier 1 or Tier 2 capital until they redeem such instruments or until the instruments mature.

The final rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Bank, if their capital levels begin to show signs of weakness. These revisions take effect January 1, 2015. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions will be required to meet the following increased capital level requirements in order to qualify as well capitalized: (i) a new common equity Tier 1 capital ratio of 6.5%; (ii) a Tier 1 capital ratio of 8% (increased from 6%); (iii) a total capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (increased from 4%).

The final rules set forth certain changes for the calculation of risk-weighted assets, which the Company will be required to utilize beginning January 1, 2015. The standardized approach final rule utilizes an increased number of credit risk exposure categories and risk weights, and also addresses: (i) an alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; (iv) revised capital treatment for derivatives and repo-style transactions; and (v) disclosure requirements for top-tier banking organizations with \$50 billion or more in total assets that are not subject to the advanced approach rules that apply to banks with greater than \$250 billion in consolidated assets. Based on the Company's current capital composition and levels, the Company believes that it would be in compliance with the requirements as set forth in the final rules if they were presently in effect.

**Liquidity**

The Bank's principal source of asset liquidity is cash at Federal Reserve and other banks and marketable investment securities available for sale. At September 30, 2014, cash at Federal Reserve and other banks in excess of reserve

requirements and investment securities available for sale totaled \$409,495,000, representing a decrease of \$255,161,000 (38.4%) from December 31, 2013. This decrease in cash and securities available for sale is due mainly to increases in investments held to maturity and loans during the nine months ended September 30, 2014. In addition, the Company generates additional liquidity from its operating activities. The Company's profitability during the first nine months of 2014 generated cash flows from operations of \$21,752,000 compared to \$33,632,000 during the first nine months of 2013. Maturities of investment securities produced cash inflows of \$37,953,000 during the nine months ended September 30, 2014 compared to \$45,397,000 for the nine months ended September 30, 2013. During the nine months ended September 30, 2014, the Company invested \$224,403,000 in securities and \$96,040,000 in loans net of loan principal reductions, compared to \$194,458,000 invested in securities and \$102,684,000 invested in loans during the nine months ended September 30, 2013. Proceeds from the sale of foreclosed assets accounted for \$7,818,000 and \$12,252,000 of investing sources of funds during the nine months ended September 30, 2014 and 2013, respectively. These changes in investment and loan balances, and proceeds from sale of foreclosed assets, contributed to net cash used by investing activities of \$278,871,000 and \$245,549,000 during the nine months ended September 30, 2014 and 2013, respectively. Financing activities provided net cash of \$28,430,000 and \$4,168,000 during the nine months ended September 30, 2014 and 2013, respectively. Deposit balance increases provided \$26,873,000 and \$3,609,000 during the nine months ended September 30, 2014 and 2013, respectively. Net increases in other borrowings provided \$6,330,000 and \$5,429,000 during the nine months ended September 30, 2014 and 2013, respectively. Dividends paid used \$5,322,000 and \$4,976,000 of cash during the nine months ended September 30, 2014 and 2013, respectively. The Company's liquidity is dependent on dividends received from the Bank. Dividends from the Bank are subject to certain regulatory restrictions.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The Company's assessment of market risk as of September 30, 2014 indicates there are no material changes in the quantitative and qualitative disclosures from those in our Annual Report on Form 10-K for the year ended December 31, 2013.

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**Table of Contents****Item 4. Controls and Procedures**

The Company's management, including its Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of the Company's disclosure controls and procedures as of September 30, 2014. Disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), are controls and procedures designed to reasonably assure that information required to be disclosed in the Company's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of September 30, 2014.

During the nine months ended September 30, 2014, there were no changes in our internal controls or in other factors that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

**PART II OTHER INFORMATION****Item 1 Legal Proceedings**

Due to the nature of our business, we are involved in legal proceedings that arise in the ordinary course of our business. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

See Note 18 to the condensed consolidated financial statements at Item 1 of Part I of this report, for a discussion of the Company's involvement in litigation.

**Item 1A Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed under Part I Item 1A Risk Factors in our Form 10-K for the year ended December 31, 2013 which are incorporated by reference herein. These factors could materially adversely affect our business, financial condition, liquidity, results of operations and capital position, and could cause our actual results to differ materially from our historical results or the results contemplated by the forward-looking statements contained in this report. The information below updates some of the factors in the 10-K.

***We may fail to realize the cost savings anticipated for the North Valley Bancorp merger or fail to successfully integrate the business operations of the two companies in an efficient manner.***

We completed our merger with North Valley Bancorp on October 3, 2014. The success of the merger will depend, in part, on our ability to realize anticipated cost savings and to combine the businesses of the Company and North Valley Bancorp in a manner that permits growth opportunities to be realized and does not materially disrupt the existing customer relationships of Tri Counties Bank or North Valley Bank, nor result in decreased revenues due to any loss of customers.

