

WESTAMERICA BANCORPORATION

Form 10-Q

November 03, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: 001-09383

WESTAMERICA BANCORPORATION

(Exact Name of Registrant as Specified in Its Charter)

CALIFORNIA

(State or Other Jurisdiction of  
Incorporation or Organization)

94-2156203

(I.R.S. Employer  
Identification No.)

1108 FIFTH AVENUE, SAN RAFAEL, CALIFORNIA 94901

(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code (707) 863-6000

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, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting  
company

(Do not check if a smaller reporting company)

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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 of each of the registrant's classes of common stock, as of the latest practicable date:

| Title of Class                | Shares outstanding as of October 24, 2014 |
|-------------------------------|---|
| Common Stock,<br>No Par Value | 25,886,994                                |

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## FORWARD-LOOKING STATEMENTS

This report on Form 10-Q contains forward-looking statements about Westamerica Bancorporation for which it claims the protection of the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, expenses, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other financial items; (ii) statements of plans, objectives and expectations of the Company or its management or board of directors, including those relating to products or services; (iii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as "believes", "anticipates", "expects", "intends", "targeted", "projected", "continue", "remain", "will", "should", "may" and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

These forward-looking statements are based on Management's current knowledge and belief and include information concerning the Company's possible or assumed future financial condition and results of operations. 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. These factors include but are not limited to (1) the length and severity of difficulties in the global, national and California economies and the effects of government efforts to address those difficulties; (2) liquidity levels in capital markets; (3) fluctuations in asset prices including, but not limited to stocks, bonds, real estate, and commodities; (4) the effect of acquisitions and integration of acquired businesses; (5) economic uncertainty created by terrorist threats and attacks on the United States, the actions taken in response, and the uncertain effect of these events on the national and regional economies; (6) changes in the interest rate environment; (7) changes in the regulatory environment; (8) competitive pressure in the banking industry; (9) operational risks including a failure or breach in data processing systems or those of third party vendors and other service providers, including as a result of cyber attacks or fraud; (10) volatility of interest rate sensitive loans, deposits and investments; (11) asset/liability management risks and liquidity risks; (12) the effect of natural disasters, including earthquakes, fire, flood, drought, and other disasters, on the uninsured value of loan collateral, the financial condition of debtors and issuers of investment securities, the economic conditions affecting the Company's market place, and commodities and asset values, and (13) changes in the securities markets. The reader is directed to the Company's annual report on Form 10-K for the year ended December 31, 2013, for further discussion of factors which could affect the Company's business and cause actual results to differ materially from those expressed in any forward-looking statement made in this report. The Company undertakes no obligation to update any forward-looking statements in this report.

## PART I - FINANCIAL INFORMATION

## Item 1 Financial Statements

WESTAMERICA BANCORPORATION  
CONSOLIDATED BALANCE SHEETS  
(unaudited)

|   | At<br>September<br>30,<br>2014 | At December<br>31,<br>2013 |
|---|--------------------------------|----------------------------|
| (In thousands)  |                                |                            |
| <b>Assets:</b>  |                                |                            |
| Cash and due from banks   | \$524,338                      | \$ 472,028                 |
| Investment securities available for sale  | 1,391,362                      | 1,079,381                  |
| Investment securities held to maturity, with fair values of: \$1,041,385 at September 30, 2014 and \$1,112,676 at December 31, 2013           | 1,035,041                      | 1,132,299                  |
| Loans   | 1,732,382                      | 1,827,744                  |
| Allowance for loan losses   | (31,769 )                      | (31,693 )                  |
| Loans, net of allowance for loan losses   | 1,700,613                      | 1,796,051                  |
| Other real estate owned   | 7,273                          | 13,320                     |
| Premises and equipment, net   | 37,335                         | 37,314                     |
| Identifiable intangibles, net   | 15,338                         | 18,557                     |
| Goodwill  | 121,673                        | 121,673                    |
| Other assets  | 160,752                        | 176,432                    |
| <b>Total Assets</b>   | <b>\$4,993,725</b>             | <b>\$ 4,847,055</b>        |
| <b>Liabilities:</b>   |                                |                            |
| Noninterest bearing deposits  | \$1,893,480                    | \$ 1,740,182               |
| Interest bearing deposits   | 2,428,158                      | 2,423,599                  |
| Total deposits  | 4,321,638                      | 4,163,781                  |
| Short-term borrowed funds   | 76,943                         | 62,668                     |
| Federal Home Loan Bank advances   | 20,156                         | 20,577                     |
| Term repurchase agreement   | -                              | 10,000                     |
| Other liabilities   | 41,593                         | 47,095                     |
| <b>Total Liabilities</b>  | <b>4,460,330</b>               | <b>4,304,121</b>           |
| <b>Shareholders' Equity:</b>  |                                |                            |
| Common stock (no par value), authorized - 150,000 shares Issued and outstanding: 25,906 at September 30, 2014 and 26,510 at December 31, 2013 | 380,195                        | 378,946                    |
| Deferred compensation   | 2,711                          | 2,711                      |
| Accumulated other comprehensive income  | 9,733                          | 4,313                      |
| Retained earnings   | 140,756                        | 156,964                    |
| <b>Total Shareholders' Equity</b>   | <b>533,395</b>                 | <b>542,934</b>             |
| <b>Total Liabilities and Shareholders' Equity</b>   | <b>\$4,993,725</b>             | <b>\$ 4,847,055</b>        |

See accompanying notes to unaudited consolidated financial statements.



WESTAMERICA BANCORPORATION  
CONSOLIDATED STATEMENTS OF INCOME  
(unaudited)

|  | For the Three Months                  |                 | For the Nine Months |                 |
|--|---------------------------------------|-----------------|---------------------|-----------------|
|  | 2014                                  | 2013            | Ended September 30, |                 |
|  | 2014                                  | 2013            | 2014                | 2013            |
|  | (In thousands, except per share data) |                 |                     |                 |
| <b>Interest and Fee Income:</b>                            |                                       |                 |                     |                 |
| Loans  | \$22,129                              | \$25,116        | \$67,817            | \$78,696        |
| Investment securities available for sale                   | 6,350                                 | 5,426           | 17,855              | 16,293          |
| Investment securities held to maturity                     | 6,421                                 | 7,414           | 20,195              | 22,701          |
| <b>Total Interest and Fee Income</b>                       | <b>34,900</b>                         | <b>37,956</b>   | <b>105,867</b>      | <b>117,690</b>  |
| <b>Interest Expense:</b>                                   |                                       |                 |                     |                 |
| Deposits   | 709                                   | 809             | 2,216               | 2,555           |
| Short-term borrowed funds                                  | 23                                    | 20              | 64                  | 58              |
| Term repurchase agreement                                  | 11                                    | 25              | 60                  | 73              |
| Federal Home Loan Bank advances                            | 103                                   | 122             | 304                 | 360             |
| Debt financing   | -                                     | 200             | -                   | 601             |
| <b>Total Interest Expense</b>                              | <b>846</b>                            | <b>1,176</b>    | <b>2,644</b>        | <b>3,647</b>    |
| <b>Net Interest Income</b>                                 | <b>34,054</b>                         | <b>36,780</b>   | <b>103,223</b>      | <b>114,043</b>  |
| Provision for Loan Losses                                  | 600                                   | 1,800           | 2,600               | 6,400           |
| <b>Net Interest Income After Provision For Loan Losses</b> | <b>33,454</b>                         | <b>34,980</b>   | <b>100,623</b>      | <b>107,643</b>  |
| <b>Noninterest Income:</b>                                 |                                       |                 |                     |                 |
| Service charges on deposit accounts                        | 6,207                                 | 6,433           | 18,322              | 19,427          |
| Merchant processing services                               | 1,742                                 | 2,151           | 5,485               | 6,973           |
| Debit card fees  | 1,543                                 | 1,467           | 4,482               | 4,302           |
| Other service fees   | 695                                   | 716             | 2,044               | 2,174           |
| ATM processing fees  | 637                                   | 701             | 1,891               | 2,128           |
| Trust fees   | 629                                   | 567             | 1,899               | 1,720           |
| Financial services commissions                             | 194                                   | 150             | 585                 | 614             |
| Other  | 1,407                                 | 2,234           | 4,534               | 5,643           |
| <b>Total Noninterest Income</b>                            | <b>13,054</b>                         | <b>14,419</b>   | <b>39,242</b>       | <b>42,981</b>   |
| <b>Noninterest Expense:</b>                                |                                       |                 |                     |                 |
| Salaries and related benefits                              | 13,639                                | 13,826          | 41,691              | 42,293          |
| Occupancy  | 3,811                                 | 3,829           | 11,284              | 11,353          |
| Outsourced data processing services                        | 2,093                                 | 2,139           | 6,314               | 6,436           |
| Amortization of identifiable intangibles                   | 1,056                                 | 1,163           | 3,219               | 3,547           |
| Furniture and equipment                                    | 1,059                                 | 974             | 3,070               | 2,875           |
| Professional fees  | 700                                   | 730             | 1,707               | 2,109           |
| Courier service  | 663                                   | 725             | 1,938               | 2,204           |
| Other real estate owned                                    | (287 )                                | 179             | (908 )              | 791             |
| Other  | 3,882                                 | 4,193           | 12,131              | 13,019          |
| <b>Total Noninterest Expense</b>                           | <b>26,616</b>                         | <b>27,758</b>   | <b>80,446</b>       | <b>84,627</b>   |
| <b>Income Before Income Taxes</b>                          | <b>19,892</b>                         | <b>21,641</b>   | <b>59,419</b>       | <b>65,997</b>   |
| Provision for income taxes                                 | 4,738                                 | 4,903           | 13,801              | 14,876          |
| <b>Net Income</b>  | <b>\$15,154</b>                       | <b>\$16,738</b> | <b>\$45,618</b>     | <b>\$51,121</b> |
| <br>   |                                       |                 |                     |                 |
| Average Common Shares Outstanding                          | 25,973                                | 26,670          | 26,192              | 26,900          |
| Diluted Average Common Shares Outstanding                  | 26,016                                | 26,705          | 26,262              | 26,919          |

Per Common Share Data:

|                  |        |        |        |        |
|------------------|--------|--------|--------|--------|
| Basic earnings   | \$0.58 | \$0.63 | \$1.74 | \$1.90 |
| Diluted earnings | 0.58   | 0.63   | 1.74   | 1.90   |
| Dividends paid   | 0.38   | 0.37   | 1.14   | 1.11   |

See accompanying notes to unaudited consolidated financial statements.



WESTAMERICA BANCORPORATION  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(unaudited)

|  | For the Three Months |          | For the Nine Months |           |
|--|----------------------|----------|---------------------|-----------|
|  | Ended September 30,  |          |                     |           |
|  | 2014                 | 2013     | 2014                | 2013      |
|  | (In thousands)       |          |                     |           |
| Net income   | \$15,154             | \$16,738 | \$45,618            | \$51,121  |
| Other comprehensive (loss) income:   |                      |          |                     |           |
| (Decrease) increase in net unrealized gains on securities available for sale             | (4,884 )             | (712 )   | 9,305               | (18,173 ) |
| Deferred tax benefit (expense)   | 2,054                | 299      | (3,912 )            | 7,641     |
| (Decrease) increase in net unrealized gains on securities available for sale, net of tax | (2,830 )             | (413 )   | 5,393               | (10,532 ) |
| Post-retirement benefit transition obligation amortization                               | 15                   | 15       | 45                  | 45        |
| Deferred tax expense   | (6 )                 | (6 )     | (18 )               | (18 )     |
| Post-retirement benefit transition obligation amortization, net of tax                   | 9                    | 9        | 27                  | 27        |
| Total other comprehensive (loss) income  | (2,821 )             | (404 )   | 5,420               | (10,505 ) |
| Total comprehensive income   | \$12,333             | \$16,334 | \$51,038            | \$40,616  |

See accompanying notes to unaudited consolidated financial statements.

WESTAMERICA BANCORPORATION  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
(unaudited)

|  | Common<br>Shares<br>Outstanding | Common<br>Stock | Accumulated<br>Deferred<br>Compensation<br><br>(In thousands) | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Retained<br>Earnings | Total     |
|--|---------------------------------|-----------------|---|--|----------------------|-----------|
| Balance, December 31, 2012                             | 27,213                          | \$ 372,012      | \$ 3,101  | \$ 14,625  | \$ 170,364           | \$560,102 |
| Net income for the period                              |                                 |                 |   |  | 51,121               | 51,121    |
| Other comprehensive loss                               |                                 |                 |   | (10,505 )  |                      | (10,505 ) |
| Exercise of stock options                              | 221                             | 9,219           |   |  |                      | 9,219     |
| Tax benefit decrease upon<br>exercise of stock options |                                 | (202 )          |   |  |                      | (202 )    |
| Restricted stock activity                              | 15                              | 1,068           | (390 )  |  |                      | 678       |
| Stock based compensation                               |                                 | 1,081           |   |  |                      | 1,081     |
| Stock awarded to employees                             | 2                               | 84              |   |  |                      | 84        |
| Retirement of common stock<br>including repurchases    | (873 )                          | (12,174 )       |   |  | (27,615 )            | (39,789 ) |
| Dividends  |                                 |                 |   |  | (29,949 )            | (29,949 ) |
| Balance, September 30, 2013                            | 26,578                          | \$ 371,088      | \$ 2,711  | \$ 4,120   | \$ 163,921           | \$541,840 |
| Balance, December 31, 2013                             | 26,510                          | \$ 378,946      | \$ 2,711  | \$ 4,313   | \$ 156,964           | \$542,934 |
| Net income for the period                              |                                 |                 |   |  | 45,618               | 45,618    |
| Other comprehensive income                             |                                 |                 |   | 5,420  |                      | 5,420     |
| Exercise of stock options                              | 256                             | 12,396          |   |  |                      | 12,396    |
| Tax benefit decrease upon<br>exercise of stock options |                                 | (447 )          |   |  |                      | (447 )    |
| Restricted stock activity                              | 21                              | 1,114           |   |  |                      | 1,114     |
| Stock based compensation                               |                                 | 1,009           |   |  |                      | 1,009     |
| Stock awarded to employees                             | 2                               | 88              |   |  |                      | 88        |
| Retirement of common stock<br>including repurchases    | (883 )                          | (12,911 )       |   |  | (31,899 )            | (44,810 ) |
| Dividends  |                                 |                 |   |  | (29,927 )            | (29,927 ) |
| Balance, September 30, 2014                            | 25,906                          | \$ 380,195      | \$ 2,711  | \$ 9,733   | \$ 140,756           | \$533,395 |

See accompanying notes to unaudited consolidated financial statements.

WESTAMERICA BANCORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)

|  | For the Nine Months<br>Ended September 30, |                  |
|--|--|------------------|
|  | 2014                                       | 2013             |
|  | (In thousands)                             |                  |
| <b>Operating Activities:</b>   |  |                  |
| Net income   | \$45,618                                   | \$51,121         |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |  |                  |
| Depreciation and amortization  | 12,275                                     | 13,325           |
| Loan loss provision  | 2,600                                      | 6,400            |
| Net amortization of deferred loan fees   | (179 )                                     | (333 )           |
| Decrease in interest income receivable   | 1,537                                      | 1,420            |
| Decrease in other assets   | 1,390                                      | 7,344            |
| (Decrease) increase in income taxes payable  | (1,160 )                                   | 856              |
| Increase in net deferred tax asset   | (19 )                                      | (3,719 )         |
| (Decrease) increase in interest expense payable  | (102 )                                     | 50               |
| Decrease in other liabilities  | (3,841 )                                   | (984 )           |
| Stock option compensation expense  | 1,009                                      | 1,081            |
| Tax benefit decrease upon exercise of stock options                                      | 447  | 202              |
| Gain on sale of other assets   | (400 )                                     | (548 )           |
| Net loss on sale of premises and equipment   | 22   | 16               |
| Originations of mortgage loans for resale  | -  | (441 )           |
| Proceeds from sale of mortgage loans originated for resale                               | -  | 447              |
| Net gain on sale of foreclosed assets  | (1,014 )                                   | (892 )           |
| Writedown of foreclosed assets   | 113  | 1,752            |
| <b>Net Cash Provided by Operating Activities</b>   | <b>58,296</b>                              | <b>77,097</b>    |
| <b>Investing Activities:</b>   |  |                  |
| Net repayments of loans  | 93,115                                     | 231,002          |
| Proceeds from FDIC1 loss-sharing indemnification   | 6,703                                      | 6,478            |
| Purchases of investment securities available for sale                                    | (747,630)                                  | (355,440)        |
| Proceeds from sale/maturity/calls of securities available for sale                       | 444,906                                    | 100,660          |
| Purchases of investment securities held to maturity                                      | (26,435 )                                  | (152,116)        |
| Proceeds from maturity/calls of securities held to maturity                              | 115,799                                    | 164,369          |
| Purchases of premises and equipment  | (2,392 )                                   | (1,581 )         |
| Net change in FRB2/FHLB3 securities  | 3,248                                      | 2,243            |
| Proceeds from sale of foreclosed assets  | 7,549                                      | 14,986           |
| <b>Net Cash (Used in) Provided by Investing Activities</b>                               | <b>(105,137)</b>                           | <b>10,601</b>    |
| <b>Financing Activities:</b>   |  |                  |
| Net change in deposits   | 157,947                                    | (123,914)        |
| Net change in short-term borrowings and FHLB3 advances                                   | 3,992                                      | (5,866 )         |
| Exercise of stock options  | 12,396                                     | 9,219            |
| Tax benefit decrease upon exercise of stock options                                      | (447 )                                     | (202 )           |
| Retirement of common stock including repurchases   | (44,810 )                                  | (39,789 )        |
| Common stock dividends paid  | (29,927 )                                  | (29,949 )        |
| <b>Net Cash Provided by (Used in) Financing Activities</b>                               | <b>99,151</b>                              | <b>(190,501)</b> |
| <b>Net Change In Cash and Due from Banks</b>   | <b>52,310</b>                              | <b>(102,803)</b> |
| Cash and Due from Banks at Beginning of Period   | 472,028                                    | 491,382          |

|  |           |           |
|--|-----------|-----------|
| Cash and Due from Banks at End of Period               | \$524,338 | \$388,579 |
| Supplemental Cash Flow Disclosures:                    |           |           |
| Supplemental disclosure of non cash activities:        |           |           |
| Loan collateral transferred to other real estate owned | \$968     | \$5,404   |
| Securities purchases pending settlement                | 2,622     | 1,961     |
| Supplemental disclosure of cash flow activities:       |           |           |
| Interest paid for the period                           | 2,959     | 3,982     |
| Income tax payments for the period                     | 14,981    | 17,931    |

See accompanying notes to unaudited consolidated financial statements.

1 Federal Deposit Insurance Corporation ("FDIC")

2 Federal Reserve Bank ("FRB")

3 Federal Home Loan Bank ("FHLB")

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### Note 1: Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. The results of operations reflect interim adjustments, all of which are of a normal recurring nature and which, in the opinion of Management, are necessary for a fair presentation of the results for the interim periods presented. The interim results for the three and nine months ended September 30, 2014 and 2013 are not necessarily indicative of the results expected for the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes as well as other information included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

The Company has evaluated events and transactions subsequent to the balance sheet date. Based on this evaluation, the Company is not aware of any events or transactions that occurred subsequent to the balance sheet date but prior to filing that would require recognition or disclosure in its unaudited consolidated financial statements.

### Note 2: Accounting Policies

The Company's accounting policies are discussed in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. Certain amounts in prior periods have been reclassified to conform to the current presentation.

Certain accounting policies underlying the preparation of these financial statements require Management to make estimates and judgments. These estimates and judgments may significantly affect reported amounts of assets and liabilities, revenues and expenses, and disclosures of contingent assets and liabilities. Management exercises judgment to estimate the appropriate level of the allowance for credit losses and to evaluate the extent of other than temporary impairment of investment securities, which are discussed in the Company's accounting policies.

### Recently Adopted Accounting Standards

FASB ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, was issued July 2013 to provide guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar loss, or a tax credit carryforward exists. The update provides that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward, unless an exception applies. The adoption of the update did not have a material effect on the Company's financial statements at January 1, 2014, the date adopted.

### Recently Issued Accounting Standards

FASB ASU 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures, was issued on June 12, 2014. The Update improves the financial reporting of repurchase agreements and other similar transactions through a change in accounting for repurchase-to-maturity transactions and repurchase financings, and the introduction of two new disclosure requirements. New disclosures are required for (1) transfers accounted for as sales in transactions that are economically similar to repurchase agreements, in which the transferor retains substantially all of the exposure to the economic return on the transferred financial asset throughout the term of the transaction and (2) repurchase agreements, securities lending transactions, and

repurchase-to-maturity transactions accounted for as secured borrowings about the nature of collateral pledged and the time to maturity of those transactions.

The Company will be required to adhere to new disclosure requirements when the Update is adopted April 1, 2015 for the interim period ending June 30, 2015.

FASB ASU 2014-01, Investments- Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects, was issued January 2014 to permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). For those investments in qualified affordable housing projects not accounted for using the proportional amortization method, the investment should be accounted for as an equity method investment or a cost method investment in accordance with GAAP. The policy election must be applied consistently to all qualified affordable housing project investments.

The update also requires a reporting entity to disclose information regarding its investments in qualified affordable housing projects, and the effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of operations.

Management is evaluating the impact that the change in accounting policy would have on the Company's financial statements. Management does not expect the adoption of this update to have a material effect on the financial statements when adopted on January 1, 2015.