The Company and North Valley Bancorp have previously operated independently. To realize the anticipated benefits of the merger, the businesses of the Company and North Valley Bancorp and Tri Counties Bank and North Valley

Bank must be successfully combined. While we considered existing leases and other contractual obligations in developing estimates of cost savings, changes in transaction volumes, operating systems and procedures and other factors may cause the actual cost savings to be different from our estimates. In addition, difficulties encountered in integrating our information systems could prevent us from realizing some of the estimated cost savings. Such difficulties could also jeopardize customer relationships and cause a loss of deposits or loan customers and the revenue associated with those customers. It is possible that the integration process could result in the loss of key employees, as well as the disruption of each company's ongoing businesses or inconsistencies in standards, controls, procedures and policies, any or all of which could adversely affect our ability to maintain relationships with customers and employees after the merger or to achieve the anticipated benefits of the merger. Our integration efforts may also divert management attention and resources. A failure to successfully complete the complicated integration process could have an adverse effect on the combined companies or the combined bank. If the combined bank is not able to achieve these cost-savings objectives, the anticipated benefits of the merger may not be realized fully or at all or may take longer to realize than expected.

***Our results of operations and the market price of our common stock may be affected by factors different from those affecting our result of operations and shares prior to the merger with North Valley Bancorp.***

Approximately 28.9% of the outstanding shares of TriCo Bancshares common stock outstanding immediately after the North Valley Bancorp merger were held by former shareholders of North Valley Bancorp. The Company's business differs from North Valley Bancorp's in some respects. The results of operations of the combined company and the market price of our common stock may be affected by factors different from those that affected the independent results of our operations and the market price of our common stock prior to the merger.

**Table of Contents****Item 2 Unregistered Sales of Equity Securities and Use of Proceeds**

The following table shows information concerning the common stock repurchased by the Company during the three months ended September 30, 2014 pursuant to the Company's stock repurchase plan adopted on August 21, 2007, which is discussed in more detail under "Capital Resources" in this report and is incorporated herein by reference:

| Period           | (a) Total number of shares purchased | (b) Average price paid per share | (c) Total number of shares purchased as part of publicly announced plans or programs | (d) Maximum number of shares that may yet be purchased under the plans or programs |
|------------------|--------------------------------------|----------------------------------|--|--|
| Jul. 1-31, 2014  |                                      |                                  |  | 333,400  |
| Aug. 1-31, 2014  |                                      |                                  |  | 333,400  |
| Sep., 1-30, 2014 |                                      |                                  |  | 333,400  |
| Total            |                                      |                                  |  | 333,400  |

**Item 6 Exhibits**

| Exhibit No. | Exhibit   |
|-------------|---|
| 2.1         | Purchase and Assumption Agreement Whole Bank All Deposits, among the Federal Deposit Insurance Corporation, receiver of Granite Community Bank, N.A., Granite Bay, California, the Federal Deposit Insurance Corporation and Tri Counties Bank, dated as of May 28, 2010, and related addendum (incorporated by reference to Exhibit 2.1 to TriCo's Current Report on Form 8-K filed June 3, 2010).                     |
| 2.2         | Purchase and Assumption Agreement Whole Bank All Deposits, among the Federal Deposit Insurance Corporation, receiver of Citizens Bank of Northern California, Nevada City, California, the Federal Deposit Insurance Corporation and Tri Counties Bank, dated as of September 23, 2011, and related addendum (incorporated by reference to Exhibit 2.1 to TriCo's Current Report on Form 8-K filed September 27, 2011). |
| 2.3         | Agreement and Plan of Merger and Reorganization by and between TriCo and North Valley Bancorp dated January 21, 2014 (incorporated by reference to Exhibit 2.1 to TriCo's Current Report on Form 8-K filed January 21, 2014).   |
| 3.1         | Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 to TriCo's Current Report on Form 8-K filed on March 16, 2009).  |
| 3.2         | Bylaws of TriCo Bancshares, as amended (incorporated by reference to Exhibit 3.1 to TriCo's Current Report on Form 8-K filed February 17, 2011).  |
| 4.1         | Certificate of Determination of Preferences of Series AA Junior Participating Preferred Stock (incorporated by reference to Exhibit 3.3 to TriCo's Quarterly Report on Form 10-Q for the quarter  |



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ended September 30, 2001).