### Note 3: Investment Securities

An analysis of the amortized cost, unrealized gains and losses accumulated in other comprehensive income, and fair value of investment securities available for sale follows:

|  | Investment Securities Available for Sale |            |              |              |
|--|--|------------|--------------|--------------|
|  | At September 30, 2014                    |            |              |              |
|  | Amortized                                | Gross      | Gross        | Fair         |
|  | Cost                                     | Unrealized | Unrealized   | Value        |
|  |  | Gains      | Losses       |              |
|  | (In thousands)                           |            |              |              |
| U.S. Treasury securities                         | \$ 3,499                                 | \$ 10      | \$ -         | \$ 3,509     |
| Securities of U.S. Government sponsored entities | 442,482                                  | 214        | (1,160 )     | 441,536      |
| Residential mortgage-backed securities           | 26,574                                   | 1,799      | (20 )        | 28,353       |
| Commercial mortgage-backed securities            | 3,021                                    | 7          | (7 )         | 3,021        |
| Obligations of states and political subdivisions | 176,614                                  | 10,203     | (197 )       | 186,620      |
| Residential collateralized mortgage obligations  | 240,091                                  | 594        | (11,400 )    | 229,285      |
| Asset-backed securities                          | 8,674                                    | -          | (35 )        | 8,639        |
| FHLMC(1) and FNMA(2) stock                       | 804                                      | 13,798     | -            | 14,602       |
| Corporate securities                             | 470,570                                  | 3,674      | (1,106 )     | 473,138      |
| Other securities                                 | 2,039                                    | 756        | (136 )       | 2,659        |
| Total  | \$ 1,374,368                             | \$ 31,055  | \$ (14,061 ) | \$ 1,391,362 |

(1) Federal Home Loan Mortgage Corporation

(2) Federal National Mortgage Association

An analysis of the amortized cost, unrealized gains and losses, and fair value of investment securities held to maturity follows:

|  | Investment Securities Held to Maturity |            |            |          |
|--|--|------------|------------|----------|
|  | At September 30, 2014                  |            |            |          |
|  | Amortized                              | Gross      | Gross      | Fair     |
|  | Cost                                   | Unrealized | Unrealized | Value    |
|  |  | Gains      | Losses     |          |
|  | (In thousands)                         |            |            |          |
| Securities of U.S. Government sponsored entities | \$ 1,164                               | \$ -       | \$ -       | \$ 1,164 |
| Residential mortgage-backed securities           | 59,182                                 | 926        | (86 )      | 60,022   |
| Total  | 703,554                                | 11,483     | (2,909 )   | 712,128  |

|  |              |           |             |              |
|--|--------------|-----------|-------------|--------------|
| Obligations of states and political subdivisions |              |           |             |              |
| Residential collateralized mortgage obligations  | 271,141      | 1,673     | (4,743 )    | 268,071      |
| Total  | \$ 1,035,041 | \$ 14,082 | \$ (7,738 ) | \$ 1,041,385 |

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An analysis of the amortized cost, unrealized gains and losses accumulated in other comprehensive income, and fair value of investment securities available for sale follows:

|  | Investment Securities Available for Sale |                              |                               |                     |
|--|--|------------------------------|-------------------------------|---------------------|
|  | At December 31, 2013                     |                              |                               |                     |
|  | Amortized<br>Cost                        | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value       |
|  | (In thousands)                           |                              |                               |                     |
| U.S. Treasury securities                         | \$ 3,500                                 | \$ 9                         | \$ (3)                        | \$ 3,506            |
| Securities of U.S. Government sponsored entities | 131,080                                  | 75                           | (663)                         | 130,492             |
| Residential mortgage-backed securities           | 32,428                                   | 1,763                        | (15)                          | 34,176              |
| Commercial mortgage-backed securities            | 3,411                                    | 19                           | (5)                           | 3,425               |
| Obligations of states and political subdivisions | 186,082                                  | 5,627                        | (323)                         | 191,386             |
| Residential collateralized mortgage obligations  | 266,890                                  | 730                          | (14,724)                      | 252,896             |
| Asset-backed securities                          | 14,653                                   | 3                            | (101)                         | 14,555              |
| FHLMC and FNMA stock                             | 804                                      | 12,568                       | -                             | 13,372              |
| Corporate securities                             | 430,794                                  | 2,901                        | (1,264)                       | 432,431             |
| Other securities                                 | 2,049                                    | 1,251                        | (158)                         | 3,142               |
| <b>Total</b>                                     | <b>\$ 1,071,691</b>                      | <b>\$ 24,946</b>             | <b>\$ (17,256)</b>            | <b>\$ 1,079,381</b> |

An analysis of the amortized cost, unrealized gains and losses, and fair value of investment securities held to maturity follows:

|  | Investment Securities Held to Maturity |                              |                               |                     |
|--|--|------------------------------|-------------------------------|---------------------|
|  | At December 31, 2013                   |                              |                               |                     |
|  | Amortized<br>Cost                      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value       |
|  | (In thousands)                         |                              |                               |                     |
| Securities of U.S. Government sponsored entities | \$ 1,601                               | \$ -                         | \$ (4)                        | \$ 1,597            |
| Residential mortgage-backed securities           | 65,076                                 | 854                          | (624)                         | 65,306              |
| Obligations of states and political subdivisions | 756,707                                | 6,211                        | (21,667)                      | 741,251             |
| Residential collateralized mortgage obligations  | 308,915                                | 1,209                        | (5,602)                       | 304,522             |
| <b>Total</b>                                     | <b>\$ 1,132,299</b>                    | <b>\$ 8,274</b>              | <b>\$ (27,897)</b>            | <b>\$ 1,112,676</b> |

The amortized cost and fair value of investment securities by contractual maturity are shown in the following tables at the dates indicated:

| At September 30, 2014            |               |                                |               |
|----------------------------------|---------------|--------------------------------|---------------|
| Securities Available<br>for Sale |               | Securities Held<br>to Maturity |               |
| Amortized<br>Cost                | Fair<br>Value | Amortized<br>Cost              | Fair<br>Value |

(In thousands)

|   |             |             |              |              |
|---|-------------|-------------|--------------|--------------|
| Maturity in years:  |             |             |              |              |
| 1 year or less  | \$45,444    | \$45,671    | \$ 13,767    | \$ 14,233    |
| Over 1 to 5 years   | 625,789     | 629,181     | 216,979      | 220,062      |
| Over 5 to 10 years  | 362,884     | 366,119     | 270,071      | 273,124      |
| Over 10 years   | 67,722      | 72,471      | 203,901      | 205,873      |
| Subtotal  | 1,101,839   | 1,113,442   | 704,718      | 713,292      |
| Mortgage-backed securities and residential collateralized |             |             |              |              |
| mortgage obligations                                      | 269,686     | 260,659     | 330,323      | 328,093      |
| Other securities  | 2,843       | 17,261      | -            | -            |
| Total   | \$1,374,368 | \$1,391,362 | \$ 1,035,041 | \$ 1,041,385 |

Securities available for sale at September 30, 2014 with maturity dates over five years but less than ten years include \$255,634 (fair value) of securities of U.S. Government sponsored entities with call options on dates within one year or less, of which \$89,821 have interest coupons which will increase if the issuer does not exercise the call option.

|  | At December 31, 2013             |               |                                |               |
|--|----------------------------------|---------------|--------------------------------|---------------|
|  | Securities Available<br>for Sale |               | Securities Held<br>to Maturity |               |
|  | Amortized<br>Cost                | Fair<br>Value | Amortized<br>Cost              | Fair<br>Value |
|  | (In thousands)                   |               |                                |               |
| Maturity in years:   |                                  |               |                                |               |
| 1 year or less   | \$75,385                         | \$75,609      | \$ 9,639                       | \$ 9,900      |
| Over 1 to 5 years  | 536,333                          | 538,111       | 187,051                        | 189,827       |
| Over 5 to 10 years   | 66,669                           | 68,166        | 314,630                        | 310,104       |
| Over 10 years  | 87,722                           | 90,484        | 246,988                        | 233,017       |
| Subtotal   | 766,109                          | 772,370       | 758,308                        | 742,848       |
| Mortgage-backed securities and residential collateralized mortgage obligations | 302,729                          | 290,497       | 373,991                        | 369,828       |
| Other securities   | 2,853                            | 16,514        | -                              | -             |
| Total  | \$1,071,691                      | \$1,079,381   | \$ 1,132,299                   | \$ 1,112,676  |

Expected maturities of mortgage-backed securities can differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties. In addition, such factors as prepayments and interest rates may affect the yield on the carrying value of mortgage-backed securities. At September 30, 2014 and December 31, 2013, the Company had no high-risk collateralized mortgage obligations as defined by regulatory guidelines.

An analysis of gross unrealized losses of investment securities available for sale follows:

|  | Investment Securities Available for Sale |                                      |                                   |                                      |                                   |                                      |                                   |                               |
|--|--|--------------------------------------|-----------------------------------|--------------------------------------|-----------------------------------|--------------------------------------|-----------------------------------|-------------------------------|
|  | At September 30, 2014                    |                                      |                                   |                                      |                                   |                                      |                                   |                               |
|  | No.<br>of<br>Investment<br>Positions     | Less than 12 months<br>Fair<br>Value | No. of<br>Investment<br>Positions | 12 months or longer<br>Fair<br>Value | No. of<br>Investment<br>Positions | Total<br>Unrealized<br>Fair<br>Value | No. of<br>Investment<br>Positions | Total<br>Unrealized<br>Losses |
|  | (\$ in thousands)                        |                                      |                                   |                                      |                                   |                                      |                                   |                               |
| Securities of U.S. Government sponsored entities | 24                                       | \$358,842                            | 1                                 | \$9,943                              | 25                                | \$368,785                            |                                   |                               |
| Residential mortgage-backed securities           | -  | -                                    | 2                                 | 828                                  | 2                                 | 828                                  |                                   |                               |
| Commercial mortgage-backed securities            | -  | -                                    | 2                                 | 1,822                                | 2                                 | 1,822                                |                                   |                               |
| Obligations of states and political subdivisions | 8  | 2,783                                | 21                                | 6,460                                | 29                                | 9,243                                |                                   |                               |
| Residential collateralized mortgage obligations  | -  | -                                    | 38                                | 209,504                              | 38                                | 209,504                              |                                   |                               |
| Asset-backed securities                          | 1  | 5,030                                | 1                                 | 3,609                                | 2                                 | 8,639                                |                                   |                               |
| Corporate securities                             | 31                                       | 93,716                               | 5                                 | 34,218                               | 36                                | 127,934                              |                                   |                               |

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|                  |    |           |            |    |           |             |     |           |             |
|------------------|----|-----------|------------|----|-----------|-------------|-----|-----------|-------------|
| Other securities | -  | -         | -          | 1  | 1,864     | (136 )      | 1   | 1,864     | (136 )      |
| Total            | 64 | \$460,371 | \$(1,922 ) | 71 | \$268,248 | \$(12,139 ) | 135 | \$728,619 | \$(14,061 ) |

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An analysis of gross unrealized losses of investment securities held to maturity follows:

| Investment Securities Held to Maturity<br>At September 30, 2014 |                                   |   |                      |                                   |                                      |                      |                                   |                   |                               |
|---|-----------------------------------|---|----------------------|-----------------------------------|--------------------------------------|----------------------|-----------------------------------|-------------------|-------------------------------|
|   | No. of<br>Investment<br>Positions | Less than 12<br>months<br>Fair<br>Value | Unrealized<br>Losses | No. of<br>Investment<br>Positions | 12 months or longer<br>Fair<br>Value | Unrealized<br>Losses | No. of<br>Investment<br>Positions | Fair<br>Value     | Total<br>Unrealized<br>Losses |
|   | (\$ in thousands)                 |   |                      |                                   |                                      |                      |                                   |                   |                               |
| Securities of U.S. Government sponsored entities                | 1                                 | \$ 1,164                                | \$ -                 | -                                 | \$-                                  | \$ -                 | 1                                 | \$1,164           | \$ -                          |
| Residential mortgage-backed securities                          | 2                                 | 9,658                                   | (48 )                | 2                                 | 3,320                                | (38 )                | 4                                 | 12,978            | (86 )                         |
| Obligations of states and political subdivisions                | 14                                | 10,434                                  | (45 )                | 180                               | 162,095                              | (2,864 )             | 194                               | 172,529           | (2,909 )                      |
| Residential collateralized mortgage obligations                 | 15                                | 63,098                                  | (787 )               | 23                                | 132,175                              | (3,956 )             | 38                                | 195,273           | (4,743 )                      |
| <b>Total</b>  | <b>32</b>                         | <b>\$ 84,354</b>                        | <b>\$ (880 )</b>     | <b>205</b>                        | <b>\$ 297,590</b>                    | <b>\$ (6,858 )</b>   | <b>237</b>                        | <b>\$ 381,944</b> | <b>\$ (7,738 )</b>            |

The unrealized losses on the Company's investment securities were caused by market conditions for these types of investments, particularly changes in risk-free interest rates. The Company evaluates securities on a quarterly basis including changes in security ratings issued by ratings agencies, changes in the financial condition of the issuer, and, for mortgage-related and asset-backed securities, delinquency and loss information with respect to the underlying collateral, changes in the levels of subordination for the Company's particular position within the repayment structure and remaining credit enhancement as compared to expected credit losses of the security. Substantially all of these securities continue to be investment grade rated by a major rating agency. In addition to monitoring credit rating agency evaluations, Management performs its own evaluations regarding the credit worthiness of the issuer or the securitized assets underlying asset backed securities.

The Company does not intend to sell any investments and has concluded that it is more likely than not that it will not be required to sell the investments prior to recovery of the amortized cost basis. Therefore, the Company does not consider these investments to be other-than-temporarily impaired as of September 30, 2014.

The fair values of the investment securities could decline in the future if the general economy deteriorates, inflation increases, credit ratings decline, the issuer's financial condition deteriorates, or the liquidity for securities declines. As a result, other than temporary impairments may occur in the future.

As of September 30, 2014, \$773,297 thousand of investment securities were pledged to secure public deposits, short-term borrowed funds and FHLB advances. As of December 31, 2013, \$778,588 thousand of investment securities were pledged to secure public deposits, short-term borrowed funds, FHLB advances and term repurchase agreements.

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An analysis of gross unrealized losses of investment securities available for sale follows:

|  | Investment Securities Available for Sale<br>At December 31, 2013 |   |                                   |                                      |   |  |                                   |               |                               |
|--|--|---|-----------------------------------|--------------------------------------|---|--|-----------------------------------|---------------|-------------------------------|
|  | No.<br>of<br>Investment<br>Positions                             | Less than<br>12 months<br>Fair<br>Value | 12 months<br>Unrealized<br>Losses | No.<br>of<br>Investment<br>Positions | 12 months or<br>longer<br>Fair<br>Value | 12 months or<br>longer<br>Unrealized<br>Losses | No. of<br>Investment<br>Positions | Fair<br>Value | Total<br>Unrealized<br>Losses |
|  | (\$ in thousands)  |   |                                   |                                      |   |  |                                   |               |                               |
| U.S.<br>Treasury securities                            | 1  | \$2,994                                 | \$ (3 )                           | -                                    | \$-                                     | \$ -   | 1                                 | \$2,994       | \$ (3 )                       |
| Securities of<br>U.S. Government sponsored<br>entities | 15   | 91,669                                  | (663 )                            | -                                    | -                                       | -  | 15                                | 91,669        | (663 )                        |
| Residential<br>mortgage-backed<br>securities           | 3  | 864                                     | (15 )                             | -                                    | -                                       | -  | 3                                 | 864           | (15 )                         |
| Commercial<br>mortgage-backed<br>securities            | 1  | 1,072                                   | (5 )                              | -                                    | -                                       | -  | 1                                 | 1,072         | (5 )                          |
| Obligations of<br>states and<br>political subdivisions | 35   | 17,516                                  | (222 )                            | 11                                   | 3,214                                   | (101 )   | 46                                | 20,730        | (323 )                        |
| Residential collateralized<br>mortgage obligations     | 34   | 187,848                                 | (12,326 )                         | 6                                    | 40,575                                  | (2,398 )                                       | 40                                | 228,423       | (14,724 )                     |
| Asset-backed securities                                | 1  | 5,002                                   | (1 )                              | 1                                    | 4,475                                   | (100 )   | 2                                 | 9,477         | (101 )                        |
| Corporate securities                                   | 25   | 117,751                                 | (1,087 )                          | 2                                    | 9,824                                   | (177 )   | 27                                | 127,575       | (1,264 )                      |
| Other securities                                       | -  | -                                       | -                                 | 1                                    | 1,842                                   | (158 )   | 1                                 | 1,842         | (158 )                        |
| Total  | 115  | \$424,716                               | \$ (14,322 )                      | 21                                   | \$59,930                                | \$ (2,934 )                                    | 136                               | \$484,646     | \$ (17,256 )                  |

An analysis of gross unrealized losses of investment securities held to maturity follows:

|  | Investment Securities Held to Maturity<br>At December 31, 2013 |   |                                   |                                   |   |  |                                   |               |                               |
|--|--|---|-----------------------------------|-----------------------------------|---|--|-----------------------------------|---------------|-------------------------------|
|  | No.<br>of<br>Investment<br>Positions                           | Less than<br>12 months<br>Fair<br>Value | 12 months<br>Unrealized<br>Losses | No. of<br>Investment<br>Positions | 12 months or<br>longer<br>Fair<br>Value | 12 months or<br>longer<br>Unrealized<br>Losses | No. of<br>Investment<br>Positions | Fair<br>Value | Total<br>Unrealized<br>Losses |
|  | (\$ in thousands)  |   |                                   |                                   |   |  |                                   |               |                               |
| Securities of<br>U.S. Government sponsored<br>entities | 1  | \$1,597                                 | \$ (4 )                           | -                                 | \$-                                     | \$ -   | 1                                 | \$1,597       | \$ (4 )                       |
| Residential mortgage-backed<br>securities              | 13   | 38,396                                  | (616 )                            | 1                                 | 392                                     | (8 )   | 14                                | 38,788        | (624 )                        |
| Obligations of<br>states and<br>political subdivisions | 530  | 355,797                                 | (14,893 )                         | 64                                | 64,427                                  | (6,774 )                                       | 594                               | 420,224       | (21,667 )                     |
|  | 42   | 214,981                                 | (5,175 )                          | 5                                 | 14,120                                  | (427 )   | 47                                | 229,101       | (5,602 )                      |

Residential collateralized  
mortgage obligations

|       |     |           |            |    |          |           |     |           |            |
|-------|-----|-----------|------------|----|----------|-----------|-----|-----------|------------|
| Total | 586 | \$610,771 | \$(20,688) | 70 | \$78,939 | \$(7,209) | 656 | \$689,710 | \$(27,897) |
|-------|-----|-----------|------------|----|----------|-----------|-----|-----------|------------|

The unrealized losses on the Company's investment securities were caused by market conditions for these types of investments, particularly rising risk-free interest rates causing bond prices to decline.

The following table provides information about the amount of interest income earned on investment securities that is fully taxable and that is exempt from regular federal income tax:

|  | For the Three Months |          | For the Nine Months |          |
|--|----------------------|----------|---------------------|----------|
|  | 2014                 | 2013     | 2014                | 2013     |
|  | Ended September 30,  |          |                     |          |
|  | (In thousands)       |          |                     |          |
| Taxable  | \$6,348              | \$5,502  | \$17,907            | \$16,626 |
| Tax-exempt                                       | 6,423                | 7,338    | 20,143              | 22,368   |
| Total interest income from investment securities | \$12,771             | \$12,840 | \$38,050            | \$38,994 |



## Note 4: Loans and Allowance for Credit Losses

The FDIC indemnification expired February 6, 2014 for County Bank non-single-family residential collateralized purchased loans; accordingly, such loans have been reclassified from purchased covered loans to purchased non-covered loans.

A summary of the major categories of loans outstanding is shown in the following tables.

| At September 30, 2014             |            |                        |              |                         |                              |             |
|-----------------------------------|------------|------------------------|--------------|-------------------------|------------------------------|-------------|
|                                   | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment & Other | Total       |
| (In thousands)                    |            |                        |              |                         |                              |             |
| Originated loans                  | \$370,060  | \$ 573,179             | \$ 9,824     | \$ 156,794              | \$ 379,708                   | \$1,489,565 |
| Purchased covered loans:          |            |                        |              |                         |                              |             |
| Gross purchased covered loans     | -          | -                      | -            | 2,905                   | 15,119                       | 18,024      |
| Credit risk discount              | -          | -                      | -            | (434 )                  | (67 )                        | (501 )      |
| Purchased non-covered loans:      |            |                        |              |                         |                              |             |
| Gross purchased non-covered loans | 20,318     | 167,052                | 2,931        | 979                     | 44,247                       | 235,527     |
| Credit risk discount              | (1,460 )   | (7,060 )               | (50 )        | (262 )                  | (1,401 )                     | (10,233 )   |
| Total                             | \$388,918  | \$ 733,171             | \$ 12,705    | \$ 159,982              | \$ 437,606                   | \$1,732,382 |

| At December 31, 2013              |            |                        |              |                         |                              |             |
|-----------------------------------|------------|------------------------|--------------|-------------------------|------------------------------|-------------|
|                                   | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment & Other | Total       |
| (In thousands)                    |            |                        |              |                         |                              |             |
| Originated loans                  | \$338,824  | \$ 596,653             | \$ 10,723    | \$ 176,196              | \$ 400,888                   | \$1,523,284 |
| Purchased covered loans:          |            |                        |              |                         |                              |             |
| Gross purchased covered loans     | 20,066     | 175,562                | 3,223        | 8,558                   | 54,194                       | 261,603     |
| Credit risk discount              | (1,530 )   | (8,122 )               | (50 )        | (434 )                  | (797 )                       | (10,933 )   |
| Purchased non-covered loans:      |            |                        |              |                         |                              |             |
| Gross purchased non-covered loans | 7,525      | 35,712                 | -            | 999                     | 12,799                       | 57,035      |
| Credit risk discount              | (726 )     | (786 )                 | -            | (262 )                  | (1,471 )                     | (3,245 )    |
| Total                             | \$364,159  | \$ 799,019             | \$ 13,896    | \$ 185,057              | \$ 465,613                   | \$1,827,744 |

Changes in the carrying amount of impaired purchased loans were as follows:

|                          | For the<br>Nine Months<br>Ended<br>September 30,<br>2014 | For the Year Ended<br>December 31, 2013 |
|--------------------------|--|---|
| Impaired purchased loans |  | (In thousands)                          |

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|  |          |    |          |
|--|----------|----|----------|
| Carrying amount at the beginning of the period | \$ 4,936 | \$ | 14,629   |
| Reductions during the period                   | (292 )   |    | (9,693 ) |
| Carrying amount at the end of the period       | \$ 4,644 | \$ | 4,936    |

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Changes in the accretable yield for purchased loans were as follows:

|  | For the<br>Nine Months<br>Ended<br>September 30,<br>2014 | For the<br>Year Ended<br>December 31, 2013 |
|--|--|--|
| (In thousands)                                 |  |  |
| Accretable yield:                              |  |  |
| Balance at the beginning of the period         | \$ 2,505   | \$ 4,948                                   |
| Reclassification from nonaccretable difference | 3,513  | 12,504                                     |
| Accretion                                      | (3,287 )   | (14,947 )                                  |
| Balance at the end of the period               | \$ 2,731   | \$ 2,505                                   |
| Accretion                                      | \$ (3,287 )  | \$ (14,947 )                               |
| Reduction in FDIC indemnification asset        | 278  | 11,438                                     |
| (Increase) in interest income                  | \$ (3,009 )  | \$ (3,509 )                                |

The following summarizes activity in the allowance for credit losses:

| Allowance for Credit Losses                     |                              |                                      |                               |                             |  |                               |             |          |          |
|---|------------------------------|--------------------------------------|-------------------------------|-----------------------------|--|-------------------------------|-------------|----------|----------|
| For the Three Months Ended September 30, 2014   |                              |                                      |                               |                             |  |                               |             |          |          |
| Consumer  |                              |                                      |                               |                             |  |                               |             |          |          |
|   | Commercial<br>Real<br>Estate | Commercial<br>Estate<br>Construction | Residential<br>Real<br>Estate | Installment<br>and<br>Other | Purchased<br>and<br>Non-covered<br>Loans | Purchased<br>Covered<br>Loans | Unallocated | Total    |          |
| (In thousands)                                  |                              |                                      |                               |                             |  |                               |             |          |          |
| Allowance for loan losses:                      |                              |                                      |                               |                             |  |                               |             |          |          |
| Balance at beginning of period                  | \$5,297                      | \$10,664                             | \$442                         | \$409                       | \$2,055                                  | \$2,707                       | \$-         | \$10,824 | \$32,398 |
| Additions:                                      |                              |                                      |                               |                             |  |                               |             |          |          |
| Provision                                       | (269 )                       | (640 )                               | -                             | (17 )                       | 802                                      | (184 )                        | -           | 908      | 600      |
| Deductions:                                     |                              |                                      |                               |                             |  |                               |             |          |          |
| Chargeoffs                                      | (905 )                       | -                                    | -                             | -                           | (916 )                                   | -                             | -           | -        | (1,821 ) |
| Recoveries                                      | 229                          | 15                                   | -                             | -                           | 297                                      | 51                            | -           | -        | 592      |
| Net loan (losses) recoveries                    | (676 )                       | 15                                   | -                             | -                           | (619 )                                   | 51                            | -           | -        | (1,229 ) |
| Balance at end of period                        | 4,352                        | 10,039                               | 442                           | 392                         | 2,238                                    | 2,574                         | -           | 11,732   | 31,769   |
| Liability for off-balance sheet credit exposure | 1,706                        | 24                                   | 105                           | -                           | 451                                      | 131                           | -           | 276      | 2,693    |
| Total allowance for credit losses               | \$6,058                      | \$10,063                             | \$547                         | \$392                       | \$2,689                                  | \$2,705                       | \$-         | \$12,008 | \$34,462 |

| Allowance for Credit Losses                  |                              |                                      |                               |                             |  |                               |             |         |          |
|--|------------------------------|--------------------------------------|-------------------------------|-----------------------------|--|-------------------------------|-------------|---------|----------|
| For the Nine Months Ended September 30, 2014 |                              |                                      |                               |                             |  |                               |             |         |          |
| Consumer                                     |                              |                                      |                               |                             |  |                               |             |         |          |
|  | Commercial<br>Real<br>Estate | Commercial<br>Estate<br>Construction | Residential<br>Real<br>Estate | Installment<br>and<br>Other | Purchased<br>and<br>Non-covered<br>Loans | Purchased<br>Covered<br>Loans | Unallocated | Total   |          |
| (In thousands)                               |                              |                                      |                               |                             |  |                               |             |         |          |
| Allowance for loan losses:                   |                              |                                      |                               |                             |  |                               |             |         |          |
| Balance at beginning of period               | \$4,005                      | \$12,070                             | \$602                         | \$405                       | \$3,198                                  | \$-                           | \$1,561     | \$9,852 | \$31,693 |
| Additions:                                   |                              |                                      |                               |                             |  |                               |             |         |          |
| Provision                                    | 945                          | (2,224 )                             | (163 )                        | 17                          | 942                                      | 1,203                         | -           | 1,880   | 2,600    |

|   |         |          |       |       |         |         |         |          |          |
|---|---------|----------|-------|-------|---------|---------|---------|----------|----------|
| Deductions:                                     |         |          |       |       |         |         |         |          |          |
| Chargeoffs                                      | (1,114) | -        | -     | (30)  | (3,217) | (260)   | -       | -        | (4,621)  |
| Recoveries                                      | 516     | 193      | 3     | -     | 1,315   | 70      | -       | -        | 2,097    |
| Net loan recoveries (losses)                    | (598)   | 193      | 3     | (30)  | (1,902) | (190)   | -       | -        | (2,524)  |
| Indemnification expiration                      | -       | -        | -     | -     | -       | 1,561   | (1,561) | -        | -        |
| Balance at end of period                        | 4,352   | 10,039   | 442   | 392   | 2,238   | 2,574   | -       | 11,732   | 31,769   |
| Liability for off-balance sheet credit exposure |         |          |       |       |         |         |         |          |          |
|   | 1,706   | 24       | 105   | -     | 451     | 131     | -       | 276      | 2,693    |
| Total allowance for credit losses               | \$6,058 | \$10,063 | \$547 | \$392 | \$2,689 | \$2,705 | \$-     | \$12,008 | \$34,462 |

Allowance for Credit Losses  
For the Three Months Ended September 30, 2013

Consumer

|                | Commercial<br>Real<br>Estate | Commercial<br>Estate<br>Construction | Residential<br>Real<br>Estate | Installments<br>and<br>Other | Purchased<br>Non-covered<br>Loans | Purchased<br>Covered<br>Loans | Unallocated | Total |
|----------------|------------------------------|--------------------------------------|-------------------------------|------------------------------|-----------------------------------|-------------------------------|-------------|-------|
| (In thousands) |                              |                                      |                               |                              |                                   |                               |             |       |

|   |         |          |       |       |         |     |         |          |          |
|---|---------|----------|-------|-------|---------|-----|---------|----------|----------|
| Allowance for loan losses:                      |         |          |       |       |         |     |         |          |          |
| Balance at beginning of period                  | \$4,384 | \$11,275 | \$478 | \$532 | \$2,603 | \$- | \$285   | \$11,369 | \$30,926 |
| Additions:                                      |         |          |       |       |         |     |         |          |          |
| Provision                                       | 102     | 447      | 53    | (104) | 1,154   | -   | 1,300   | (1,152)  | 1,800    |
| Deductions:                                     |         |          |       |       |         |     |         |          |          |
| Chargeoffs                                      | (637)   | (117)    | -     | -     | (909)   | -   | (79)    | -        | (1,742)  |
| Recoveries                                      | 326     | 30       | -     | -     | 516     | -   | 60      | -        | 932      |
| Net loan losses                                 | (311)   | (87)     | -     | -     | (393)   | -   | (19)    | -        | (810)    |
| Balance at end of period                        | 4,175   | 11,635   | 531   | 428   | 3,364   | -   | 1,566   | 10,217   | 31,916   |
| Liability for off-balance sheet credit exposure |         |          |       |       |         |     |         |          |          |
|   | 1,613   | -        | 103   | -     | 483     | -   | -       | 494      | 2,693    |
| Total allowance for credit losses               | \$5,788 | \$11,635 | \$634 | \$428 | \$3,847 | \$- | \$1,566 | \$10,711 | \$34,609 |

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Allowance for Credit Losses  
For the Nine Months Ended September 30, 2013

|   | Consumer       |            |              |             |                 |           |           |             |          |
|---|----------------|------------|--------------|-------------|-----------------|-----------|-----------|-------------|----------|
|   | Commercial     | Commercial | Residential  | Residential | Installation    | Purchased | Purchased | Unallocated | Total    |
|   | Real           | Estate     | Real         | Estate      | and Non-covered | Loans     | Loans     |             |          |
|   | Commercial     | Estate     | Construction | Estate      | Other           | Loans     | Loans     | Unallocated | Total    |
|   | (In thousands) |            |              |             |                 |           |           |             |          |
| Allowance for loan losses:                      |                |            |              |             |                 |           |           |             |          |
| Balance at beginning of period                  | \$6,445        | \$10,063   | \$484        | \$380       | \$3,194         | \$-       | \$1,005   | \$8,663     | \$30,234 |
| Additions:                                      |                |            |              |             |                 |           |           |             |          |
| Provision                                       | (667 )         | 2,100      | 47           | 157         | 1,660           | 116       | 1,433     | 1,554       | 6,400    |
| Deductions:                                     |                |            |              |             |                 |           |           |             |          |
| Chargeoffs                                      | (2,687)        | (656 )     | -            | (109)       | (3,114)         | (116)     | (955 )    | -           | (7,637 ) |
| Recoveries                                      | 1,084          | 128        | -            | -           | 1,624           | -         | 83        | -           | 2,919    |
| Net loan losses                                 | (1,603)        | (528 )     | -            | (109)       | (1,490)         | (116)     | (872 )    | -           | (4,718 ) |
| Balance at end of period                        | 4,175          | 11,635     | 531          | 428         | 3,364           | -         | 1,566     | 10,217      | 31,916   |
| Liability for off-balance sheet credit exposure |                |            |              |             |                 |           |           |             |          |
|   | 1,613          | -          | 103          | -           | 483             | -         | -         | 494         | 2,693    |
| Total allowance for credit losses               | \$5,788        | \$11,635   | \$634        | \$428       | \$3,847         | \$-       | \$1,566   | \$10,711    | \$34,609 |

The allowance for credit losses and recorded investment in loans were evaluated for impairment as follows:

Allowance for Credit Losses and Recorded Investment in Loans Evaluated for Impairment  
At September 30, 2014

|   | Consumer       |            |              |             |                 |           |           |             |       |
|---|----------------|------------|--------------|-------------|-----------------|-----------|-----------|-------------|-------|
|   | Commercial     | Commercial | Residential  | Residential | Installation    | Purchased | Purchased | Unallocated | Total |
|   | Real           | Estate     | Real         | Estate      | and Non-covered | Loans     | Loans     |             |       |
|   | Commercial     | Estate     | Construction | Estate      | Other           | Loans     | Loans     | Unallocated | Total |
|   | (In thousands) |            |              |             |                 |           |           |             |       |
| Allowance for credit losses:                          |                |            |              |             |                 |           |           |             |       |
| Individually evaluated for impairment                 | \$-            | \$-        | \$-          | \$-         | \$-             | \$892     | \$-       | \$-         | \$-   |
| Collectively evaluated for impairment                 | 6,058          | 10,063     | 547          | 392         | 2,689           | 1,813     | -         | 12,008      |       |
| Purchased loans with evidence of credit deterioration |                |            |              |             |                 |           |           |             |       |
| Total   | \$6,058        | \$10,063   | \$547        | \$392       | \$2,689         | \$2,705   | \$-       | \$12,008    |       |
| Carrying value of loans:                              |                |            |              |             |                 |           |           |             |       |
| Individually evaluated for impairment                 | \$2,714        | \$3,037    | \$-          | \$-         | \$-             | \$13,118  | \$-       | \$-         | \$-   |
| Collectively evaluated for impairment                 | 367,346        | 570,142    | 9,824        | 156,794     | 379,708         | 207,764   | 17,291    | -           |       |
| Purchased loans with evidence of credit deterioration |                |            |              |             |                 |           |           |             |       |
| Total   | \$370,060      | \$573,179  | \$9,824      | \$156,794   | \$379,708       | \$225,294 | \$17,523  | \$-         |       |

Allowance for Credit Losses and Recorded Investment in Loans Evaluated for Impairment  
At December 31, 2013

|                              | Consumer       |            |              |             |                 |           |           |             |       |
|------------------------------|----------------|------------|--------------|-------------|-----------------|-----------|-----------|-------------|-------|
|                              | Commercial     | Commercial | Residential  | Residential | Installation    | Purchased | Purchased | Unallocated | Total |
|                              | Real           | Estate     | Real         | Estate      | and Non-covered | Loans     | Loans     |             |       |
|                              | Commercial     | Estate     | Construction | Estate      | Other           | Loans     | Loans     | Unallocated | Total |
|                              | (In thousands) |            |              |             |                 |           |           |             |       |
| Allowance for credit losses: |                |            |              |             |                 |           |           |             |       |

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|   |           |           |          |           |           |          |           |          |
|---|-----------|-----------|----------|-----------|-----------|----------|-----------|----------|
| Individually evaluated for impairment                 | \$100     | \$1,243   | \$-      | \$-       | \$-       | \$-      | \$153     | \$-      |
| Collectively evaluated for impairment                 | 5,563     | 10,827    | 639      | 405       | 3,695     | -        | 1,408     | 10,353   |
| Purchased loans with evidence of credit deterioration | -         | -         | -        | -         | -         | -        | -         | -        |
| Total   | \$5,663   | \$12,070  | \$639    | \$405     | \$3,695   | \$-      | \$1,561   | \$10,353 |
| Carrying value of loans:                              |           |           |          |           |           |          |           |          |
| Individually evaluated for impairment                 | \$3,901   | \$3,357   | \$-      | \$-       | \$-       | \$3,785  | \$9,999   | \$-      |
| Collectively evaluated for impairment                 | 334,923   | 593,296   | 10,723   | 176,196   | 400,888   | 47,571   | 238,169   | -        |
| Purchased loans with evidence of credit deterioration | -         | -         | -        | -         | -         | 2,434    | 2,502     | -        |
| Total   | \$338,824 | \$596,653 | \$10,723 | \$176,196 | \$400,888 | \$53,790 | \$250,670 | \$-      |

The Bank's customers are small businesses, professionals and consumers. Given the scale of these borrowers, corporate credit rating agencies do not evaluate the borrowers' financial condition. The Bank maintains a Loan Review Department which reports directly to the Board of Directors. The Loan Review Department performs independent evaluations of loans and assigns credit risk grades to evaluated loans using grading standards employed by bank regulatory agencies. Loans judged to carry lower-risk attributes are assigned a "pass" grade, with a minimal likelihood of loss. Loans judged to carry higher-risk attributes are referred to as "classified loans," and are further disaggregated, with increasing expectations for loss recognition, as "substandard," "doubtful," and "loss." Loan Review Department evaluations occur every calendar quarter. If the Bank becomes aware of deterioration in a borrower's performance or financial condition between Loan Review Department examinations, assigned risk grades are re-evaluated promptly. Credit risk grades assigned by the Loan Review Department are subject to review by the Bank's regulatory authorities during regulatory examinations.

The following summarizes the credit risk profile by internally assigned grade:

Credit Risk Profile by Internally Assigned Grade  
At September 30, 2014

| Grade:               | Commercial       |                   |                 | Residential       | Consumer               | Purchased         | Purchased         | Total              |
|----------------------|------------------|-------------------|-----------------|-------------------|------------------------|-------------------|-------------------|--------------------|
|                      | Commercial       | Real Estate       | Construction    | Real Estate       | Installation and Other | Non-covered Loans | Covered Loans (1) |                    |
|                      | (In thousands)   |                   |                 |                   |                        |                   |                   |                    |
| Pass                 | \$363,911        | \$ 530,115        | \$ 9,824        | \$ 154,759        | \$ 378,677             | \$ 194,451        | \$ 15,953         | \$1,647,690        |
| Substandard          | 6,136            | 43,064            | -               | 2,035             | 680                    | 40,717            | 2,071             | 94,703             |
| Doubtful             | 13               | -                 | -               | -                 | 13                     | 337               | -                 | 363                |
| Loss                 | -                | -                 | -               | -                 | 338                    | 22                | -                 | 360                |
| Credit risk discount | -                | -                 | -               | -                 | -                      | (10,233 )         | (501 )            | (10,734 )          |
| <b>Total</b>         | <b>\$370,060</b> | <b>\$ 573,179</b> | <b>\$ 9,824</b> | <b>\$ 156,794</b> | <b>\$ 379,708</b>      | <b>\$ 225,294</b> | <b>\$ 17,523</b>  | <b>\$1,732,382</b> |

(1) Credit risk profile reflects internally assigned grade of purchased covered loans without regard to FDIC indemnification.

Credit Risk Profile by Internally Assigned Grade  
At December 31, 2013

| Grade:               | Commercial       |                   |                  | Residential       | Consumer               | Purchased         | Purchased         | Total              |
|----------------------|------------------|-------------------|------------------|-------------------|------------------------|-------------------|-------------------|--------------------|
|                      | Commercial       | Real Estate       | Construction     | Real Estate       | Installation and Other | Non-covered Loans | Covered Loans (1) |                    |
|                      | (In thousands)   |                   |                  |                   |                        |                   |                   |                    |
| Pass                 | \$329,667        | \$ 554,991        | \$ 10,274        | \$ 174,113        | \$ 399,377             | \$ 41,490         | \$ 196,882        | \$1,706,794        |
| Substandard          | 8,142            | 41,662            | 449              | 2,083             | 1,127                  | 14,587            | 64,624            | 132,674            |
| Doubtful             | 1,015            | -                 | -                | -                 | 19                     | 958               | 97                | 2,089              |
| Loss                 | -                | -                 | -                | -                 | 365                    | -                 | -                 | 365                |
| Credit risk discount | -                | -                 | -                | -                 | -                      | (3,245 )          | (10,933 )         | (14,178 )          |
| <b>Total</b>         | <b>\$338,824</b> | <b>\$ 596,653</b> | <b>\$ 10,723</b> | <b>\$ 176,196</b> | <b>\$ 400,888</b>      | <b>\$ 53,790</b>  | <b>\$ 250,670</b> | <b>\$1,827,744</b> |

(1) Credit risk profile reflects internally assigned grade of purchased covered loans without regard to FDIC indemnification.

The following tables summarize loans by delinquency and nonaccrual status:

Summary of Loans by Delinquency and Nonaccrual Status  
At September 30, 2014

|                        | Current and Accruing | 30-59 Days Past Due and Accruing | 60-89 Days Past Due and Accruing | Past Due 90 days or More and Accruing | Nonaccrual | Total Loans |
|------------------------|----------------------|----------------------------------|----------------------------------|---------------------------------------|------------|-------------|
|                        |                      |                                  |                                  |                                       |            |             |
| Commercial             | \$ 368,428           | \$ 723                           | \$ 414                           | \$ -                                  | \$ 495     | \$ 370,060  |
| Commercial real estate | 563,817              | 3,679                            | 1,469                            | -                                     | 4,214      | 573,179     |

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|                                |              |           |          |        |           |              |
|--------------------------------|--------------|-----------|----------|--------|-----------|--------------|
| Construction                   | 8,894        | -         | 930      | -      | -         | 9,824        |
| Residential real estate        | 152,538      | 2,659     | 1,597    | -      | -         | 156,794      |
| Consumer installment and other | 375,971      | 2,936     | 459      | 342    | -         | 379,708      |
| Total originated loans         | 1,469,648    | 9,997     | 4,869    | 342    | 4,709     | 1,489,565    |
| Purchased non-covered loans    | 209,775      | 891       | 1,255    | 76     | 13,297    | 225,294      |
| Purchased covered loans        | 17,224       | -         | 4        | -      | 295       | 17,523       |
| Total                          | \$ 1,696,647 | \$ 10,888 | \$ 6,128 | \$ 418 | \$ 18,301 | \$ 1,732,382 |

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## Summary of Loans by Delinquency and Nonaccrual Status

At December 31, 2013

|                                | Current and<br>Accruing | 30-59<br>Days Past<br>Due and<br>Accruing | 60-89<br>Days<br>Past Due<br>and<br>Accruing | Past Due<br>90 days<br>or More<br>and<br>Accruing | Nonaccrual | Total Loans  |
|--------------------------------|-------------------------|---|--|---|------------|--------------|
| (In thousands)                 |                         |   |  |   |            |              |
| Commercial                     | \$ 336,497              | \$ 677                                    | \$ 383                                       | \$ -  | \$ 1,267   | \$ 338,824   |
| Commercial real estate         | 586,619                 | 4,012                                     | 2,473  | -   | 3,549      | 596,653      |
| Construction                   | 10,275                  | -   | -  | -   | 448        | 10,723       |
| Residential real estate        | 173,082                 | 2,789                                     | 325  | -   | -          | 176,196      |
| Consumer installment and other | 396,725                 | 3,035                                     | 606  | 410   | 112        | 400,888      |
| Total originated loans         | 1,503,198               | 10,513                                    | 3,787  | 410   | 5,376      | 1,523,284    |
| Purchased non-covered loans    | 45,755                  | 4,237                                     | 180  | -   | 3,618      | 53,790       |
| Purchased covered loans        | 236,577                 | 845                                       | 940  | -   | 12,308     | 250,670      |
| Total                          | \$ 1,785,530            | \$ 15,595                                 | \$ 4,907                                     | \$ 410  | \$ 21,302  | \$ 1,827,744 |

The following is a summary of the effect of nonaccrual loans on interest income:

|   | For the Three<br>Months |       | For the Nine Months |         |
|---|-------------------------|-------|---------------------|---------|
|   | Ended September 30,     |       |                     |         |
|   | 2014                    | 2013  | 2014                | 2013    |
| (In thousands)  |                         |       |                     |         |
| Interest income that would have been recognized had the loans performed in accordance with their original terms | \$298                   | \$502 | \$833               | \$1,405 |
| Net interest income reversed (recognized) on nonaccrual loans   | 15                      | (20)  | (55)                | (113)   |
| Total reduction of interest income  | \$313                   | \$482 | \$778               | \$1,292 |

There were no commitments to lend additional funds to borrowers whose loans were on nonaccrual status at September 30, 2014 and December 31, 2013.

The following summarizes impaired loans:

|  | Impaired Loans<br>At September 30, 2014 |                                |                      |
|--|---|--------------------------------|----------------------|
|  | Recorded<br>Investment                  | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| (In thousands)                                     |   |                                |                      |
| Impaired loans with no related allowance recorded: |   |                                |                      |
| Commercial   | \$ 3,389                                | \$ 3,563                       | \$ -                 |
| Commercial real estate                             | 13,463                                  | 16,044                         | -                    |
| Construction                                       | 1,834                                   | 1,884                          | -                    |
| Consumer installment and other                     | 1,183                                   | 1,332                          | -                    |
| Impaired loans with an allowance recorded:         |   |                                |                      |
| Commercial   | 259                                     | 259                            | 259                  |
| Commercial real estate                             | 6,330                                   | 9,796                          | 633                  |

|                                |          |          |        |
|--------------------------------|----------|----------|--------|
| Total:                         |          |          |        |
| Commercial                     | \$ 3,648 | \$ 3,822 | \$ 259 |
| Commercial real estate         | 19,793   | 25,840   | 633    |
| Construction                   | 1,834    | 1,884    | -      |
| Consumer installment and other | 1,183    | 1,332    | -      |

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|  | Impaired Loans<br>At December 31, 2013 |  |                      |
|--|--|--|----------------------|
|  | Recorded<br>Investment                 | Unpaid<br>Principal<br>Balance<br>(In thousands) | Related<br>Allowance |
| Impaired loans with no related allowance recorded: |  |  |                      |
| Commercial   | \$ 3,931                               | \$ 4,498   | \$ -                 |
| Commercial real estate                             | 11,002                                 | 13,253   | -                    |
| Construction                                       | 2,483                                  | 2,947  | -                    |
| Consumer installment and other                     | 2,014                                  | 2,133  | -                    |
| Impaired loans with an allowance recorded:         |  |  |                      |
| Commercial   | 1,000                                  | 2,173  | 100                  |
| Commercial real estate                             | 9,773                                  | 12,482   | 1,396                |
| Total:   |  |  |                      |
| Commercial   | \$ 4,931                               | \$ 6,671   | \$ 100               |
| Commercial real estate                             | 20,775                                 | 25,735   | 1,396                |
| Construction                                       | 2,483                                  | 2,947  | -                    |
| Consumer installment and other                     | 2,014                                  | 2,133  | -                    |

Impaired loans include troubled debt restructured loans. Impaired loans at September 30, 2014, included \$5,907 thousand of restructured loans, including \$711 thousand that were on nonaccrual status. Impaired loans at December 31, 2013, included \$5,453 thousand of restructured loans, including \$529 thousand that were on nonaccrual status.

|                                   | Impaired Loans                           |                                   |                                  |                                   |   |                                   |                                  |        |
|-----------------------------------|--|-----------------------------------|----------------------------------|-----------------------------------|---|-----------------------------------|----------------------------------|--------|
|                                   | For the Three Months Ended September 30, |                                   |                                  |                                   | For the Nine Months Ended September 30, |                                   |                                  |        |
|                                   | 2014                                     |                                   | 2013                             |                                   | 2014                                    |                                   | 2013                             |        |
| Average<br>Recorded<br>Investment | Recognized<br>Interest<br>Income         | Average<br>Recorded<br>Investment | Recognized<br>Interest<br>Income | Average<br>Recorded<br>Investment | Recognized<br>Interest<br>Income        | Average<br>Recorded<br>Investment | Recognized<br>Interest<br>Income |        |
| (In thousands)                    |  |                                   |                                  |                                   |   |                                   |                                  |        |
| Commercial                        | \$3,885                                  | \$ 59                             | \$ 9,977                         | \$ 35                             | \$4,388                                 | \$ 186                            | \$ 11,726                        | \$ 141 |
| Commercial real estate            | 20,787                                   | 103                               | 27,714                           | 129                               | 19,961                                  | 373                               | 27,795                           | 634    |
| Construction                      | 1,934                                    | -                                 | 2,660                            | 29                                | 2,076                                   | -                                 | 2,389                            | 80     |
| Residential real estate           | -  | -                                 | 207                              | -                                 | 108                                     | -                                 | 483                              | -      |
| Consumer installment and other    | 1,207                                    | 7                                 | 1,054                            | 8                                 | 1,416                                   | 22                                | 1,359                            | 23     |
| Total                             | \$27,813                                 | \$ 169                            | \$ 41,612                        | \$ 201                            | \$27,949                                | \$ 581                            | \$ 43,752                        | \$ 878 |

The following table provides information on troubled debt restructurings:

| Troubled Debt Restructurings<br>At September 30, 2014 |                                    |                              |                          |
|---|------------------------------------|------------------------------|--------------------------|
| Number<br>of  | Pre-Modification<br>Carrying Value | Period-End<br>Carrying Value | Period-End<br>Individual |

|                                | Contracts |    |       | (In thousands) |       | Impairment Allowance |
|--------------------------------|-----------|----|-------|----------------|-------|----------------------|
| Commercial                     | 6         | \$ | 3,465 | \$             | 3,109 | \$ 259               |
| Commercial real estate         | 3         |    | 2,754 |                | 2,787 | -                    |
| Consumer installment and other | 1         |    | 18    |                | 11    | -                    |
| Total                          | 10        | \$ | 6,237 | \$             | 5,907 | \$ 259               |

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Troubled Debt Restructurings  
At September 30, 2013

|                        | Number<br>of<br>Contracts | Pre-Modification<br>Carrying Value | Period-End<br>Carrying Value<br>(In thousands) | Period-End<br>Individual<br>Impairment<br>Allowance |
|------------------------|---------------------------|------------------------------------|--|---|
| Commercial             | 4                         | \$ 1,991                           | \$ 1,689                                       | \$ -  |
| Commercial real estate | 3                         | 6,295                              | 5,849  | 394   |
| Total                  | 7                         | \$ 8,286                           | \$ 7,538                                       | \$ 394  |

During the three and nine months ended September 30, 2014, the Company modified three loans with a total carrying value of \$617 thousand and five loans with a total carrying value of \$726 thousand, respectively, that were considered troubled debt restructurings. The concessions granted in the five restructurings completed in the first nine months of 2014 consisted of modification of payment terms to extend the maturity date to allow for deferred principal repayment. During the three and nine months ended September 30, 2014, no troubled debt restructured loans defaulted.