- 10.1\* Form of Change of Control Agreement dated as of July 17, 2013, among TriCo, Tri Counties Bank and each of Dan Bailey, Craig Carney, Richard O Sullivan, Thomas Reddish, and Ray Rios (incorporated by reference to Exhibit 10.2 to TriCo s Current Report on Form 8-K filed on July 23, 2013).
- 10.2\* TriCo s 1995 Incentive Stock Option Plan (incorporated by reference to Exhibit 4.1 to TriCo s Form S-8 Registration Statement dated August 23, 1995 (No. 33-62063)).
- 10.3\* TriCo s 2001 Stock Option Plan, as amended (incorporated by reference to Exhibit 10.7 to TriCo s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
- 10.4\* TriCo s 2009 Equity Incentive plan, as amended (incorporated by reference to Exhibit 10.2 to TriCo s Current Report on Form 8-K filed April 3, 2013).
- 10.5\* Amended Employment Agreement between TriCo and Richard Smith dated as of March 28, 2013 (incorporated by reference to Exhibit 10.1 to TriCo s Current Report on Form 8-K filed April 3, 2013).
- 10.6\* Transaction Bonus Agreement between TriCo Bancshares and Richard P. Smith dated as of August 7, 2014 (incorporated by reference to Exhibit 10.4 to TriCo s Form 8-K filed on August 13, 2014).
- 10.7\* Tri Counties Bank Executive Deferred Compensation Plan restated April 1, 1992, and January 1, 2005 (incorporated by reference to Exhibit 10.9 to TriCo s Quarterly Report on Form 10-Q for the quarter ended September 30, 2005).
- 10.8\* Tri Counties Bank Deferred Compensation Plan for Directors effective January 1, 2005 (incorporated by reference to Exhibit 10.10 to TriCo s Quarterly Report on Form 10-Q for the quarter ended September 30, 2005).
- 10.9\* 2005 Tri Counties Bank Deferred Compensation Plan for Executives and Directors effective January 1, 2005 (incorporated by reference to Exhibit 10.11 to TriCo s Quarterly Report on Form 10-Q for the quarter ended September 30, 2005).
- 10.10\* Tri Counties Bank Supplemental Retirement Plan for Directors dated September 1, 1987, as restated January 1, 2001, and amended and restated January 1, 2004 (incorporated by reference to Exhibit 10.12 to TriCo s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004).
- 10.11\* 2004 TriCo Bancshares Supplemental Retirement Plan for Directors effective January 1, 2004 (incorporated by reference to Exhibit 10.13 to TriCo s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004).
- 10.12\* Tri Counties Bank Supplemental Executive Retirement Plan effective September 1, 1987, as amended and restated January 1, 2004 (incorporated by reference to Exhibit 10.14 to TriCo s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004).
- 10.13\* 2004 TriCo Bancshares Supplemental Executive Retirement Plan effective January 1, 2004 (incorporated by reference to Exhibit 10.15 to TriCo s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004).
- 10.14\* Form of Joint Beneficiary Agreement effective March 31, 2003 between Tri Counties Bank and each of George Barstow, Dan Bay, Ron Bee, Craig Carney, Robert Elmore, Greg Gill, Richard Miller, Richard O Sullivan, Thomas Reddish, Jerald Sax, and Richard Smith (incorporated by reference to Exhibit 10.14 to TriCo s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).



**Table of Contents****Item 6 Exhibits (continued)**

|         |   |
|---------|---|
| 10.15*  | Form of Joint Beneficiary Agreement effective March 31, 2003 between Tri Counties Bank and each of Don Amaral, William Casey, Craig Compton, John Hasbrook, Michael Koehnen, Donald Murphy, Carroll Taresh, and Alex Vereschagin (incorporated by reference to Exhibit 10.15 to TriCo's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).                        |
| 10.16*  | Form of Tri Counties Bank Executive Long Term Care Agreement effective June 10, 2003 between Tri Counties Bank and each of Craig Carney, Richard Miller, Richard O. Sullivan, and Thomas Reddish (incorporated by reference to Exhibit 10.16 to TriCo's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).  |
| 10.17*  | Form of Tri Counties Bank Director Long Term Care Agreement effective June 10, 2003 between Tri Counties Bank and each of Don Amaral, William Casey, Craig Compton, John Hasbrook, Michael Koehnen, Donald Murphy, Carroll Taresh, and Alex Vereschagin (incorporated by reference to Exhibit 10.17 to TriCo's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003). |
| 10.18*  | Form of Indemnification Agreement between TriCo Bancshares and its directors and executive officers (incorporated by reference to Exhibit 10.1 to TriCo's Current Report on Form 8-K filed September 10, 2013).   |
| 10.19*  | Form of Indemnification Agreement between Tri Counties Bank its directors and executive officers (incorporated by reference to Exhibit 10.2 to TriCo's Current Report on Form 8-K filed September 10, 2013).  |
| 31.1    | Rule 13a-14(a)/15d-14(a) Certification of CEO   |
| 31.2    | Rule 13a-14(a)/15d-14(a) Certification of CFO   |
| 32.1    | Section 1350 Certification of CEO   |
| 32.2    | Section 1350 Certification of CFO   |
| 101.INS | XBRL Instance Document  |
| 101.SCH | XBRL Taxonomy Extension Schema Document   |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document   |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document  |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document  |

\* Management contract or compensatory plan or arrangement

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**SIGNATURES**

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

**TRICO BANCSHARES**  
(Registrant)

Date: November 7, 2014

/s/ Thomas J. Reddish  
Thomas J. Reddish  
Executive Vice President and Chief Financial Officer  
(Duly authorized officer and principal financial officer)