During the three months ended September 30, 2013, no loans were modified that were considered troubled debt restructurings. During the nine months ended September 30, 2013, the Company modified four loans with a total carrying value of \$3,019 thousand that were considered troubled debt restructurings. The concessions granted in the four restructurings completed in the first nine months of 2013 consisted of modification of payment terms to lower the interest rate and extend the maturity date to allow for deferred principal repayment. During the three months and nine months ended September 30, 2013, no troubled debt restructurings and one commercial real estate loan with a carrying value of \$3,954 thousand defaulted, respectively. A troubled debt restructuring is considered to be in default when payments are 90 days or more past due.

The Company pledges loans to secure borrowings from the Federal Home Loan Bank of San Francisco (FHLB). The carrying value of the FHLB advances was \$20,156 thousand and \$20,577 thousand at September 30, 2014 and December 31, 2013, respectively. The loans restricted due to collateral requirements approximated \$20,374 thousand and \$24,242 thousand at September 30, 2014 and December 31, 2013, respectively. The FHLB does not have the right to sell or repledge such loans.

There were no loans held for sale at September 30, 2014 and December 31, 2013.

#### Note 5: Concentration of Credit Risk

The Company's business activity is with customers in Northern and Central California. The loan portfolio is well diversified within the Company's geographic market, although the Company has significant credit arrangements that are secured by real estate collateral. In addition to real estate loans outstanding as disclosed in Note 4, the Company had loan commitments and standby letters of credit related to real estate loans of \$65,965 thousand and \$62,277 thousand at September 30, 2014 and December 31, 2013, respectively. The Company requires collateral on all real estate loans with loan-to-value ratios at origination generally no greater than 75% on commercial real estate loans and no greater than 80% on residential real estate loans.

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## Note 6: Other Assets

Other assets consisted of the following:

|                                      | At<br>September<br>30,<br>2014 | At December 31,<br>2013 |
|--------------------------------------|--------------------------------|-------------------------|
|                                      | (In thousands)                 |                         |
| Cost method equity investments:      |                                |                         |
| Federal Reserve Bank stock (1)       | \$ 14,069                      | \$ 14,069               |
| Federal Home Loan Bank stock (2)     | 940                            | 4,188                   |
| Other investments                    | 286                            | 376                     |
| Total cost method equity investments | 15,295                         | 18,633                  |
| Life insurance cash surrender value  | 45,583                         | 43,896                  |
| Net deferred tax asset               | 48,873                         | 53,281                  |
| Limited partnership investments      | 16,802                         | 18,198                  |
| Interest receivable                  | 17,388                         | 18,925                  |
| FDIC indemnification receivable      | -                              | 4,032                   |
| Prepaid assets                       | 5,123                          | 5,229                   |
| Other assets                         | 11,688                         | 14,238                  |
| Total other assets                   | \$ 160,752                     | \$ 176,432              |

(1) A bank applying for membership in the Federal Reserve System is required to subscribe to stock in the Federal Reserve Bank of San Francisco (FRB) in a sum equal to six percent of the bank's paid-up capital stock and surplus. One-half of the amount of the bank's subscription shall be paid to the FRB and the remaining half will be subject to call when deemed necessary by the Board of Governors of the Federal Reserve System.

(2) Borrowings from the FHLB must be supported by capital stock holdings. The minimum activity-based requirement is 4.7% of the outstanding advances. The requirement may be adjusted from time to time by the FHLB within limits established in the FHLB's Capital Plan.

## Note 7: Goodwill and Identifiable Intangible Assets

The Company has recorded goodwill and other identifiable intangibles associated with purchase business combinations. Goodwill is not amortized, but is periodically evaluated for impairment. The Company did not recognize impairment during the nine months ended September 30, 2014 and year ended December 31, 2013. Identifiable intangibles are amortized to their estimated residual values over their expected useful lives. Such lives and residual values are also periodically reassessed to determine if any amortization period adjustments are indicated. During the nine months ended September 30, 2014 and year ended December 31, 2013, no such adjustments were recorded.

The carrying values of goodwill were:

|          | At<br>September<br>30,<br>2014 | At December 31,<br>2013 |
|----------|--------------------------------|-------------------------|
|          | (In thousands)                 |                         |
| Goodwill | \$ 121,673                     | \$ 121,673              |

The gross carrying amount of identifiable intangible assets and accumulated amortization was:

|                                      | At September 30, 2014       |                             | At December 31, 2013        |                             |
|--------------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                                      | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |
|                                      | (In thousands)              |                             |                             |                             |
| Core Deposit Intangibles             | \$56,808                    | \$ (42,215 )                | \$ 56,808                   | \$ (39,242 )                |
| Merchant Draft Processing Intangible | 10,300                      | (9,555 )                    | 10,300                      | (9,309 )                    |
| Total Identifiable Intangible Assets | \$67,108                    | \$ (51,770 )                | \$ 67,108                   | \$ (48,551 )                |



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As of September 30, 2014, the current year and estimated future amortization expense for identifiable intangible assets was:

|   | Core<br>Deposit<br>Intangibles | Merchant<br>Draft<br>Processing<br>Intangible | Total   |
|---|--------------------------------|---|---------|
|   | (In thousands)                 |   |         |
| Nine months ended September 30, 2014 (actual) | \$2,973                        | \$ 246  | \$3,219 |
| Estimate for year ended December 31, 2014     | 3,946                          | 324   | 4,270   |
| 2015  | 3,594                          | 262   | 3,856   |
| 2016  | 3,292                          | 212   | 3,504   |
| 2017  | 2,913                          | 164   | 3,077   |
| 2018  | 1,892                          | 29  | 1,921   |
| 2019  | 538                            | -   | 538     |

Note 8: Deposits and Borrowed Funds

The following table provides additional detail regarding deposits:

|                     | Deposits                    |                         |
|---------------------|-----------------------------|-------------------------|
|                     | At<br>September<br>30, 2014 | At December 31,<br>2013 |
|                     | (In thousands)              |                         |
| Noninterest-bearing | \$1,893,480                 | \$ 1,740,182            |
| Interest-bearing:   |                             |                         |
| Transaction         | 775,377                     | 763,088                 |
| Savings             | 1,231,640                   | 1,167,744               |
| Time                | 421,141                     | 492,767                 |
| Total deposits      | \$4,321,638                 | \$ 4,163,781            |

Demand deposit overdrafts of \$2,775 thousand and \$3,002 thousand were included as loan balances at September 30, 2014 and December 31, 2013, respectively. Interest expense for aggregate time deposits with individual account balances in excess of \$100 thousand was \$219 thousand and \$683 thousand in the third quarter and first nine months of 2014, respectively and \$257 thousand and \$843 thousand in the third quarter and first nine months of 2013, respectively.

Short-term borrowed funds of \$76,943 thousand and \$62,668 thousand at September 30, 2014 and December 31, 2013, respectively, represent securities sold under agreements to repurchase the securities. As the Company is obligated to repurchase the securities, the transfer of the securities is accounted for as a secured borrowing rather than a sale. Securities sold under repurchase agreements are held in the custody of independent securities brokers. The carrying amount of the securities approximates \$164,062 thousand and \$113,902 thousand at September 30, 2014 and December 31, 2013, respectively. The short-term borrowed funds mature on an overnight basis.

Federal Home Loan Bank (“FHLB”) advances with a carrying value of \$20,156 thousand at September 30, 2014 and \$20,577 thousand at December 31, 2013 are secured by residential real estate loans and securities. The amount of such loans and securities approximates \$28,686 thousand at September 30, 2014 and \$32,953 thousand at December 31, 2013. The FHLB advances are due in full at par value upon their maturity dates: \$20,000 thousand mature in January 2015. The FHLB advances may be paid off prior to such maturity dates subject to prepayment fees.

The term repurchase agreement matured and was repaid in full in August 2014. At December 31, 2013, the carrying value of the term repurchase agreement was \$10,000 thousand, representing securities sold under an agreement to repurchase the securities. The Company accounted for the transfer of the securities as a secured borrowing rather than a sale due to its obligation to repurchase the securities. At December 31, 2013, the carrying amount of the related securities was approximately \$11,278 thousand, which were held in the custody of independent securities brokers.

The Company has a \$35,000 thousand unsecured line of credit which had no outstanding balance at September 30, 2014 and December 31, 2013. The line of credit has a variable interest rate, which was 2.0% per annum at September 30, 2014, with interest payable monthly on outstanding advances. Advances may be made up to the unused credit limit through March 18, 2015.

#### Note 9: Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Available for sale investment securities 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 other real estate owned, impaired loans, certain loans held for investment, investment securities held to maturity, and other assets. These nonrecurring fair value adjustments typically involve the lower-of-cost-or-fair value accounting of individual assets.

In accordance with the Fair Value Measurement and Disclosure topic of the Codification, the Company bases its fair values on the price that would be received to sell an asset or paid to transfer a liability in the principal market or most advantageous market for an asset or liability in an orderly transaction between market participants on the measurement date under current market conditions. A fair value measurement reflects all of the assumptions that market participants would use in pricing the 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.

The Company groups its assets and liabilities measured at fair value into a three-level hierarchy, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. When the valuation assumptions used to measure the fair value of the asset or liability are categorized within different levels of the fair value hierarchy, the asset or liability is categorized in its entirety within the lowest level of the hierarchy. These levels are:

Level 1 – Valuation is based upon quoted prices for identical instruments traded in active exchange markets, such as the New York Stock Exchange. Level 1 includes U.S. Treasury, equity and federal agency securities, which are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

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 2 includes mortgage-backed securities, corporate securities, asset-backed securities, municipal bonds and residential collateralized mortgage obligations.

Level 3 – Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company's 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.

The Company relies on independent vendor pricing services to measure fair value for investment securities available for sale and investment securities held to maturity. The Company employs three pricing services. To validate the pricing of these vendors, the Company routinely randomly samples securities and compares vendors' pricing for each of the sampled securities for consistency; significant pricing differences, if any, are evaluated using all available independent quotes with the lowest quote generally used as the fair value estimate. In addition, the Company conducts "other than temporary impairment (OTTI)" analysis on a quarterly basis; securities selected for OTTI analysis include all securities at a market price below 95 percent of par value and with a market to book ratio below 95:100. As with any valuation technique used to estimate fair value, changes in underlying assumptions used could significantly affect the results of current and future values. Accordingly, these fair value estimates may not be realized in an actual sale of the securities.

When the Company changes its valuation assumptions for measuring financial assets and financial liabilities at fair value, either due to changes in current market conditions or other factors, it may need to transfer those assets or

liabilities to another level in the hierarchy based on the new assumptions used. The Company recognizes these transfers at the end of the reporting period that the transfers occur. For the nine months ended September 30, 2014 and year ended December 31, 2013, there were no transfers in or out of levels 1, 2 or 3.

## Assets Recorded at Fair Value on a Recurring Basis

The table below presents assets measured at fair value on a recurring basis.

|  | Fair Value  | At September 30, 2014   |   |  |
|--|-------------|---|---|--|
|  |             | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (In thousands)                                   |             |   |   |  |
| U.S. Treasury securities                         | \$3,509     | \$3,509   | \$ -  | \$ -   |
| Securities of U.S. Government sponsored entities | 441,536     | 441,536   | -   | -  |
| Residential mortgage-backed securities           | 28,353      | -   | 28,353  | -  |
| Commercial mortgage-backed securities            | 3,021       | -   | 3,021   | -  |
| Obligations of states and political subdivisions | 186,620     | -   | 186,620   | -  |
| Residential collateralized mortgage obligations  | 229,285     | -   | 229,285   | -  |
| Asset-backed securities                          | 8,639       | -   | 8,639   | -  |
| FHLMC and FNMA stock                             | 14,602      | 14,602  | -   | -  |
| Corporate securities                             | 473,138     | -   | 473,138   | -  |
| Other securities                                 | 2,659       | 795   | 1,864   | -  |
| Total securities available for sale              | \$1,391,362 | \$460,442   | \$ 930,920  | \$ -   |

|  | Fair Value  | At December 31, 2013  |   |  |
|--|-------------|---|---|--|
|  |             | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (In thousands)                                   |             |   |   |  |
| U.S. Treasury securities                         | \$3,506     | \$3,506   | \$ -  | \$ -   |
| Securities of U.S. Government sponsored entities | 130,492     | 130,492   | -   | -  |
| Residential mortgage-backed securities           | 34,176      | -   | 34,176  | -  |
| Commercial mortgage-backed securities            | 3,425       | -   | 3,425   | -  |
| Obligations of states and political subdivisions | 191,386     | -   | 191,386   | -  |
| Residential collateralized mortgage obligations  | 252,896     | -   | 252,896   | -  |
| Asset-backed securities                          | 14,555      | -   | 14,555  | -  |
| FHLMC and FNMA stock                             | 13,372      | 13,372  | -   | -  |
| Corporate securities                             | 432,431     | -   | 432,431   | -  |
| Other securities                                 | 3,142       | 1,300   | 1,842   | -  |
| Total securities available for sale              | \$1,079,381 | \$148,670   | \$ 930,711  | \$ -   |

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## Assets Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower-of-cost or fair-value accounting of individual assets. For assets measured at fair value on a nonrecurring basis that were recorded in the balance sheet at September 30, 2014 and December 31, 2013, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related assets at period end.

|   | At September 30, 2014 |       |          |         | For the<br>Nine Months Ended<br>September 30, 2014 |                |
|---|-----------------------|-------|----------|---------|--|----------------|
|   | Fair<br>Value         | Level |          |         | Total Losses                                       |                |
|   |                       | 1     | Level 2  | Level 3 |  |                |
|   |                       |       |          |         |  |                |
|   |                       |       |          |         |  | (In thousands) |
| Other real estate owned                                     | \$7,273               | \$-   | \$7,273  | \$-     | \$   | (43 )          |
| Impaired loans  | 7,475                 | -     | 6,700    | 775     |  | (260 )         |
| Total assets measured at fair value on a nonrecurring basis | \$14,748              | \$-   | \$13,973 | \$775   | \$   | (303 )         |

|   | At December 31, 2013 |       |          |         | For the<br>Year Ended<br>December 31, 2013 |                |
|---|----------------------|-------|----------|---------|--|----------------|
|   | Fair<br>Value        | Level |          |         | Total Losses                               |                |
|   |                      | 1     | Level 2  | Level 3 |  |                |
|   |                      |       |          |         |  |                |
|   |                      |       |          |         |  | (In thousands) |
| Other real estate owned                                     | \$13,320             | \$-   | \$13,320 | \$-     | \$   | (814 )         |
| Impaired loans  | 9,672                | -     | 7,967    | 1,705   |  | (233 )         |
| Total assets measured at fair value on a nonrecurring basis | \$22,992             | \$-   | \$21,287 | \$1,705 | \$   | (1,047 )       |

Level 2 – Valuation is based upon independent market prices or appraised value of the collateral, less 10% for selling costs, generally. Level 2 includes other real estate owned that has been measured at fair value upon transfer to foreclosed assets and impaired loans collateralized by real property where a specific reserve has been established or a charge-off has been recorded. Losses on other real estate owned represent losses recognized in earnings during the period subsequent to its initial classification as foreclosed assets.

Level 3 – Valuation is based upon estimated liquidation values of loan collateral. The value of level 3 assets can also include a component of real estate, which is valued as described for level 2 inputs, when collateral for the impaired loan includes both business assets and real estate. Level 3 includes impaired loans where a specific reserve has been established or a charge-off has been recorded.

## Disclosures about Fair Value of Financial Instruments

The following section describes the valuation methodologies used by the Company for estimating fair value of financial instruments not recorded at fair value in the balance sheet.

**Cash and Due from Banks** Cash and due from banks represent U.S. dollar denominated coin and currency, deposits at the Federal Reserve Bank and correspondent banks, and amounts being settled with other banks to complete the processing of customers' daily transactions. Collectively, the Federal Reserve Bank and financial institutions operate in a market in which cash and due from banks transactions are processed continuously in significant daily volumes

honoring the face value of the U.S. dollar.

**Investment Securities Held to Maturity** The fair values of investment securities were estimated using quoted prices as described above for Level 1 and Level 2 valuation.

**Loans** Loans were separated into two groups for valuation. Variable rate loans, except for those described below, which reprice frequently with changes in market rates were valued using historical cost. Fixed rate loans and variable rate loans that have reached their minimum contractual interest rates were valued by discounting the future cash flows expected to be received from the loans using current interest rates charged on loans with similar characteristics. Additionally, the allowance for loan losses of \$31,769 thousand at September 30, 2014 and \$31,693 thousand at December 31, 2013 and the fair value discount due to credit default risk associated with purchased covered and purchased non-covered loans of \$501 thousand and \$10,233 thousand, respectively at September 30, 2014 and purchased covered and purchased non-covered loans of \$10,933 thousand and \$3,245 thousand, respectively at December 31, 2013 were applied against the estimated fair values to recognize estimated future defaults of contractual cash flows. The Company does not consider these values to be a liquidation price for the loans.



**FDIC Indemnification Receivable** The fair value of the FDIC indemnification receivable recorded in Other Assets was estimated by discounting estimated future cash flows using current market rates for financial instruments with similar characteristics.

**Deposit Liabilities** Deposits with no stated maturity such as checking accounts, savings accounts and money market accounts can be readily converted to cash or used to settle transactions at face value through the broad financial system operated by the Federal Reserve Bank and financial institutions. The fair value of deposits with no stated maturity is equal to the amount payable on demand. The fair values of time deposits were estimated by discounting estimated future contractual cash flows using current market rates for financial instruments with similar characteristics.

**Short-Term Borrowed Funds** The carrying amount of securities sold under agreement to repurchase and other short-term borrowed funds approximate fair value due to the relatively short period of time between their origination and their expected realization.

**Federal Home Loan Bank Advances** The fair values of FHLB advances were estimated by using redemption amounts quoted by the Federal Home Loan Bank of San Francisco.

**Term Repurchase Agreement** The fair value of the term repurchase agreement was estimated by using interpolated yields for financial instruments with similar characteristics.

The table below is a summary of fair value estimates for financial instruments and the level of the fair value hierarchy within which the fair value measurements are categorized, excluding financial instruments recorded at fair value on a recurring basis. The values assigned do not necessarily represent amounts which ultimately may be realized for assets or paid to settle liabilities. In addition, these values do not give effect to adjustments to fair value which may occur when financial instruments are sold or settled in larger quantities. The carrying amounts in the following table are recorded in the balance sheet under the indicated captions.

The Company has not included assets and liabilities that are not financial instruments, such as goodwill, long-term relationships with deposit, merchant processing and trust customers, other purchased intangibles, premises and equipment, deferred taxes and other assets and liabilities. The total estimated fair values do not represent, and should not be construed to represent, the underlying value of the Company.

|  | At September 30, 2014 |                      |  |   |   |
|--|-----------------------|----------------------|--|---|---|
|  | Carrying Amount       | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (In thousands)                         |                       |                      |  |   |   |
| <b>Financial Assets:</b>               |                       |                      |  |   |   |
| Cash and due from banks                | \$524,338             | \$524,338            | \$524,338  | \$-   | \$-                                       |
| Investment securities held to maturity | 1,035,041             | 1,041,385            | 1,164  | 1,040,221                                     | -   |
| Loans                                  | 1,700,613             | 1,701,539            | -  | -   | 1,701,539                                 |
| <b>Financial Liabilities:</b>          |                       |                      |  |   |   |
| Deposits                               | \$4,321,638           | \$4,319,692          | \$-  | \$3,900,497                                   | \$419,195                                 |
| Short-term borrowed funds              | 76,943                | 76,943               | -  | 76,943  | -   |

|                                 |        |        |        |   |   |
|---------------------------------|--------|--------|--------|---|---|
| Federal Home Loan Bank advances | 20,156 | 20,161 | 20,161 | - | - |
|---------------------------------|--------|--------|--------|---|---|

|   | At December 31, 2013 |             |           |             |              |
|---|----------------------|-------------|-----------|-------------|--------------|
|   | Carrying             | Estimated   | Quoted    | Significant | Significant  |
|   | Amount               | Fair Value  | Prices in | Other       | Unobservable |
|   |                      |             | Active    | Inputs      | Inputs       |
|   |                      |             | Markets   | (Level 2)   | (Level 3)    |
|   |                      |             | for       |             |              |
|   |                      |             | Identical | Observable  |              |
|   |                      |             | Assets    | (Level 2)   |              |
|   |                      |             | (Level 1) |             |              |
| (In thousands)                                    |                      |             |           |             |              |
| <b>Financial Assets:</b>                          |                      |             |           |             |              |
| Cash and due from banks                           | \$472,028            | \$472,028   | \$472,028 | \$-         | \$-          |
| Investment securities held to maturity            | 1,132,299            | 1,112,676   | 1,597     | 1,111,079   | -            |
| Loans   | 1,796,051            | 1,800,625   | -         | -           | 1,800,625    |
| Other assets - FDIC indemnification<br>receivable | 4,032                | 4,032       | -         | -           | 4,032        |
| <b>Financial Liabilities:</b>                     |                      |             |           |             |              |
| Deposits  | \$4,163,781          | \$4,162,935 | \$-       | \$3,671,014 | \$491,921    |
| Short-term borrowed funds                         | 62,668               | 62,668      | -         | 62,668      | -            |
| Federal Home Loan Bank advances                   | 20,577               | 20,558      | 20,558    | -           | -            |
| Term repurchase agreement                         | 10,000               | 10,054      | -         | 10,054      | -            |

The majority of the Company's standby letters of credit and other commitments to extend credit carry current market interest rates if converted to loans. No premium or discount was ascribed to these commitments because virtually all funding would be at current market rates.

#### Note 10: Commitments and Contingent Liabilities

Loan commitments are agreements to lend to a customer provided there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future funding requirements. Loan commitments are subject to the Company's normal credit policies and collateral requirements. Unfunded loan commitments were \$314,937 thousand and \$320,934 thousand at September 30, 2014 and December 31, 2013, respectively. Standby letters of credit commit the Company to make payments on behalf of customers when certain specified future events occur. Standby letters of credit are primarily issued to support customers' short-term financing requirements and must meet the Company's normal credit policies and collateral requirements. Financial and performance standby letters of credit outstanding totaled \$28,652 thousand and \$31,777 thousand at September 30, 2014 and December 31, 2013, respectively. The Company also had commitments for commercial and similar letters of credit of \$40 thousand at September 30, 2014 and \$344 thousand at December 31, 2013.

Due to the nature of its business, the Company is subject to various threatened or filed legal cases. Based on the advice of legal counsel, the Company does not expect such cases will have a material, adverse effect on its financial position or results of operations. Legal liabilities are accrued when obligations become probable and the amount is reasonably estimable.

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## Note 11: Earnings Per Common Share

The table below shows earnings per common share and diluted earnings per common share. Basic earnings per common share are computed by dividing net income by the average number of common shares outstanding during the period. Diluted earnings per common share are computed by dividing net income by the average number of common shares outstanding during the period plus the impact of common stock equivalents.

|  | For the Three Months                  |          | For the Nine Months |          |
|--|---------------------------------------|----------|---------------------|----------|
|  | Ended September 30,                   |          |                     |          |
|  | 2014                                  | 2013     | 2014                | 2013     |
|  | (In thousands, except per share data) |          |                     |          |
| Net income (numerator)   | \$15,154                              | \$16,738 | \$45,618            | \$51,121 |
| Basic earnings per common share  |                                       |          |                     |          |
| Weighted average number of common shares outstanding - basic (denominator)   | 25,973                                | 26,670   | 26,192              | 26,900   |
| Basic earnings per common share  | \$0.58                                | \$0.63   | \$1.74              | \$1.90   |
| Diluted earnings per common share  |                                       |          |                     |          |
| Weighted average number of common shares outstanding - basic                 | 25,973                                | 26,670   | 26,192              | 26,900   |
| Add common stock equivalents for options                                     | 43                                    | 35       | 70                  | 19       |
| Weighted average number of common shares outstanding - diluted (denominator) | 26,016                                | 26,705   | 26,262              | 26,919   |
| Diluted earnings per common share  | \$0.58                                | \$0.63   | \$1.74              | \$1.90   |

For the three and nine months ended September 30, 2014, options to purchase 1,322 thousand and 1,060 thousand shares of common stock, respectively, were outstanding but not included in the computation of diluted net income per share because the option exercise price exceeded the fair value of the stock such that their inclusion would have had an anti-dilutive effect.

For the three and nine months ended September 30, 2013, options to purchase 1,356 thousand and 1,979 thousand shares of common stock, respectively, were outstanding but not included in the computation of diluted net income per share because the option exercise price exceeded the fair value of the stock such that their inclusion would have had an anti-dilutive effect.

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WESTAMERICA BANCORPORATION  
FINANCIAL SUMMARY

|   | For the Three Months                  |             | For the Nine Months |             |       |   |       |   |
|---|---------------------------------------|-------------|---------------------|-------------|-------|---|-------|---|
|   | Ended September 30,                   |             | 2014                |             |       |   |       |   |
|   | 2014                                  | 2013        | 2014                | 2013        |       |   |       |   |
|   | (In thousands, except per share data) |             |                     |             |       |   |       |   |
| Net Interest and Fee Income (FTE)1        | \$37,905                              | \$41,224    | \$115,351           | \$127,687   |       |   |       |   |
| Provision for Loan Losses                 | 600                                   | 1,800       | 2,600               | 6,400       |       |   |       |   |
| Noninterest Income                        | 13,054                                | 14,419      | 39,242              | 42,981      |       |   |       |   |
| Noninterest Expense                       | 26,616                                | 27,758      | 80,446              | 84,627      |       |   |       |   |
| Income Before Income Taxes (FTE)1         | 23,743                                | 26,085      | 71,547              | 79,641      |       |   |       |   |
| Income Tax Provision (FTE)1               | 8,589                                 | 9,347       | 25,929              | 28,520      |       |   |       |   |
| Net Income                                | \$15,154                              | \$16,738    | \$45,618            | \$51,121    |       |   |       |   |
| Average Common Shares Outstanding         | 25,973                                | 26,670      | 26,192              | 26,900      |       |   |       |   |
| Diluted Average Common Shares Outstanding | 26,016                                | 26,705      | 26,262              | 26,919      |       |   |       |   |
| Common Shares Outstanding at Period End   | 25,906                                | 26,578      |                     |             |       |   |       |   |
| <b>Per Common Share:</b>                  |                                       |             |                     |             |       |   |       |   |
| Basic Earnings                            | \$0.58                                | \$0.63      | \$1.74              | \$1.90      |       |   |       |   |
| Diluted Earnings                          | 0.58                                  | 0.63        | 1.74                | 1.90        |       |   |       |   |
| Book Value                                | \$20.59                               | \$20.39     |                     |             |       |   |       |   |
| <b>Financial Ratios:</b>                  |                                       |             |                     |             |       |   |       |   |
| Return on Assets                          | 1.21                                  | %           | 1.37                | %           | 1.24  | % | 1.41  | % |
| Return on Common Equity                   | 11.55                                 | %           | 12.42               | %           | 11.59 | % | 12.70 | % |
| Net Interest Margin (FTE)1                | 3.66                                  | %           | 4.01                | %           | 3.75  | % | 4.13  | % |
| Net Loan Losses to Average Loans          | 0.28                                  | %           | 0.17                | %           | 0.19  | % | 0.32  | % |
| Efficiency Ratio2                         | 52.2                                  | %           | 49.9                | %           | 52.0  | % | 49.6  | % |
| <b>Average Balances:</b>                  |                                       |             |                     |             |       |   |       |   |
| Assets                                    | \$4,971,808                           | \$4,830,475 | \$4,923,705         | \$4,859,473 |       |   |       |   |
| Earning Assets                            | 4,125,835                             | 4,093,727   | 4,111,364           | 4,125,407   |       |   |       |   |
| Loans                                     | 1,760,115                             | 1,902,389   | 1,794,513           | 1,990,937   |       |   |       |   |
| Deposits                                  | 4,303,389                             | 4,130,881   | 4,250,969           | 4,153,956   |       |   |       |   |
| Shareholders' Equity                      | 520,702                               | 534,634     | 526,337             | 538,319     |       |   |       |   |
| <b>Period End Balances:</b>               |                                       |             |                     |             |       |   |       |   |
| Assets                                    | \$4,993,725                           | \$4,806,487 |                     |             |       |   |       |   |
| Earning Assets                            | 4,158,785                             | 4,078,819   |                     |             |       |   |       |   |
| Loans                                     | 1,732,382                             | 1,877,308   |                     |             |       |   |       |   |
| Deposits                                  | 4,321,638                             | 4,108,307   |                     |             |       |   |       |   |
| Shareholders' Equity                      | 533,395                               | 541,840     |                     |             |       |   |       |   |
| <b>Capital Ratios at Period End:</b>      |                                       |             |                     |             |       |   |       |   |
| Total Risk Based Capital                  | 15.03                                 | %           | 15.99               | %           |       |   |       |   |
| Tangible Equity to Tangible Assets        | 8.16                                  | %           | 8.58                | %           |       |   |       |   |
| Dividends Paid Per Common Share           | \$0.38                                | \$0.37      | \$1.14              | \$1.11      |       |   |       |   |

|                              |    |   |    |   |    |   |    |   |
|------------------------------|----|---|----|---|----|---|----|---|
| Common Dividend Payout Ratio | 66 | % | 59 | % | 66 | % | 58 | % |
|------------------------------|----|---|----|---|----|---|----|---|

The above financial summary has been derived from the Company's unaudited consolidated financial statements. This information should be read in conjunction with those statements, notes and the other information included elsewhere herein. Percentages under the heading "Financial Ratios" are annualized with the exception of the efficiency ratio.

1 Yields on securities and certain loans have been adjusted upward to a "fully taxable equivalent" ("FTE") basis, which is a non-GAAP financial measure, in order to reflect the effect of income which is exempt from federal income taxation at the current statutory tax rate.

2 The efficiency ratio is defined as noninterest expense divided by total revenue (net interest income on an FTE basis, which is a non-GAAP financial measure, and noninterest income).

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The Federal Reserve's Federal Open Market Committee has maintained highly accommodative monetary policies to influence interest rates to low levels in order to provide stimulus to the economy following the "financial crisis" recession. Westamerica Bancorporation and subsidiaries' (the "Company") principal source of revenue is net interest and fee income, which represents interest earned on loans and investment securities ("earning assets") reduced by interest paid on deposits and other borrowings ("interest-bearing liabilities"). The relatively low level of market interest rates has reduced the spread between interest rates on earning assets and interest bearing liabilities. The Company's net interest margin and net interest income declined as market interest rates on newly originated loans remain below the yields earned on older-dated loans and on the overall loan portfolio. The Company is reducing its exposure to rising interest rates by purchasing shorter-duration investment securities with lower yields than longer-duration securities. The Company's credit quality continued to improve, as nonperforming assets declined fifty percent in the twelve months ended September 30, 2014 and net loan losses declined in the nine months ended September 30, 2014 compared to the comparable period of 2013. The improvement in credit quality has resulted in Management reducing the provision for loan losses by fifty-nine percent in the nine months ended September 30, 2014 compared to the comparable period of 2013. The credit quality improvement also contributed to reducing noninterest expenses related to nonperforming assets. Management is focused on controlling all noninterest expense levels, particularly due to market interest rate pressure on net interest income.

The Company reported net income of \$15.2 million or \$0.58 diluted earnings per common share for the third quarter 2014 and net income of \$45.6 million or \$1.74 diluted earnings per common share for the nine months ended September 30, 2014. These results compare to net income of \$16.7 million or \$0.63 diluted earnings per common share for the third quarter 2013 and net income of \$51.1 million or \$1.90 diluted earnings per common share for the nine months ended September 30, 2013.

## Net Income

Following is a summary of the components of net income for the periods indicated:

|  | For the Three Months                  |             | For the Nine Months |             |
|--|---------------------------------------|-------------|---------------------|-------------|
|  | Ended September 30,                   |             |                     |             |
|  | 2014                                  | 2013        | 2014                | 2013        |
|  | (In thousands, except per share data) |             |                     |             |
| Net interest income (FTE)                                      | \$37,905                              | \$41,224    | \$115,351           | \$127,687   |
| Provision for loan losses                                      | (600 )                                | (1,800 )    | (2,600 )            | (6,400 )    |
| Noninterest income   | 13,054                                | 14,419      | 39,242              | 42,981      |
| Noninterest expense  | (26,616 )                             | (27,758 )   | (80,446 )           | (84,627 )   |
| Income before taxes (FTE)                                      | 23,743                                | 26,085      | 71,547              | 79,641      |
| Income tax provision (FTE)                                     | (8,589 )                              | (9,347 )    | (25,929 )           | (28,520 )   |
| Net income   | \$15,154                              | \$16,738    | \$45,618            | \$51,121    |
| Average diluted common shares                                  | 26,016                                | 26,705      | 26,262              | 26,919      |
| Diluted earnings per common share                              | \$0.58                                | \$0.63      | \$1.74              | \$1.90      |
| Average total assets   | \$4,971,808                           | \$4,830,475 | \$4,923,705         | \$4,859,473 |
| Net income to average total assets (annualized)                | 1.21 %                                | 1.37 %      | 1.24 %              | 1.41 %      |
| Net income to average common stockholders' equity (annualized) | 11.55 %                               | 12.42 %     | 11.59 %             | 12.70 %     |

Net income for the third quarter of 2014 was \$1.6 million less than the same quarter of 2013, the net result of declines



in net interest and fee income (fully taxable equivalent or “FTE”) and noninterest income, partially offset by decreases in the provision for loan losses, noninterest expense and income tax provision (FTE). A decrease in net interest and fee income (FTE) was mostly attributed to lower average balances of loans and lower yields on interest-earning assets, partially offset by higher average balances of investments and lower average balances of higher-costing interest-bearing liabilities. The provision for loan losses was reduced, reflecting Management's evaluation of losses inherent in the loan portfolio; net losses and nonperforming loan volumes have declined relative to earlier periods. Lower noninterest income was mostly attributable to lower merchant processing service fees, lower service charges on deposit accounts and the recognition in 2013 of a loan principal recovery exceeding the purchase date fair value (included in “other noninterest income”). Noninterest expense decreased primarily due to reduced other real estate owned (“OREO”) expense net of disposition gains and lower personnel costs.

Comparing the first nine months of 2014 with the first nine months of 2013, net income decreased \$5.5 million primarily due to lower net interest and fee income (FTE) and lower noninterest income, partially offset by decreases in the provision for loan losses, noninterest expense and income tax provision (FTE). The lower net interest and fee income (FTE) was primarily caused by a lower average volume of loans and lower yields on interest earning assets, partially offset by higher average balances of investments and lower average balances of higher-costing interest-bearing liabilities. The provision for loan losses was reduced, reflecting Management's evaluation of losses inherent in the loan portfolio. Lower noninterest income was mostly attributable to lower merchant processing service fees, lower service charges on deposit accounts and the recognition in 2013 of a loan principal recovery exceeding the purchase date fair value (included in “other noninterest income”). Noninterest expense decreased mostly due to reduced OREO expense net of disposition gains, personnel costs, loan administration expenses, limited partnership operating losses (included in other noninterest expense) and professional fees.

## Net Interest and Fee Income (FTE)

Following is a summary of the components of net interest and fee income (FTE) for the periods indicated:

|  | For the Three Months |             | For the Nine Months |             |
|--|----------------------|-------------|---------------------|-------------|
|  | Ended September 30,  |             | 2013                |             |
|  | 2014                 | 2013        | 2014                | 2013        |
|  | (In thousands)       |             |                     |             |
| Interest and fee income                | \$34,900             | \$37,956    | \$105,867           | \$117,690   |
| Interest expense                       | (846 )               | (1,176 )    | (2,644 )            | (3,647 )    |
| FTE adjustment                         | 3,851                | 4,444       | 12,128              | 13,644      |
| Net interest income (FTE)              | \$37,905             | \$41,224    | \$115,351           | \$127,687   |
| Average earning assets                 | \$4,125,835          | \$4,093,727 | \$4,111,364         | \$4,125,407 |
| Net interest margin (FTE) (annualized) | 3.66 %               | 4.01 %      | 3.75 %              | 4.13 %      |

Net interest and fee income (FTE) decreased during the third quarter 2014 by \$3.3 million from the same period in 2013 to \$37.9 million, mainly due to lower average balances of loans (down \$142 million) and lower yields on interest-earning assets (down 38 basis points “bp”), partially offset by higher average balances of investments (up \$174 million) and lower average balances of higher-costing interest-bearing liabilities.

Comparing the first nine months of 2014 with the first nine months of 2013, net interest and fee income (FTE) decreased \$12.3 million primarily due to a lower average volume of loans (down \$196 million) and lower yields on interest-earning assets (down 41 bp), partially offset by higher average balances of investments (up \$182 million) and lower average balances of higher-costing interest-bearing liabilities.

Loan volumes have declined due to problem loan workout activities (such as chargeoffs, collateral repossessions and principal payments), particularly with purchased loans, and reduced volumes of loan originations. In Management’s opinion, current levels of competitive loan pricing do not provide adequate forward earnings potential. As a result, the Company has not currently taken an aggressive posture relative to loan portfolio growth. Management has maintained relatively stable interest-earning asset volumes by increasing investment securities as loan volumes have declined.

Yields on interest-earning assets have declined due to relatively low interest rates prevailing in the market. In the first nine months of 2014, the Company purchased shorter-duration investment securities with lower yields than longer-duration securities in order to reduce its exposure to anticipated rising interest rates. The Company’s high levels of liquidity will provide an opportunity to obtain higher yielding assets once market interest rates start rising. The Company has been replacing higher-cost funding sources with low-cost deposits and interest expense has declined to offset some of the decline in interest income.

## Interest and Fee Income (FTE)

Interest and fee income (FTE) for the third quarter of 2014 decreased \$3.6 million or 8.6% from the same period in 2013. The decrease was caused by lower average balances of loans and lower yields on interest-earning assets, partially offset by higher average balances of investments.

The total average balances of loans declined due to decreases in the average balances of commercial real estate loans (down \$105 million), consumer loans (down \$42 million), residential real estate loans (down \$35 million) and tax-exempt commercial loans (down \$19 million), partially offset by a \$61 million increase in the average balance of taxable commercial loans. The average investment portfolio increased largely due to higher average balances of securities of U.S. Government sponsored entities (up \$304 million), partially offset by a \$107 million decrease in

average balances of collateralized mortgage obligations and mortgage-backed securities.

The average yield on the Company's earning assets decreased from 4.12% in the third quarter 2013 to 3.74% in the corresponding period of 2014. The composite yield on loans declined 27 bp to 5.08% mostly due to lower yields on taxable commercial loans (down 97 bp), consumer loans (down 25 bp), commercial real estate loans (down 9 bp) and construction loans (down 459 bp). Nonperforming loans are included in average loan volumes used to compute loan yields; fluctuations in nonaccrual loan volumes impact loan yields. Construction yields were higher in the third quarter 2013 due to higher interest received on nonaccrual loans and discount accretion on purchased loans. The investment yields in general declined due to market rates. The investment portfolio yield decreased 32 bp to 2.74% primarily due to lower yields on municipal securities (down 40 bp) and corporate securities (down 10 bp), partially offset by a 54 bp increase in yields on securities of U.S. Government sponsored entities. The yield on securities of U.S. government sponsored entities rose as securities added to the portfolio in 2014 were higher yielding than securities held in the prior period.

Comparing the first nine months of 2014 with the first nine months of 2013, interest and fee income (FTE) was down \$12.3 million or 10.2%. The decrease resulted from a lower average volume of loans and lower yields on interest-earning assets, partially offset by higher average balances of investments. Average balances of loans decreased \$196 million primarily attributable to decreases in average balances of commercial real estate loans (down \$109 million), consumer loans (down \$58 million), residential real estate loans (down \$42 million) and tax-exempt commercial loans (down \$19 million), partially offset by a \$35 million increase in the average balance of taxable commercial loans. The average investment portfolio increased \$182 million mostly due to higher average balances of U.S. government sponsored entities (up \$247 million), partially offset by a \$106 million decrease in average balances of collateralized mortgage obligations and mortgage-backed securities.

The average yield on earning assets for the first nine months of 2014 was 3.84% compared with 4.25% in the first nine months of 2013. The loan portfolio yield for the first nine months of 2014 was 5.15% compared with 5.40% for the first nine months of 2013 due to lower yields on taxable commercial loans (down 64 bp), consumer loans (down 34 bp), commercial real estate loans (down 13 bp), construction loans (down 295 bp), residential real estate loans (down 10 bp) and tax-exempt commercial loans (down 18 bp). Nonperforming loans are included in average loan volumes used to compute loan yields; fluctuations in nonaccrual loan volumes impact loan yields. The yield on construction loans in the first nine months of 2013 was elevated due to higher interest received on nonaccrual loans and discount accretion on purchased loans. The investment portfolio yield decreased 37 bp to 2.81% primarily due to lower yields on municipal securities (down 50 bp) and corporate securities (down 24 bp), partially offset by higher yields on securities of U.S. government sponsored entities (up 42 bp). The yield on securities of U.S. government sponsored entities rose as securities added to the portfolio in 2014 were higher yielding than securities held in the prior period.

#### Interest Expense

Interest expense has been reduced by lowering rates paid on interest-bearing deposits and borrowings and by reducing the volume of higher-cost funding sources. A \$15 million long-term note was repaid in October 2013 and average balances of time deposits declined \$114 million in the third quarter 2014 compared with third quarter 2013 and \$142 million in the first nine months of 2014 compared with the first nine months of 2013. Lower-cost checking and savings deposits accounted for 90.1% of total average deposits in the third quarter 2014 compared with 86.9% in the third quarter 2013 and 89.4% in the first nine months of 2014 compared with 85.8% in the first nine months of 2013.

Interest expense in the third quarter of 2014 decreased \$330 thousand or 28.1% compared with the same period in 2013 due to lower average balances of higher-costing interest-bearing liabilities. Interest-bearing liabilities declined due to lower average balances of time deposits \$100 thousand or more (down \$84 million), time deposits less than \$100 thousand (down \$30 million), debt financing (down \$15 million), Federal Home Loan Bank advances (down \$5 million) and term repurchase agreement (down \$6 million), partially offset by higher average balances of money market savings (up \$58 million), money market checking accounts (up \$39 million) and regular savings (up \$22 million). The average rate paid on interest-bearing liabilities decreased from 0.18% in the third quarter of 2013 to

0.13% in the third quarter of 2014. Rates on interest-bearing deposits were 0.12% for the third quarter 2014 compared with 0.13% for the third quarter 2013.

Comparing the first nine months of 2014 with the first nine months of 2013, interest expense declined \$1.0 million or 27.5% due to lower average balances of higher-costing interest-bearing liabilities. Average balances of debt financing and Federal Home Loan Bank advances declined \$15 million and \$5 million, respectively. Average balances of interest-bearing deposits decreased primarily due to lower average balances of time deposits \$100 thousand or more (down \$111 million), time deposits less than \$100 thousand (down \$30 million) and preferred money market savings (down \$13 million), partially offset by higher average balances of money market savings (up \$52 million), money market checking accounts (up \$28 million), and regular savings (up \$17 million). Rates paid on interest-bearing liabilities averaged 0.14% during the first nine months of 2014 compared with 0.19% for the first nine months of 2013. Rates paid on interest-bearing deposits were 0.12% in the first nine months of 2014 compared with 0.14% in the first nine months of 2013.

## Net Interest Margin (FTE)

The following summarizes the components of the Company's net interest margin for the periods indicated:

|   | For the Three Months |      | For the Nine Months |      |      |      |
|---|----------------------|------|---------------------|------|------|------|
|   | Ended September 30,  |      | 2014                |      | 2013 |      |
|   | 2014                 | 2013 | 2014                | 2013 | 2014 | 2013 |
| Yield on earning assets (FTE)                 | 3.74                 | 4.12 | 3.84                | 4.25 | %    | %    |
| Rate paid on interest-bearing liabilities     | 0.13                 | 0.18 | 0.14                | 0.19 | %    | %    |
| Net interest spread (FTE)                     | 3.61                 | 3.94 | 3.70                | 4.06 | %    | %    |
| Impact of noninterest-bearing demand deposits | 0.05                 | 0.07 | 0.05                | 0.07 | %    | %    |
| Net interest margin (FTE)                     | 3.66                 | 4.01 | 3.75                | 4.13 | %    | %    |

During the first nine months of 2014, the net interest margin (FTE) was affected by low market interest rates. The volume of older-dated higher-yielding loans declined due to principal maturities and paydowns. Newly originated loans have lower yields. The Company, in anticipation of rising interest rates, has been purchasing floating rate and shorter-duration investment securities to increase liquidity. The liquidity from the shorter-duration securities can be invested at higher interest rates during a period of rising interest rates. The Company has been purchasing securities of U. S. government sponsored entities which have call options; the issuing entities have been exercising the call options, and the Company has re-invested the proceeds at higher rates; interest rates in the two to five-year time horizon have increased throughout 2014. Rates on interest-bearing liabilities were kept low by reducing the volume of higher-cost funding sources. During the third quarter 2014 the net interest margin (FTE) decreased 35 bp compared with the same period in 2013. Lower yields on earning assets were partially offset by lower rates paid on interest-bearing liabilities and resulted in a 33 bp decrease in net interest spread (FTE). The funding value of noninterest-bearing demand deposits declines as earning asset yields decline. During the first nine months of 2014, the net interest margin (FTE) decreased 38 bp compared with the first nine months of 2013. The net interest spread (FTE) in the first nine months of 2014 was 3.70% compared with 4.06% in the first nine months of 2013, the net result of a 41 bp decrease in earning asset yields, partially offset by lower cost of interest-bearing liabilities (down 5 bp).

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## Summary of Average Balances, Yields/Rates and Interest Differential

The following tables present information regarding the consolidated average assets, liabilities and shareholders' equity, the amounts of interest income earned from average interest earning assets and the resulting yields, and the amounts of interest expense incurred on average interest-bearing liabilities and the resulting rates. Average loan balances include nonperforming loans. Interest income includes reversal of previously accrued interest on loans placed on non-accrual status during the period and proceeds from loans on nonaccrual status only to the extent cash payments have been received and applied as interest income and accretion of purchased loan discounts. Yields on tax-exempt securities and loans have been adjusted upward to reflect the effect of income exempt from federal income taxation at the current statutory tax rate.

## Distribution of Assets, Liabilities &amp; Shareholders' Equity and Yields, Rates &amp; Interest Margin

|   | For the Three Months Ended<br>September 30, 2014 |                                |                  |   |
|---|--|--------------------------------|------------------|---|
|   | Average<br>Balance                               | Interest<br>Income/<br>Expense | Yields/<br>Rates |   |
|   | (In thousands)                                   |                                |                  |   |
| <b>Assets</b>                               |  |                                |                  |   |
| Investment securities:                      |  |                                |                  |   |
| Available for sale                          |  |                                |                  |   |
| Taxable                                     | \$1,148,461                                      | \$4,687                        | 1.63             | % |
| Tax-exempt (1)                              | 168,734  | 2,556                          | 6.06             | % |
| Held to maturity                            |  |                                |                  |   |
| Taxable                                     | 349,587  | 1,661                          | 1.90             | % |
| Tax-exempt (1)                              | 698,938  | 7,309                          | 4.18             | % |
| Loans:                                      |  |                                |                  |   |
| Commercial:                                 |  |                                |                  |   |
| Taxable                                     | 306,245  | 4,137                          | 5.36             | % |
| Tax-exempt (1)                              | 85,598   | 1,173                          | 5.44             | % |
| Commercial real estate                      | 741,962  | 11,465                         | 6.13             | % |
| Real estate construction                    | 13,223   | 168                            | 5.04             | % |
| Real estate residential                     | 167,265  | 1,435                          | 3.43             | % |
| Consumer installment and other              | 445,822  | 4,160                          | 3.70             | % |
| Total loans (1)                             | 1,760,115  | 22,538                         | 5.08             | % |
| Total Interest-earning assets (1)           | 4,125,835  | \$38,751                       | 3.74             | % |
| Other assets                                | 845,973  |                                |                  |   |
| Total assets                                | \$4,971,808                                      |                                |                  |   |
| <b>Liabilities and shareholders' equity</b> |  |                                |                  |   |
| Deposits:                                   |  |                                |                  |   |
| Noninterest-bearing demand                  | \$1,869,853                                      | \$-                            | -                | % |
| Savings and interest-bearing transaction    | 2,005,687  | 290                            | 0.06             | % |
| Time less than \$100,000                    | 194,338  | 200                            | 0.41             | % |
| Time \$100,000 or more                      | 233,511  | 219                            | 0.37             | % |
| Total interest-bearing deposits             | 2,433,536  | 709                            | 0.12             | % |
| Short-term borrowed funds                   | 71,067   | 23                             | 0.13             | % |
| Term repurchase agreement                   | 4,457  | 11                             | 1.00             | % |
| Federal Home Loan Bank advances             | 20,240   | 103                            | 2.02             | % |

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|   |             |          |      |   |
|---|-------------|----------|------|---|
| Total interest-bearing liabilities                      | 2,529,300   | \$846    | 0.13 | % |
| Other liabilities                                       | 51,953      |          |      |   |
| Shareholders' equity                                    | 520,702     |          |      |   |
| Total liabilities and shareholders' equity              | \$4,971,808 |          |      |   |
| Net interest spread (1) (2)                             |             |          | 3.61 | % |
| Net interest and fee income and interest margin (1) (3) |             | \$37,905 | 3.66 | % |

(1) Amounts calculated on a fully taxable equivalent basis using the current statutory federal tax rate.

(2) Net interest spread represents the average yield earned on interest-earning assets less the average rate incurred on interest-bearing liabilities.

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



## Distribution of Assets, Liabilities &amp; Shareholders' Equity and Yields, Rates &amp; Interest Margin

|   | For the Three Months Ended<br>September 30, 2013 |                    |      |                  |
|---|--|--------------------|------|------------------|
|   | Average<br>Balance                               | Interest           |      | Yields/<br>Rates |
|   |  | Income/<br>Expense |      |                  |
| (In thousands)  |  |                    |      |                  |
| <b>Assets</b>   |  |                    |      |                  |
| Investment securities:                                  |  |                    |      |                  |
| Available for sale                                      |  |                    |      |                  |
| Taxable   | \$868,008  | \$3,722            | 1.72 | %                |
| Tax-exempt (1)  | 181,954  | 2,674              | 5.88 | %                |
| Held to maturity  |  |                    |      |                  |
| Taxable   | 415,241  | 1,780              | 1.71 | %                |
| Tax-exempt (1)  | 726,135  | 8,591              | 4.73 | %                |
| Loans:  |  |                    |      |                  |
| Commercial:   |  |                    |      |                  |
| Taxable   | 245,292  | 3,915              | 6.33 | %                |
| Tax-exempt (1)  | 104,344  | 1,482              | 5.63 | %                |
| Commercial real estate                                  | 847,154  | 13,276             | 6.22 | %                |
| Real estate construction                                | 15,002   | 364                | 9.63 | %                |
| Real estate residential                                 | 202,540  | 1,736              | 3.43 | %                |
| Consumer installment and other                          | 488,057  | 4,860              | 3.95 | %                |
| Total loans (1)   | 1,902,389  | 25,633             | 5.35 | %                |
| Total interest-earning assets (1)                       | 4,093,727  | \$42,400           | 4.12 | %                |
| Other assets  | 736,748  |                    |      |                  |
| Total assets  | \$4,830,475                                      |                    |      |                  |
| <b>Liabilities and shareholders' equity</b>             |  |                    |      |                  |
| Deposits:   |  |                    |      |                  |
| Noninterest-bearing demand                              | \$1,699,169                                      | \$-                | -    | %                |
| Savings and interest-bearing transaction                | 1,889,808  | 294                | 0.06 | %                |
| Time less than \$100,000                                | 224,274  | 258                | 0.46 | %                |
| Time \$100,000 or more                                  | 317,630  | 257                | 0.32 | %                |
| Total interest-bearing deposits                         | 2,431,712  | 809                | 0.13 | %                |
| Short-term borrowed funds                               | 56,844   | 20                 | 0.14 | %                |
| Term repurchase agreement                               | 10,000   | 25                 | 0.98 | %                |
| Federal Home Loan Bank advances                         | 25,663   | 122                | 1.89 | %                |
| Debt financing  | 15,000   | 200                | 5.35 | %                |
| Total interest-bearing liabilities                      | 2,539,219  | \$1,176            | 0.18 | %                |
| Other liabilities                                       | 57,453   |                    |      |                  |
| Shareholders' equity                                    | 534,634  |                    |      |                  |
| Total liabilities and shareholders' equity              | \$4,830,475                                      |                    |      |                  |
| Net interest spread (1) (2)                             |  |                    | 3.94 | %                |
| Net interest and fee income and interest margin (1) (3) |  | \$41,224           | 4.01 | %                |

(1) Amounts calculated on a fully taxable equivalent basis using the current statutory federal tax rate.

(2) Net interest spread represents the average yield earned on interest-earning assets less the average rate incurred on interest-bearing liabilities.

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

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## Distribution of Assets, Liabilities &amp; Shareholders' Equity and Yields, Rates &amp; Interest Margin

|   | For the Nine Months Ended<br>September 30, 2014 |                    |      |                  |
|---|---|--------------------|------|------------------|
|   | Average<br>Balance                              | Interest           |      | Yields/<br>Rates |
|   |   | Income/<br>Expense |      |                  |
| (In thousands)  |   |                    |      |                  |
| <b>Assets</b>   |   |                    |      |                  |
| Investment securities:                                  |   |                    |      |                  |
| Available for sale                                      |   |                    |      |                  |
| Taxable   | \$1,057,066                                     | \$12,787           | 1.61 | %                |
| Tax-exempt (1)  | 172,936   | 7,393              | 5.70 | %                |
| Held to maturity  |   |                    |      |                  |
| Taxable   | 364,535   | 5,120              | 1.87 | %                |
| Tax-exempt (1)  | 722,314   | 23,542             | 4.35 | %                |
| Loans:  |   |                    |      |                  |
| Commercial:   |   |                    |      |                  |
| Taxable   | 294,138   | 12,261             | 5.57 | %                |
| Tax-exempt (1)  | 89,967  | 3,828              | 5.69 | %                |
| Commercial real estate                                  | 768,470   | 35,277             | 6.14 | %                |
| Real estate construction                                | 13,158  | 540                | 5.49 | %                |
| Real estate residential                                 | 175,431   | 4,474              | 3.40 | %                |
| Consumer installment and other                          | 453,349   | 12,773             | 3.77 | %                |
| Total loans (1)   | 1,794,513                                       | 69,153             | 5.15 | %                |
| Total Interest-earning assets (1)                       | 4,111,364                                       | \$117,995          | 3.84 | %                |
| Other assets  | 812,341   |                    |      |                  |
| Total assets  | \$4,923,705                                     |                    |      |                  |
| <b>Liabilities and shareholders' equity</b>             |   |                    |      |                  |
| Deposits:   |   |                    |      |                  |
| Noninterest-bearing demand                              | \$1,813,141                                     | \$-                | -    | %                |
| Savings and interest-bearing transaction                | 1,988,905                                       | 896                | 0.06 | %                |
| Time less than \$100,000                                | 201,438   | 637                | 0.42 | %                |
| Time \$100,000 or more                                  | 247,485   | 683                | 0.37 | %                |
| Total interest-bearing deposits                         | 2,437,828                                       | 2,216              | 0.12 | %                |
| Short-term borrowed funds                               | 64,836  | 64                 | 0.13 | %                |
| Term repurchase agreement                               | 8,132   | 60                 | 0.99 | %                |
| Federal Home Loan Bank advances                         | 20,379  | 304                | 1.99 | %                |
| Total interest-bearing liabilities                      | 2,531,175                                       | \$2,644            | 0.14 | %                |
| Other liabilities                                       | 53,052  |                    |      |                  |
| Shareholders' equity                                    | 526,337   |                    |      |                  |
| Total liabilities and shareholders' equity              | \$4,923,705                                     |                    |      |                  |
| Net interest spread (1) (2)                             |   |                    | 3.70 | %                |
| Net interest and fee income and interest margin (1) (3) |   | \$115,351          | 3.75 | %                |

(1) Amounts calculated on a fully taxable equivalent basis using the current statutory federal tax rate.

(2) Net interest spread represents the average yield earned on interest-earning assets less the average rate incurred on interest-bearing liabilities.

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

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## Distribution of Assets, Liabilities &amp; Shareholders' Equity and Yields, Rates &amp; Interest Margin

|   | For the Nine Months Ended<br>September 30, 2013 |                    |         |   |
|---|---|--------------------|---------|---|
|   | Average<br>Balance                              | Interest           | Yields/ |   |
|   |   | Income/<br>Expense | Rates   |   |
| (In thousands)  |   |                    |         |   |
| <b>Assets</b>   |   |                    |         |   |
| Investment securities:                                  |   |                    |         |   |
| Available for sale                                      |   |                    |         |   |
| Taxable   | \$797,721                                       | \$10,879           | 1.82    | % |
| Tax-exempt (1)  | 187,400   | 7,943              | 5.65    | % |
| Held to maturity  |   |                    |         |   |
| Taxable   | 442,962   | 5,747              | 1.73    | % |
| Tax-exempt (1)  | 706,387   | 26,397             | 4.98    | % |
| Loans:  |   |                    |         |   |
| Commercial:   |   |                    |         |   |
| Taxable   | 258,995   | 12,024             | 6.21    | % |
| Tax-exempt (1)  | 109,255   | 4,795              | 5.87    | % |
| Commercial real estate                                  | 877,490   | 41,130             | 6.27    | % |
| Real estate construction                                | 15,657  | 988                | 8.44    | % |
| Real estate residential                                 | 217,704   | 5,711              | 3.50    | % |
| Consumer installment and other                          | 511,836   | 15,720             | 4.11    | % |
| Total loans (1)   | 1,990,937                                       | 80,368             | 5.40    | % |
| Total Interest-earning assets (1)                       | 4,125,407                                       | \$131,334          | 4.25    | % |
| Other assets  | 734,066   |                    |         |   |
| Total assets  | \$4,859,473                                     |                    |         |   |
| <b>Liabilities and shareholders' equity</b>             |   |                    |         |   |
| Deposits:   |   |                    |         |   |
| Noninterest-bearing demand                              | \$1,657,819                                     | \$-                | -       | % |
| Savings and interest-bearing transaction                | 1,905,341                                       | 882                | 0.06    | % |
| Time less than \$100,000                                | 231,922   | 830                | 0.48    | % |
| Time \$100,000 or more                                  | 358,874   | 843                | 0.31    | % |
| Total interest-bearing deposits                         | 2,496,137                                       | 2,555              | 0.14    | % |
| Short-term borrowed funds                               | 58,548  | 58                 | 0.13    | % |
| Term repurchase agreement                               | 10,000  | 73                 | 0.98    | % |
| Federal Home Loan Bank advances                         | 25,719  | 360                | 1.87    | % |
| Debt financing  | 15,000  | 601                | 5.35    | % |
| Total interest-bearing liabilities                      | 2,605,404                                       | \$3,647            | 0.19    | % |
| Other liabilities                                       | 57,931  |                    |         |   |
| Shareholders' equity                                    | 538,319   |                    |         |   |
| Total liabilities and shareholders' equity              | \$4,859,473                                     |                    |         |   |
| Net interest spread (1) (2)                             |   |                    | 4.06    | % |
| Net interest and fee income and interest margin (1) (3) |   | \$127,687          | 4.13    | % |

(1) Amounts calculated on a fully taxable equivalent basis using the current statutory federal tax rate.

(2) Net interest spread represents the average yield earned on interest-earning assets less the average rate incurred on interest-bearing liabilities.

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

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### Summary of Changes in Interest Income and Expense due to Changes in Average Asset & Liability Balances and Yields Earned & Rates Paid

The following tables set forth a summary of the changes in interest income and interest expense due to changes in average assets and liability balances (volume) and changes in average interest yields/rates for the periods indicated. Changes not solely attributable to volume or yields/rates have been allocated in proportion to the respective volume and yield/rate components.

#### Summary of Changes in Interest Income and Expense

|   | Three Months Ended September 30,<br>2014                  |             |             |
|---|---|-------------|-------------|
|   | Compared with<br>Three Months Ended September 30,<br>2013 |             |             |
|   | Volume  | Yield/Rate  | Total       |
|   | (In thousands)  |             |             |
| Increase (decrease) in interest and fee income: |   |             |             |
| Investment securities:                          |   |             |             |
| Available for sale                              |   |             |             |
| Taxable   | \$ 1,203  | \$ (238 )   | \$ 965      |
| Tax-exempt (1)                                  | (194 )  | 76          | (118 )      |
| Held to maturity                                |   |             |             |
| Taxable   | (281 )  | 162         | (119 )      |
| Tax-exempt (1)                                  | (322 )  | (960 )      | (1,282 )    |
| Loans:  |   |             |             |
| Commercial:                                     |   |             |             |
| Taxable   | 973   | (751 )      | 222         |
| Tax-exempt (1)                                  | (266 )  | (43 )       | (309 )      |
| Commercial real estate                          | (1,648 )  | (163 )      | (1,811 )    |
| Real estate construction                        | (43 )   | (153 )      | (196 )      |
| Real estate residential                         | (301 )  | -           | (301 )      |
| Consumer installment and other                  | (417 )  | (283 )      | (700 )      |
| Total loans (1)                                 | (1,702 )  | (1,393 )    | (3,095 )    |
| Total decrease in interest and fee income (1)   | (1,296 )  | (2,353 )    | (3,649 )    |
| Increase (decrease) in interest expense:        |   |             |             |
| Deposits:                                       |   |             |             |
| Savings and interest-bearing transaction        | 18  | (22 )       | (4 )        |
| Time less than \$100,000                        | (34 )   | (24 )       | (58 )       |
| Time \$100,000 or more                          | (68 )   | 30          | (38 )       |
| Total interest-bearing deposits                 | (84 )   | (16 )       | (100 )      |
| Short-term borrowed funds                       | 5   | (2 )        | 3           |
| Term repurchase agreement                       | (14 )   | -           | (14 )       |
| Federal Home Loan Bank advances                 | (26 )   | 7           | (19 )       |
| Debt financing                                  | (200 )  | -           | (200 )      |
| Total decrease in interest expense              | (319 )  | (11 )       | (330 )      |
| Decrease in net interest and fee income (1)     | \$ (977 )   | \$ (2,342 ) | \$ (3,319 ) |

(1) Amounts calculated on a fully taxable equivalent basis using the current statutory federal tax rate.





## Summary of Changes in Interest Income and Expense

|  | Nine Months Ended September 30,<br>2014<br>Compared with<br>Nine Months Ended September 30,<br>2013 |             |              |
|--|---|-------------|--------------|
|  | Volume  | Yield/Rate  | Total        |
|  | (In thousands)  |             |              |
| <b>Increase (decrease) in interest and fee income:</b> |   |             |              |
| <b>Investment securities:</b>                          |   |             |              |
| <b>Available for sale</b>                              |   |             |              |
| Taxable  | \$ 3,537  | \$ (1,629 ) | \$ 1,908     |
| Tax-exempt (1)   | (613 )  | 63          | (550 )       |
| <b>Held to maturity</b>                                |   |             |              |
| Taxable  | (1,018 )  | 391         | (627 )       |
| Tax-exempt (1)   | 595   | (3,450 )    | (2,855 )     |
| <b>Loans:</b>  |   |             |              |
| <b>Commercial:</b>                                     |   |             |              |
| Taxable  | 1,632   | (1,395 )    | 237          |
| Tax-exempt (1)   | (847 )  | (120 )      | (967 )       |
| <b>Commercial real estate</b>                          |   |             |              |
| Real estate construction                               | (158 )  | (290 )      | (448 )       |
| Real estate residential                                | (1,109 )  | (128 )      | (1,237 )     |
| Consumer installment and other                         | (1,801 )  | (1,146 )    | (2,947 )     |
| Total loans (1)  | (7,393 )  | (3,822 )    | (11,215 )    |
| Total decrease in interest and fee income (1)          | (4,892 )  | (8,447 )    | (13,339 )    |
| <b>Increase (decrease) in interest expense:</b>        |   |             |              |
| <b>Deposits:</b>                                       |   |             |              |
| <b>Savings and interest-bearing transaction</b>        |   |             |              |
| Time less than \$100,000                               | (109 )  | (84 )       | (193 )       |
| Time \$100,000 or more                                 | (262 )  | 102         | (160 )       |
| Total interest-bearing deposits                        | (332 )  | (7 )        | (339 )       |
| <b>Short-term borrowed funds</b>                       |   |             |              |
| Term repurchase agreement                              | (14 )   | 1           | (13 )        |
| Federal Home Loan Bank advances                        | (75 )   | 19          | (56 )        |
| Debt financing   | (601 )  | -           | (601 )       |
| Total (decrease) increase in interest expense          | (1,016 )  | 13          | (1,003 )     |
| Decrease in net interest and fee income (1)            | \$ (3,876 )   | \$ (8,460 ) | \$ (12,336 ) |

(1) Amounts calculated on a fully taxable equivalent basis using the current statutory federal tax rate.

## Provision for Loan Losses

The Company manages credit costs by consistently enforcing conservative underwriting and administration procedures and aggressively pursuing collection efforts with debtors experiencing financial difficulties. The provision for loan losses reflects Management's assessment of credit risk in the loan portfolio during each of the periods presented.

The Company provided \$600 thousand for loan losses in the third quarter of 2014, \$1.8 million in the third quarter of 2013, \$2.6 million in the first nine months of 2014 and \$6.4 million in the first nine months of 2013. The reduced provision for loan losses for the third quarter and the first nine months of 2014 reflects Management's current evaluation of credit quality for the loan portfolio. The Company recorded purchased County Bank and Sonoma Valley Bank loans at estimated fair value upon the acquisition dates, February 6, 2009 and August 20, 2010, respectively. Such estimated fair values were recognized for individual loans, although small balance homogenous loans were pooled for valuation purposes. The valuation discounts recorded for purchased loans included Management's assessment of the risk of principal loss under economic and borrower conditions prevailing on the dates of purchase. The purchased County Bank loans secured by single-family residential real estate are "covered" through February 6, 2019 by loss-sharing agreements the Company entered with the FDIC which mitigates losses during the term of the agreements. The FDIC indemnification of purchased County Bank non-single-family residential real estate secured loans expired February 6, 2014. Any deterioration in estimated value related to principal loss subsequent to the acquisition dates requires additional loss recognition through a provision for loan losses. No assurance can be given that future provisions for loan losses related to purchased loans will not be necessary. For further information regarding credit risk, the FDIC loss-sharing agreements, net credit losses and the allowance for loan losses, see the "Loan Portfolio Credit Risk" and "Allowance for Credit Losses" sections of this report.

## Noninterest Income

The following table summarizes the components of noninterest income for the periods indicated.

|                                     | For the Three Months                  |                 | For the Nine Months |                 |
|-------------------------------------|---------------------------------------|-----------------|---------------------|-----------------|
|                                     | 2014                                  | 2013            | 2014                | 2013            |
|                                     | Ended September 30,<br>(In thousands) |                 |                     |                 |
| Service charges on deposit accounts | \$6,207                               | \$6,433         | \$18,322            | \$19,427        |
| Merchant processing services        | 1,742                                 | 2,151           | 5,485               | 6,973           |
| Debit card fees                     | 1,543                                 | 1,467           | 4,482               | 4,302           |
| ATM processing fees                 | 637                                   | 701             | 1,891               | 2,128           |
| Other service fees                  | 695                                   | 716             | 2,044               | 2,174           |
| Trust fees                          | 629                                   | 567             | 1,899               | 1,720           |
| Financial services commissions      | 194                                   | 150             | 585                 | 614             |
| Other noninterest income            | 1,407                                 | 2,234           | 4,534               | 5,643           |
| <b>Total</b>                        | <b>\$13,054</b>                       | <b>\$14,419</b> | <b>\$39,242</b>     | <b>\$42,981</b> |

Noninterest income for the third quarter 2014 declined by \$1.4 million or 9.5% from the same period in 2013. Service charges on deposits decreased \$226 thousand primarily due to declines in fees charged on overdrawn and insufficient funds accounts (down \$173 thousand) and lower activity on checking accounts (down \$105 thousand). Merchant processing services fees decreased \$409 thousand primarily due to customer attrition and lower transaction volumes. Other noninterest income decreased \$827 thousand primarily due to the recognition in 2013 of a loan principal recovery exceeding the purchase date fair value.

In the first nine months of 2014, noninterest income decreased \$3.7 million or 8.7% compared with the first nine months of 2013. Service charges on deposits decreased \$1.1 million compared with the first nine months of 2013 primarily due to declines in fees charged on overdrawn and insufficient funds accounts (down \$764 thousand) and lower activity on checking accounts (down \$311 thousand). Merchant processing services fees decreased \$1.5 million primarily due to customer attrition and lower transaction volumes. ATM processing fees decreased \$237 thousand mainly because the Bank customers had fewer transactions at non-Westamerica ATMs and other cash dispensing terminals. Debit card fees increased \$180 thousand primarily due to higher transaction volumes. Trust fees increased \$179 thousand mostly due to marketing efforts to increase customer accounts and higher court-approved fees. Other noninterest income decreased \$1.1 million primarily due to the recognition in 2013 of a loan principal recovery exceeding the purchase date fair value.

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## Noninterest Expense

The following table summarizes the components of noninterest expense for the periods indicated.

|  | For the Three Months |          | For the Nine Months |          |
|--|----------------------|----------|---------------------|----------|
|  | 2014                 | 2013     | 2014                | 2013     |
|  | Ended September 30,  |          |                     |          |
|  | (In thousands)       |          |                     |          |
| Salaries and related benefits            | \$13,639             | \$13,826 | \$41,691            | \$42,293 |
| Occupancy                                | 3,811                | 3,829    | 11,284              | 11,353   |
| Outsourced data processing services      | 2,093                | 2,139    | 6,314               | 6,436    |
| Amortization of identifiable intangibles | 1,056                | 1,163    | 3,219               | 3,547    |
| Furniture and equipment                  | 1,059                | 974      | 3,070               | 2,875    |
| Professional fees                        | 700                  | 730      | 1,707               | 2,109    |
| Courier service                          | 663                  | 725      | 1,938               | 2,204    |
| Other real estate owned                  | (287 )               | 179      | (908 )              | 791      |
| Other noninterest expense                | 3,882                | 4,193    | 12,131              | 13,019   |
| Total                                    | \$26,616             | \$27,758 | \$80,446            | \$84,627 |

Noninterest expense decreased \$1.1 million or 4.1% in the third quarter 2014 compared with the same period in 2013. Salaries and related benefits declined \$187 thousand primarily due to employee attrition. Amortization of identifiable intangibles decreased \$107 thousand as assets are amortized on a declining balance method. Expenses for other real estate owned, net of disposition gains, decreased \$466 thousand due to higher net gains on sale of repossessed loan collateral. Other noninterest expense decreased \$311 thousand mostly due to decreases in limited partnership operating losses, business insurance costs and correspondent bank charges.

In the first nine months of 2014, noninterest expense decreased \$4.2 million or 4.9% compared with the first nine months of 2013. Salaries and related benefits decreased \$602 thousand primarily due to employee attrition. Amortization of identifiable intangibles decreased \$328 thousand as assets are amortized on a declining balance method. Professional fees declined \$402 thousand due to lower legal fees associated with nonperforming assets. Expenses for other real estate owned, net of disposition gains, declined \$1.7 million due to higher net gains on sale of repossessed loan collateral. Other noninterest expense decreased \$888 thousand primarily due to lower loan administration costs and lower limited partnership operating losses.

## Provision for Income Tax

During the third quarter 2014, the Company recorded income tax provision (FTE) of \$8.6 million, compared with \$9.3 million for the third quarter 2013. The third quarter 2014 provision represents an effective tax rate (FTE) of 36.2%, compared with 35.8% for the third quarter 2013. The income tax provision (FTE) was \$25.9 million for the first nine months of 2014 compared with \$28.5 million for the corresponding period of 2013. The first nine months of 2014 effective tax rate (FTE) was 36.2% compared to 35.8% for the same period of 2013.

## Investment Portfolio

The Company maintains a securities portfolio consisting of securities issued by U.S. Treasury, U.S. Government sponsored entities, state and political subdivisions and corporations, and asset-backed and other securities. Investment securities are held in safekeeping by an independent custodian.

Management has maintained relatively stable interest-earning asset volumes by increasing investment securities as loan volumes have declined. The carrying value of the Company's investment securities portfolio was \$2.4 billion as of September 30, 2014, an increase of \$214.7 million or 9.7% compared to December 31, 2013.

Management continually evaluates the Company's investment securities portfolio in response to established asset/liability management objectives, changing market conditions that could affect profitability, and the level of interest rate risk to which the Company is exposed. These evaluations may cause Management to change the level of funds the Company deploys into investment securities, change the composition of the Company's investment securities portfolio, and change the proportion of investments allocated into the available for sale and held to maturity investment categories.

The Company has been reducing its positions in mortgage-related securities since the second quarter 2013 in an effort to manage extension risk. Extension risk represents the risk mortgages underlying the securities experience slower principal reductions as rising market interest rates cause a disincentive for borrowers to reduce principal balances; under such circumstances the Company will hold these securities for a longer period than anticipated at current yield levels rather than having the opportunity to reinvest cash flows at higher yields. The Company's positioning of the balance sheet for rising interest rates has resulted in the purchase of floating rate corporate bonds, federal agency bonds, and short-term state and municipal bonds. As of September 30, 2014, substantially all of the Company's investment securities continue to be investment grade rated by one or more major rating agencies. In addition to monitoring credit rating agency evaluations, Management performs its own evaluations regarding the credit worthiness of the issuer or the securitized assets underlying asset-backed securities.

The Company's procedures for evaluating investments in securities issued by states, municipalities and political subdivisions are in accordance with guidance issued by the Board of Governors of the Federal Reserve System, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Agencies" (SR 12-15) and other regulatory guidance. Credit ratings are considered in our analysis only as a guide to the historical default rate associated with similarly-rated bonds. There have been no significant differences in our internal analyses compared with the ratings assigned by the third party credit rating agencies.

The following tables summarize the total general obligation and revenue bonds issued by states and political subdivisions held in the Company's investment securities portfolios as of the dates indicated, identifying the state in which the issuing government municipality or agency operates.

At September 30, 2014, the Company's investment securities portfolios included securities issued by 755 state and local government municipalities and agencies located within 44 states with a fair value of \$898.7 million. The largest exposure to any one municipality or agency was \$7.5 million (fair value) represented by three revenue bonds.

|  | At September 30, 2014 |               |
|--|-----------------------|---------------|
|  | Amortized<br>Cost     | Fair<br>Value |
|  | (In thousands)        |               |
| Obligations of states and political subdivisions:      |                       |               |
| General obligation bonds:                              |                       |               |
| California   | \$ 107,912            | \$ 110,696    |
| Texas  | 56,651                | 57,715        |
| Pennsylvania   | 48,687                | 49,522        |
| Minnesota  | 27,968                | 28,357        |
| Arizona  | 27,458                | 28,324        |
| Other (34 states)                                      | 285,656               | 290,533       |
| Total general obligation bonds                         | \$ 554,332            | \$ 565,147    |
| Revenue bonds:   |                       |               |
| California   | \$ 60,290             | \$ 62,510     |
| Pennsylvania   | 28,843                | 29,441        |
| Iowa   | 18,243                | 18,925        |
| Colorado   | 18,123                | 18,361        |
| Indiana  | 17,270                | 17,130        |
| Kentucky   | 16,818                | 17,127        |
| Other (31 states)                                      | 166,249               | 170,107       |
| Total revenue bonds                                    | \$ 325,836            | \$ 333,601    |
| Total obligations of states and political subdivisions | \$ 880,168            | \$ 898,748    |

At December 31, 2013, the Company's investment securities portfolios included securities issued by 808 state and local government municipalities and agencies located within 47 states with a fair value of \$932.6 million. The largest exposure to any one municipality or agency was \$5.3 million (fair value) represented by two revenue bonds.

|  | At December 31, 2013 |            |
|--|----------------------|------------|
|  | Amortized            | Fair       |
|  | Cost                 | Value      |
|  | (In thousands)       |            |
| Obligations of states and political subdivisions:      |                      |            |
| General obligation bonds:                              |                      |            |
| California   | \$ 119,215           | \$ 119,360 |
| Texas  | 57,433               | 56,594     |
| Pennsylvania   | 48,722               | 47,394     |
| Other (37 states)                                      | 375,640              | 371,215    |
| Total general obligation bonds                         | \$ 601,010           | \$ 594,563 |
| Revenue bonds:   |                      |            |
| California   | \$ 63,001            | \$ 64,246  |
| Pennsylvania   | 29,537               | 28,898     |
| Colorado   | 18,176               | 17,563     |
| Indiana  | 17,811               | 17,031     |
| Other (37 states)                                      | 213,254              | 210,336    |
| Total revenue bonds                                    | \$ 341,779           | \$ 338,074 |
| Total obligations of states and political subdivisions | \$ 942,789           | \$ 932,637 |

At September 30, 2014, the revenue bonds in the Company's investment securities portfolios were issued by state and local government municipalities and agencies to fund public services such as water utility, sewer utility, recreational and school facilities, and general public and economic improvements. The revenue bonds were payable from 24 revenue sources. The revenue sources that represent 5% or more individually of the total revenue bonds are summarized in the following table.

|                                       | At September 30, 2014 |            |
|---------------------------------------|-----------------------|------------|
|                                       | Amortized             | Fair       |
|                                       | Cost                  | Value      |
|                                       | (In thousands)        |            |
| Revenue bonds by revenue source       |                       |            |
| Water                                 | \$ 67,684             | \$ 70,093  |
| Sewer                                 | 47,857                | 49,061     |
| Sales tax                             | 35,594                | 36,747     |
| Lease (abatement)                     | 19,126                | 19,809     |
| Lease (renewal)                       | 18,838                | 19,078     |
| College & University                  | 16,553                | 16,813     |
| Other                                 | 120,184               | 122,000    |
| Total revenue bonds by revenue source | \$ 325,836            | \$ 333,601 |

At December 31, 2013, the revenue bonds in the Company's investment securities portfolios were issued by state and local government municipalities and agencies to fund public services such as water utility, sewer utility, recreational and school facilities, and general public and economic improvements. The revenue bonds were payable from 27 revenue sources. The revenue sources that represent 5% or more individually of the total revenue bonds are summarized in the following table.

|  | At December 31, 2013 |       |
|--|----------------------|-------|
|  | Amortized            | Fair  |
|  | Cost                 | Value |



(In thousands)

| Revenue bonds by revenue source       |            |            |
|---------------------------------------|------------|------------|
| Water                                 | \$ 70,924  | \$ 70,948  |
| Sewer                                 | 49,625     | 48,911     |
| Sales tax                             | 34,291     | 33,465     |
| Lease (abatement)                     | 21,821     | 22,033     |
| Lease (renewal)                       | 21,353     | 20,742     |
| Other                                 | 143,765    | 141,975    |
| Total revenue bonds by revenue source | \$ 341,779 | \$ 338,074 |

See Note 3 to the unaudited consolidated financial statements for additional information related to the investment securities.

## Loan Portfolio Credit Risk

The Company originates loans with the intent to hold such assets until principal is repaid. Management follows written loan underwriting policies and procedures which are approved by the Bank's Board of Directors. Loans are underwritten following approved underwriting standards and lending authorities within a formalized organizational structure. The Board of Directors also approves independent real estate appraisers to be used in obtaining estimated values for real property serving as loan collateral. Prevailing economic trends and conditions are also taken into consideration in loan underwriting practices.

All loan applications must be for clearly defined legitimate purposes with a determinable primary source of repayment, and as appropriate, secondary sources of repayment. All loans are supported by appropriate documentation such as current financial statements, tax returns, credit reports, collateral information, guarantor asset verification, title reports, appraisals, and other relevant documentation.

Commercial loans represent term loans used to acquire durable business assets or revolving lines of credit used to finance working capital. Underwriting practices evaluate each borrower's cash flow as the principal source of loan repayment. Commercial loans are generally secured by the borrower's business assets as a secondary source of repayment. Commercial loans are evaluated for credit-worthiness based on prior loan performance, borrower financial information including cash flow, borrower net worth and aggregate debt.

Commercial real estate loans represent term loans used to acquire real estate to be operated by the borrower in a commercial capacity. Underwriting practices evaluate each borrower's global cash flow as the principal source of loan repayment, independent appraisal of value of the property, and other relevant factors. Commercial real estate loans are generally secured by a first lien on the property as a secondary source of repayment.

Real estate construction loans represent the financing of real estate development. Loan principal disbursements are controlled through the use of project budgets, and disbursements are approved based on construction progress, which is validated by project site inspections. The real estate serves as collateral, secured by a first lien position on the property.

Residential real estate loans generally represent first lien mortgages used by the borrower to purchase or refinance a principal residence. For interest-rate risk purposes, the Company offers only fully-amortizing, adjustable-rate mortgages. In underwriting first lien mortgages, the Company evaluates each borrower's ability to repay the loan, an independent appraisal of the value of the property, and other relevant factors. The Company does not offer riskier mortgage products, such as "interest-only" mortgages and "negative amortization" mortgages.

For loans secured by real estate, the Bank requires title insurance to insure the status of its lien and each borrower is obligated to insure the real estate collateral, naming the Company as loss payee, in an amount sufficient to repay the principal amount outstanding in the event of a property casualty loss.

Consumer loans are predominantly comprised of indirect automobile loans with underwriting based on credit history and scores, personal income, debt service capacity, and collateral values.

|                        | At<br>September<br>30,<br>2014 | At December<br>31,<br>2013 |
|------------------------|--------------------------------|----------------------------|
|                        | (In thousands)                 |                            |
| Commercial             | \$388,918                      | \$ 364,159                 |
| Commercial real estate | 733,171                        | 799,019                    |

|                                |             |              |
|--------------------------------|-------------|--------------|
| Construction                   | 12,705      | 13,896       |
| Residential real estate        | 159,982     | 185,057      |
| Consumer installment and other | 437,606     | 465,613      |
| Total                          | \$1,732,382 | \$ 1,827,744 |

The Company extends loans to commercial and consumer customers in Northern and Central California. These lending activities expose the Company to the risk borrowers will default, causing loan losses. The Company's lending activities are exposed to various qualitative risks. All loan segments are exposed to risks inherent in the economy and market conditions. Significant risk characteristics related to the commercial loan segment include the borrowers' business performance and financial condition, and the value of collateral for secured loans. Significant risk characteristics related to the commercial real estate segment include the borrowers' business performance and the value of properties collateralizing the loans. Significant risk characteristics related to the construction loan segment include the borrowers' performance in successfully developing the real estate into the intended purpose and the value of the property collateralizing the loans. Significant risk characteristics related to the residential real estate segment include the borrowers' financial wherewithal to service the mortgages and the value of the property collateralizing the loans. Significant risk characteristics related to the consumer loan segment include the financial condition of the borrowers and the value of collateral securing the loans.

The preparation of the financial statements requires Management to estimate the amount of losses inherent in the loan portfolio and establish an allowance for credit losses. The allowance for credit losses is established by assessing a provision for loan losses against the Company's earnings. In estimating credit losses, Management must exercise judgment in evaluating information deemed relevant, such as financial information regarding individual borrowers, overall credit loss experience, the amount of past due, nonperforming and classified loans, recommendations of regulatory authorities, prevailing economic conditions and other information. The amount of ultimate losses on the loan portfolio can vary from the estimated amounts. Management follows a systematic methodology to estimate loss potential in an effort to reduce the differences between estimated and actual losses.

The Company closely monitors the markets in which it conducts its lending operations and follows a strategy to control exposure to loans with high credit risk. The Bank's organization structure separates the functions of business development and loan underwriting; Management believes this segregation of duties avoids inherent conflicts of combining business development and loan approval functions. In measuring and managing credit risk, the Company adheres to the following practices.

- The Bank maintains a Loan Review Department which reports directly to the Board of Directors. The Loan Review Department performs independent evaluations of loans and assigns credit risk grades to evaluated loans using grading standards employed by bank regulatory agencies. Those loans judged to carry higher risk attributes are referred to as "classified loans." Classified loans receive elevated management attention to maximize collection.
- The Bank maintains two loan administration offices whose sole responsibility is to manage and collect classified loans.

Classified loans with higher levels of credit risk are further designated as "nonaccrual loans." Management places classified loans on nonaccrual status when full collection of contractual interest and principal payments is in doubt. Uncollected interest previously accrued on loans placed on nonaccrual status is reversed as a charge against interest income. The Company does not accrue interest income on loans following placement on nonaccrual status. Interest payments received on nonaccrual loans are applied to reduce the carrying amount of the loan unless the carrying amount is well secured by loan collateral. "Nonperforming assets" include nonaccrual loans, loans 90 or more days past due and still accruing, and repossessed loan collateral (commonly referred to as "Other Real Estate Owned").

The former County Bank loans and repossessed loan collateral were purchased from the FDIC with indemnifying loss-sharing agreements. The loss-sharing agreement on single-family residential real estate assets expires February 6, 2019. The loss-sharing agreement on non-single-family residential real estate assets expired February 6, 2014 as to losses and expires February 6, 2017 as to loss recoveries; the Company reclassified assets for which loss indemnification expired during the first quarter 2014 from "purchased covered" to "purchased non-covered".

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## Nonperforming Assets

|   | At September 30, |          | At December |
|---|------------------|----------|-------------|
|   | 2014             | 2013     | 31,         |
|   | (In thousands)   |          |             |
| <b>Originated:</b>                      |                  |          |             |
| Nonperforming nonaccrual loans          | \$4,696          | \$5,786  | \$ 5,301    |
| Performing nonaccrual loans             | 13               | 1,093    | 75          |
| Total nonaccrual loans                  | 4,709            | 6,879    | 5,376       |
| Accruing loans 90 or more days past due | 342              | 392      | 410         |
| Total nonperforming loans               | 5,051            | 7,271    | 5,786       |
| Other real estate owned                 | 5,123            | 3,162    | 5,527       |
| Total nonperforming assets              | \$10,174         | \$10,433 | \$ 11,313   |
| <b>Purchased covered:</b>               |                  |          |             |
| Nonperforming nonaccrual loans          | \$295            | \$24,348 | \$ 11,672   |
| Performing nonaccrual loans             | -                | 1,937    | 636         |
| Total nonaccrual loans                  | 295              | 26,285   | 12,308      |
| Accruing loans 90 or more days past due | -                | 23       | -           |
| Total nonperforming loans               | 295              | 26,308   | 12,308      |
| Other real estate owned                 | 585              | 9,273    | 7,793       |
| Total nonperforming assets              | \$880            | \$35,581 | \$ 20,101   |
| <b>Purchased non-covered:</b>           |                  |          |             |
| Nonperforming nonaccrual loans          | \$12,745         | \$2,664  | \$ 2,920    |
| Performing nonaccrual loans             | 552              | 701      | 698         |
| Total nonaccrual loans                  | 13,297           | 3,365    | 3,618       |
| Accruing loans 90 or more days past due | 76               | -        | -           |
| Total nonperforming loans               | 13,373           | 3,365    | 3,618       |
| Other real estate owned                 | 1,565            | 2,535    | -           |
| Total nonperforming assets              | \$14,938         | \$5,900  | \$ 3,618    |
| Total nonperforming assets              | \$25,992         | \$51,914 | \$ 35,032   |

The Bank's commercial loan customers are primarily small businesses and professionals. As a result, average loan balances are relatively small, providing risk diversification within the overall loan portfolio. At September 30, 2014, the Bank's nonaccrual loans reflected this diversification: nonaccrual originated loans with a carrying value totaling \$5 million comprised nine borrowers, and nonaccrual purchased loans with a carrying value totaling \$14 million comprised fifteen borrowers.

Management believes the overall credit quality of the loan portfolio is reasonably stable; however, classified and nonperforming assets could fluctuate from period to period. The performance of any individual loan can be affected by external factors such as the interest rate environment, economic conditions, and collateral values or factors particular to the borrower. No assurance can be given that additional increases in nonaccrual and delinquent loans will not occur in the future.

## Allowance for Credit Losses

The Company's allowance for credit losses represents Management's estimate of credit losses inherent in the loan portfolio. In evaluating credit risk for loans, Management measures loss potential of the carrying value of loans. As

described above, payments received on nonaccrual loans may be applied against the principal balance of the loans until such time as full collection of the remaining recorded balance is expected. Further, the carrying value of purchased loans includes fair value discounts assigned at the time of purchase under the provisions of FASB ASC 805, Business Combinations, and FASB ASC 310-30, Loans or Debt Securities with Deteriorated Credit Quality. The allowance for credit losses represents Management's estimate of credit losses in excess of these reductions to the carrying value of loans within the loan portfolio.

The following table summarizes the allowance for credit losses, chargeoffs and recoveries of the Company for the periods indicated:

|   | For the Three Months |          | For the Nine Months |            |
|---|----------------------|----------|---------------------|------------|
|   | 2014                 | 2013     | 2014                | 2013       |
|   | Ended September 30,  |          |                     |            |
|   | (In thousands)       |          |                     |            |
| <b>Analysis of the Allowance for Credit Losses</b>                  |                      |          |                     |            |
| Balance, beginning of period  | \$35,091             | \$33,619 | \$34,386            | \$32,927   |
| Provision for loan losses   | 600                  | 1,800    | 2,600               | 6,400      |
| Provision for unfunded commitments                                  | -                    | -        | -                   | -          |
| <b>Loans charged off</b>  |                      |          |                     |            |
| Commercial  | (905 )               | (637 )   | (1,114 )            | (2,687 )   |
| Commercial real estate  | -                    | (117 )   | -                   | (656 )     |
| Real estate construction  | -                    | -        | -                   | -          |
| Real estate residential   | -                    | -        | (30 )               | (109 )     |
| Consumer installment and other                                      | (916 )               | (909 )   | (3,217 )            | (3,114 )   |
| Purchased covered loans   | -                    | (79 )    | -                   | (955 )     |
| Purchased non-covered loans   | -                    | -        | (260 )              | (116 )     |
| Total chargeoffs  | (1,821 )             | (1,742 ) | (4,621 )            | (7,637 )   |
| <b>Recoveries of loans previously charged off</b>                   |                      |          |                     |            |
| Commercial  | 229                  | 326      | 516                 | 1,084      |
| Commercial real estate  | 15                   | 30       | 193                 | 128        |
| Real estate construction  | -                    | -        | 3                   | -          |
| Real estate residential   | -                    | -        | -                   | -          |
| Consumer installment and other                                      | 297                  | 516      | 1,315               | 1,624      |
| Purchased covered loans   | -                    | 60       | -                   | 83         |
| Purchased non-covered loans   | 51                   | -        | 70                  | -          |
| Total recoveries  | 592                  | 932      | 2,097               | 2,919      |
| Net loan losses   | (1,229 )             | (810 )   | (2,524 )            | (4,718 )   |
| Balance, end of period  | \$34,462             | \$34,609 | \$34,462            | \$34,609   |
| <b>Components:</b>  |                      |          |                     |            |
| Allowance for loan losses   | \$31,769             | \$31,916 |                     |            |
| Liability for off-balance sheet credit exposure                     | 2,693                | 2,693    |                     |            |
| Allowance for credit losses   | \$34,462             | \$34,609 |                     |            |
| <b>Net loan (losses) recoveries:</b>                                |                      |          |                     |            |
| Originated loans  | \$(1,280 )           | \$(791 ) | \$(2,334 )          | \$(3,730 ) |
| Purchased covered loans   | -                    | (19 )    | -                   | (872 )     |
| Purchased non-covered loans   | 51                   | -        | (190 )              | (116 )     |
| Net loan losses as a percentage of average total loans (annualized) | 0.28 %               | 0.17 %   | 0.19 %              | 0.32 %     |

The Company's allowance for credit losses is maintained at a level considered appropriate to provide for losses that can be estimated based upon specific and general conditions. These include conditions unique to individual borrowers, as well as overall credit loss experience, the amount of past due, nonperforming and classified loans, the amount of non-indemnified purchased loans, FDIC loss-sharing indemnification, recommendations of regulatory authorities, prevailing economic conditions and other factors. A portion of the allowance is specifically allocated to impaired loans whose full collectability of principal is uncertain. Such allocations are determined by Management based on loan-by-loan analyses. The Company evaluates all classified loans and nonaccrual loans with outstanding principal balances in excess of \$500 thousand and all "troubled debt restructured" loans for impairment. A second allocation is

based in part on quantitative analyses of historical credit loss experience, in which historical originated classified credit balances are analyzed using a statistical model to determine standard loss rates for originated loans. The results of this analysis are applied to originated classified loan balances to allocate the allowance to the respective segments of the loan portfolio. In addition, originated loans with similar characteristics not usually criticized using regulatory guidelines are analyzed based on the historical loss rates and delinquency trends, grouped by the number of days the payments on these loans are delinquent. Last, allocations are made to originated non-classified commercial and commercial real estate loans based on historical loss rates and other statistical data.

Purchased loans were recorded on the date of purchase at estimated fair value; fair value discounts include a component for estimated credit losses. The Company evaluates all nonaccrual purchased loans with outstanding principal balances in excess of \$500 thousand for impairment; the impaired loan value is compared to the recorded investment in the loan, which has been reduced by the credit default discount estimated on the date of purchase. If Management's impairment analysis determines the impaired loan value is less than the recorded investment in the purchased loan, an allocation of the allowance for credit losses is established, net of estimated FDIC indemnification. For all other purchased loans, Management evaluates post-acquisition historical credit losses on purchased loans, credit default discounts on purchased loans, and other data to evaluate the likelihood of realizing the recorded investment of purchased loans. Management establishes allocations of the allowance for credit losses for any estimated deficiency.





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|   |         |          |       |       |         |         |         |          |     |
|---|---------|----------|-------|-------|---------|---------|---------|----------|-----|
| Chargeoffs                                      | (1,114) | -        | -     | (30)  | (3,217) | (260)   | -       | -        | (4  |
| Recoveries                                      | 516     | 193      | 3     | -     | 1,315   | 70      | -       | -        | 2,  |
| Net loan recoveries (losses)                    | (598 )  | 193      | 3     | (30)  | (1,902) | (190 )  | -       | -        | (2  |
| Indemnification expiration                      | -       | -        | -     | -     | -       | 1,561   | (1,561) | -        | -   |
| Balance at end of period                        | 4,352   | 10,039   | 442   | 392   | 2,238   | 2,574   | -       | 11,732   | 3   |
| Liability for off-balance sheet credit exposure | 1,706   | 24       | 105   | -     | 451     | 131     | -       | 276      | 2,  |
| Total allowance for credit losses               | \$6,058 | \$10,063 | \$547 | \$392 | \$2,689 | \$2,705 | \$-     | \$12,008 | \$3 |



promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate... To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy remains appropriate. In determining how long to maintain the current 0 to 1/4 percent target range for the federal funds rate, the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation." In this context, Management's most likely earnings forecast for the twelve months ending September 30, 2015 assumes market interest rates remain relatively stable and yields on newly originated or refinanced loans and on purchased investment securities will reflect current interest rates, which are generally lower than yields on the Company's older dated loans and investment securities.

In adjusting the Company's asset/liability position, Management attempts to manage interest rate risk while enhancing the net interest margin and net interest income. At times, depending on expected increases or decreases in general interest rates, the relationship between long and short term interest rates, market conditions and competitive factors, Management may adjust the Company's interest rate risk position in order to manage its net interest margin and net interest income. The Company's results of operations and net portfolio values remain subject to changes in interest rates and to fluctuations in the difference between long and short term interest rates.

The Company's asset and liability position ranged from risk neutral to slightly "liability sensitive" at September 30, 2014, depending on the interest rate assumptions applied to the simulation model employed by Management to measure interest rate risk. A "liability sensitive" position results in a slightly larger change in interest expense than in interest income resulting from application of assumed interest rate changes. Simulation estimates depend on, and will change with, the size and mix of the actual and projected balance sheet at the time of each simulation. Management's interest rate risk management is currently biased toward stable interest rates in the near-term, and ultimately, rising interest rates. Management continues to monitor the interest rate environment as well as economic conditions and other factors it deems relevant in managing the Company's exposure to interest rate risk.

The Company does not currently engage in trading activities or use derivative instruments to control interest rate risk, even though such activities may be permitted with the approval of the Company's Board of Directors.

#### Market Risk - Equity Markets

Equity price risk can affect the Company. As an example, any preferred or common stock holdings, as permitted by banking regulations, can fluctuate in value. Management regularly assesses the extent and duration of any declines in market value, the causes of such declines, the likelihood of a recovery in market value, and its intent to hold securities until a recovery in value occurs. Declines in value of preferred or common stock holdings that are deemed "other than temporary" could result in loss recognition in the Company's income statement.

Fluctuations in the Company's common stock price can impact the Company's financial results in several ways. First, the Company has regularly repurchased and retired its common stock; the market price paid to retire the Company's common stock can affect the level of the Company's shareholders' equity, cash flows and shares outstanding. Second, the Company's common stock price impacts the number of dilutive equivalent shares used to compute diluted earnings per share. Third, fluctuations in the Company's common stock price can motivate holders of options to purchase Company common stock through the exercise of such options thereby increasing the number of shares outstanding. Finally, the amount of compensation expense associated with share based compensation fluctuates with changes in and the volatility of the Company's common stock price.

#### Market Risk - Other

Market values of loan collateral can directly impact the level of loan charge-offs and the provision for loan losses. The financial condition and liquidity of debtors issuing bonds and debtors whose mortgages or other obligations are securitized can directly impact the credit quality of the Company's investment portfolio requiring the Company to recognize other than temporary impairment charges. Other types of market risk, such as foreign currency exchange risk and commodity price risk, are not significant in the normal course of the Company's business activities.

#### Liquidity and Funding

The objective of liquidity management is to manage cash flow and liquidity reserves so that they are adequate to fund the Company's operations and meet obligations and other commitments on a timely basis and at a reasonable cost. The Company achieves this objective through the selection of asset and liability maturity mixes that it believes best meet its needs. The Company's liquidity position is enhanced by its ability to raise additional funds as needed in the wholesale markets.

In recent years, the Company's deposit base has provided the majority of the Company's funding requirements. This relatively stable and low-cost source of funds, along with shareholders' equity, provided 97 percent of funding for average total assets in the first nine months of 2014 and 2013. The stability of the Company's funding from customer deposits is in part reliant on the confidence clients have in the Company. The Company places a very high priority in maintaining this confidence through conservative credit and capital management practices and by maintaining an

appropriate level of liquidity reserves.

During the first nine months of 2014 and 2013, non-deposit funding has continued to be provided by short-term borrowings, a term repurchase agreement, and Federal Home Loan Bank advances, and additionally, long-term debt for the first nine months of 2013. These non-deposit sources of funds comprise a modest portion of total funding.

Liquidity is further provided by assets such as balances held at the Federal Reserve Bank, investment securities, and amortizing loans. The Company's investment securities portfolio provides a substantial secondary liquidity reserve. The Company held \$2.4 billion in total investment securities at September 30, 2014. Under certain deposit, borrowing and other arrangements, the Company must hold and pledge investment securities as collateral. At September 30, 2014, such collateral requirements totaled approximately \$773 million.

Liquidity risk can result from the mismatching of asset and liability cash flows, or from disruptions in the financial markets. The Company performs liquidity stress tests on a periodic basis to evaluate the sustainability of its liquidity. Under the stress testing, the Company assumes outflows of funds increase beyond expected levels. Measurement of such heightened outflows considers the composition of the Company's deposit base, including any concentration of deposits, non-deposit funding such as short-term borrowings and Federal Home Loan Bank advances, and unfunded lending commitments. The Company evaluates its stock of highly liquid assets to meet the assumed higher levels of outflows. Highly liquid assets include cash and amounts due from other banks from daily transaction settlements, reduced by branch cash needs and Federal Reserve Bank reserve requirements, and investment securities based on regulatory risk-weighting guidelines. Based on the results of the most recent liquidity stress test, Management is satisfied with the liquidity condition of the Bank and the Company. However, no assurance can be given the Bank or Company will not experience a period of reduced liquidity.

Management will monitor the Company's cash levels throughout 2014. Loan demand from credit-worthy borrowers will be dictated by economic and competitive conditions. The Company aggressively solicits non-interest bearing demand deposits and money market checking deposits, which are the least sensitive to changes in interest rates. The growth of these deposit balances is subject to heightened competition, the success of the Company's sales efforts, delivery of superior customer service, new regulations and market conditions. The Company does not aggressively solicit higher-costing time deposits; as a result, Management anticipates such deposits will decline. Changes in interest rates, most notably rising interest rates, could impact deposit volumes. Depending on economic conditions, interest rate levels, and a variety of other conditions, deposit growth may be used to fund loans, reduce borrowings or purchase investment securities. However, due to possible concerns such as uncertainty in the general economic environment, competition and political uncertainty, loan demand and levels of customer deposits are not certain. Shareholder dividends are expected to continue subject to the Board's discretion and continuing evaluation of capital levels, earnings, asset quality and other factors.

Westamerica Bancorporation ("Parent Company") is a separate entity apart from Westamerica Bank ("Bank") and must provide for its own liquidity. In addition to its operating expenses, the Parent Company is responsible for the payment of dividends declared for its shareholders, and interest and principal on any outstanding debt. Substantially all of the Parent Company's revenues are obtained from subsidiary dividends and service fees. The Bank's dividends paid to the Parent Company and proceeds from the exercise of stock options provided adequate cash flow for the Parent Company in the first nine months of 2014 and 2013 to pay shareholder dividends of \$30 million in each period, and retire common stock in the amount of \$45 million and \$40 million, respectively. Payment of dividends to the Parent Company by the Bank is limited under California and Federal laws. The Company believes these regulatory dividend restrictions will not have an impact on the Parent Company's ability to meet its ongoing cash obligations.

#### Capital Resources

The Company has historically generated high levels of earnings, which provides a means of raising capital. The Company's net income as a percentage of average shareholders' equity ("return on equity" or "ROE") has been 11.6% (annualized) in the first nine months of 2014, 12.5% in 2013 and 14.9% in 2012. The Company also raises capital as employees exercise stock options. Capital raised through the exercise of stock options totaled \$12.4 million in the first nine months of 2014, \$21.5 million in 2013 and \$7.6 million in 2012.

The Company paid common dividends totaling \$29.9 million in the first nine months of 2014, \$40.1 million in 2013 and \$41.0 million in 2012, which represent dividends per common share of \$1.14, \$1.49 and \$1.48, respectively. The Company's earnings have historically exceeded dividends paid to shareholders. The amount of earnings in excess of dividends provides the Company resources to finance growth and maintain appropriate levels of shareholders' equity. In the absence of profitable growth opportunities, the Company has repurchased and retired its common stock as another means to return earnings to shareholders. The Company repurchased and retired 883 thousand shares valued at \$44.8 million in the first nine months of 2014, 1.2 million shares valued at \$57.3 million in 2013 and 1.1 million

shares valued at \$51.5 million in 2012.

The Company's primary capital resource is shareholders' equity, which was \$533.4 million at September 30, 2014 compared with \$542.9 million at December 31, 2013. The Company's ratio of equity to total assets was 10.68% at September 30, 2014 and 11.20% at December 31, 2013.

The Company performs capital stress tests on a periodic basis to evaluate the sustainability of its capital. Under the stress testing, the Company assumes various scenarios such as deteriorating economic and operating conditions, unanticipated asset devaluations, and significant operational lapses. The Company measures the impact of these scenarios on its earnings and capital. Based on the results of the most recent stress tests, Management is satisfied with the capital condition of the Bank and the Company. However, no assurance can be given the Bank or Company will not experience a period of reduced earnings or a reduction in capital from unanticipated events and circumstances.



## Capital to Risk-Adjusted Assets

The following summarizes the ratios of regulatory capital to risk-adjusted assets for the Company on the dates indicated:

|                | At September 30, |      | At December |      | Minimum Well-capitalized |             | Regulatory  |             | by         |            |
|----------------|------------------|------|-------------|------|--------------------------|-------------|-------------|-------------|------------|------------|
|                | 2014             | 2013 | 31,         | 31,  | Regulatory               | Regulatory  | Requirement | Requirement | Definition | Definition |
|                |                  |      | 2013        | 2013 | Requirement              | Requirement |             |             |            |            |
| Tier I Capital | 13.61            | %    | 14.59       | %    | 14.71                    | %           | 4.00        | %           | 6.00       | %          |
| Total Capital  | 15.03            | %    | 15.99       | %    | 16.18                    | %           | 8.00        | %           | 10.00      | %          |
| Leverage ratio | 8.12             | %    | 8.61        | %    | 8.55                     | %           | 4.00        | %           | 5.00       | %          |

The following summarizes the ratios of capital to risk-adjusted assets for the Bank on the dates indicated:

|                | At September 30, |      | At December |      | Minimum Well-capitalized |             | Regulatory  |             | by         |            |
|----------------|------------------|------|-------------|------|--------------------------|-------------|-------------|-------------|------------|------------|
|                | 2014             | 2013 | 31,         | 31,  | Regulatory               | Regulatory  | Requirement | Requirement | Definition | Definition |
|                |                  |      | 2013        | 2013 | Requirement              | Requirement |             |             |            |            |
| Tier I Capital | 12.36            | %    | 13.37       | %    | 13.26                    | %           | 4.00        | %           | 6.00       | %          |
| Total Capital  | 14.00            | %    | 14.97       | %    | 14.93                    | %           | 8.00        | %           | 10.00      | %          |
| Leverage ratio | 7.33             | %    | 7.84        | %    | 7.67                     | %           | 4.00        | %           | 5.00       | %          |

FDIC-indemnified assets are generally 20% risk-weighted. The FDIC indemnification expires on February 6, 2019 as to single-family residential real estate indemnified assets and expired on February 6, 2014 as to non-single-family residential real estate indemnified assets. Subsequent to such dates, previously FDIC-indemnified assets will generally be included in the 100% risk-weight category. The expiration of FDIC indemnification related to non-single-family residential real estate assets on February 6, 2014 caused an increase in risk-weighted assets, and a corresponding decline in the Tier 1 and Total Capital ratios.

On July 2, 2013, the Federal Reserve Board approved a final rule that implements changes to the regulatory capital framework for all banking organizations. The rule's provisions which would most affect the regulatory capital requirements of the Company and the Bank:

- Introduce a new "Common Equity Tier 1" capital measurement,
- Establish higher minimum levels of capital,
- Introduce a "capital conservation buffer,"
- Increase the risk-weighting of certain assets, and
- Establish limits on the amount of deferred tax assets with any excess treated as a deduction from Tier 1 capital.

Under the final rule, a banking organization that is not subject to the "advanced approaches rule" may make a one-time election not to include most elements of Accumulated Other Comprehensive Income, including net-of-tax unrealized gains and losses on available for sale investment securities, in regulatory capital. Neither the Company nor the Bank are subject to the "advanced approaches rule" and intend to make the election not to include most elements of Accumulated Other Comprehensive Income in regulatory capital.

Generally, banking organizations that are not subject to the "advanced approaches rule" must begin complying with the final rule on January 1, 2015; on such date, the Company and the Bank become subject to the revised definitions of

regulatory capital, the new minimum regulatory capital ratios, and various regulatory capital adjustments and deductions according to transition provisions and timelines. All banking organizations must begin calculating standardized total risk-weighted assets on January 1, 2015. The transition period for the capital conservation buffer for all banking organizations will begin on January 1, 2016 and end January 1, 2019. Any bank subject to the rule which is unable to maintain its “capital conservation buffer” will be restricted in the payment of discretionary executive compensation and shareholder distributions, such as dividends and share repurchases.

The final rule does not supersede provisions of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) requiring federal banking agencies to take prompt corrective action (PCA) to resolve problems of insured depository institutions. The final rule revises the PCA thresholds to incorporate the higher minimum levels of capital, including the newly proposed “common equity tier 1” ratio.

Management has evaluated the capital structure and assets for the Company and the Bank as of September 30, 2014 assuming the Federal Reserve's final rule was currently fully phased-in. Based on this evaluation, the Company and the Bank currently maintain capital in excess of all the final rule regulatory ratios, as follows:

|                      | Final Rule          |                    | Final Rule           |          | Final Rule |          | Proforma Measurements as of         |   |         |      |
|----------------------|---------------------|--------------------|----------------------|----------|------------|----------|-------------------------------------|---|---------|------|
|                      | Minimum             | "Well-capitalized" | Minimum              | "Capital | Plus       | "Capital | September 30, 2014                  |   |         |      |
|                      | Capital Requirement | Under PCA Proposal | Conservation Buffer" |          |            |          | Assuming Final Rule Fully Phased-in |   | Company | Bank |
| Capital Measurement: |                     |                    |                      |          |            |          |                                     |   |         |      |
| Leverage             | 4.00                | %                  | 5.00                 | %        | 4.00       | %        | 8.12                                | % | 7.33    | %    |
| Common Equity Tier 1 | 4.50                | %                  | 6.50                 | %        | 7.00       | %        | 13.56                               | % | 12.31   | %    |
| Tier I Capital       | 6.00                | %                  | 8.00                 | %        | 8.50       | %        | 13.56                               | % | 12.31   | %    |
| Total Capital        | 8.00                | %                  | 10.00                | %        | 10.50      | %        | 14.97                               | % | 13.94   | %    |

The Company and the Bank intend to maintain regulatory capital in excess of the highest regulatory standard. The Company and the Bank routinely project capital levels by analyzing forecasted earnings, credit quality, securities valuations, shareholder dividends, asset volumes, share repurchase activity, stock option exercise proceeds, and other factors. Based on current capital projections, the Company and the Bank expect to maintain regulatory capital levels exceeding the highest effective regulatory standard and pay quarterly dividends to shareholders. No assurance can be given that changes in capital management plans will not occur.

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

The Company does not currently engage in trading activities or use derivative instruments to control interest rate risk, even though such activities may be permitted with the approval of the Company's Board of Directors.

Credit risk and interest rate risk are the most significant market risks affecting the Company, and equity price risk can also affect the Company's financial results. These risks are described in the preceding sections regarding "Loan Portfolio Credit Risk," and "Asset/Liability and Market Risk Management." Other types of market risk, such as foreign currency exchange risk and commodity price risk, are not significant in the normal course of the Company's business activities.

### Item 4. Controls and Procedures

The Company's principal executive officer and principal financial officer have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended, as of September 30, 2014.

Based upon their evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that material information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported as and when required and that such information is communicated to the Company's management, including the principal executive officer and the principal financial officer, to allow for timely decisions regarding required disclosures. The evaluation did not identify any change in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2014 that has materially affected, or is reasonably likely to

materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

Due to the nature of its business, the Company is subject to various threatened or filed legal cases resulting from loan collection efforts, transaction processing for deposit accounts and employment practices. The Company establishes a liability for contingent litigation losses for any legal matter when payments associated with the claims become probable and the costs can be reasonably estimated.

## Item 1A. Risk Factors

The Company's Form 10-K as of December 31, 2013 includes detailed disclosure about the risks faced by the Company's business; such risks have not materially changed since the Form 10-K was filed.

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

(a) Previously reported on Form 8-K.

(b) None

(c) Issuer Purchases of Equity Securities

The table below sets forth the information with respect to purchases made by or on behalf of the Company or any "affiliated purchaser" (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of common stock during the quarter ended September 30, 2014.

| Period                                 | (a)<br>Total Number of<br>Shares<br>Purchased | (b)<br>Average Price<br>Paid per Share<br>(In thousands, except per share data) | (c)<br>Total Number<br>of Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plans or<br>Programs* | (d)<br>Maximum<br>Number<br>of Shares that<br>May<br>Yet Be<br>Purchased<br>Under the Plans<br>or Programs |
|--|---|---|---|--|
| July 1<br>through<br>July 31           | 121   | \$ 48.84  | 121   | 1,948  |
| August 1<br>through<br>August 31       | 13  | 47.36   | 13  | 1,935  |
| September 1<br>through<br>September 30 | 41  | 48.32   | 41  | 1,894  |
| Total                                  | 175   | \$ 48.62  | 175   | 1,894  |

\* Includes 2 thousand, 4 thousand and 7 thousand shares purchased in July, August and September, respectively, by the Company in private transactions with the independent administrator of the Company's Tax Deferred Savings/Retirement Plan (ESOP). The Company includes the shares purchased in such transactions within the total

number of shares authorized for purchase pursuant to the currently existing publicly announced program.

The Company repurchases shares of its common stock in the open market to optimize the Company's use of equity capital and enhance shareholder value and with the intention of lessening the dilutive impact of issuing new shares related to stock option plans and other ongoing requirements.

Shares were repurchased during the period from July 1 through July 23, 2014 pursuant to a program approved by the Board of Directors on July 25, 2013 authorizing the purchase of up to 2 million shares of the Company's common stock. Shares were repurchased during the period from July 24, 2014 through September 30, 2014 pursuant to a replacement program approved by the Board of Directors on July 24, 2014 authorizing the purchase of up to 2 million shares of the Company's common stock from time to time prior to September 1, 2015.

Item 3. Defaults upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None

Item 6. Exhibits

The exhibit list required by this item is incorporated by reference to the Exhibit Index filed with this report.

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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.

WESTAMERICA BANCORPORATION  
(Registrant)

/s/ JOHN "ROBERT" THORSON  
John "Robert" Thorson  
Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

Date: November 3, 2014



EXHIBIT INDEX

Exhibit 31.1: Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a)

Exhibit 31.2: Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a)

Exhibit 32.1: Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2: Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 101: Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2014, is formatted in XBRL interactive data files: (i) Consolidated Statements of Income for the three and nine months ended September 30, 2014 and 2013; (ii) Consolidated Balance Sheets at September 30, 2014, and December 31, 2013; (iii) Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2014 and 2013, (iv) Consolidated Statements of Changes in Shareholders' Equity for the nine months ended September 30, 2014 and 2013; (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and 2013 and (vi) Notes to the unaudited Consolidated Financial Statements.