Exchange Bank

February 29, 2012

Dear Shareholders:

The 2011 Consolidated Financial Statements for the Exchange Bank are enclosed. We are pleased to report that these pages reflect solid improvement in nearly every key financial and operating area of our Bank. In a year of considerable challenge and economic turbulence, our net income for 2011 was $12.2MM with this representing a 19% improvement over 2010. These results are reflective of holding down expenses, maintaining a strong interest margin and achieving a reduction in loan loss provisions for problem credits.

This truly has become a small planet and events that happen either half way around the world or across the street seem to have a near immediate impact on our market. To that end, during 2011 national economic performance slightly improved, but growth remains well below potential with continued high unemployment and weak levels of consumer spending and production. At year-end, fourth quarter gross domestic production (GDP) was tracking in the 2.5% range, a positive and welcomed improvement from the 1.5% economic range in the early part of the year. This improvement, however, is well below a 4% to 5% level that we would normally expect to see sustained in the early part of a recovery.

In similar fashion, our local economy continued to recover in 2011, but at a very moderate and uneven pace. Some sectors, such as Tech and Bio-Med, produced robust growth, while others such as construction and our grape growers struggled with weak demand and weather related problems. By November, however, unemployment was 8.9% in Sonoma County, marking the first time since January 2009 that it had fallen below 9%. A well-respected economist, Chris Thornberg of Beacon Economics, recently indicated that the outlook for our Sonoma County is improving due to increased tourism, a decline in commercial real estate vacancies, a modest increase in consumer confidence and a pickup in the export market.

We do not ignore the fact that the signals of current and projected economic activity remain mixed, particularly when we recognize the financial uncertainties that exist in Europe, our own domestic imbalances with government fiscal policies and, on a more local level, the slow pace of new job creation and the protracted time that will be needed to resolve the deep residual problems in the housing market.

Many of our long-time customers are still painfully struggling through these difficult days. As a community bank that has for decades been proudly invested in virtually every sector and in every corner of our local markets, we are committed to working with each company

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and with each family on a personal, day-to-day, credit-by-credit basis in an effort to find practical solutions. This one-on-one banking, the Exchange Bank way, has produced good results and is bringing us closer to restoring our high standards for credit excellence. Problem loans and non-performing assets were reduced by 26% and 8.1% respectively in 2011. Our year-end loan loss reserve level was equal to 3.02% of loans, reflecting a prudent acknowledgement of the uncertainty in today's economic environment.

We believe our results are evidence that we have come a long way toward our goal of a full recovery, but there remains unfinished work.

We recognize how important our dividend is to our shareholders and to this community. Reinstating the dividend remains our highest priority; however, for the near term, the level of problem assets and the uncertainty we still have with regard to the sustainability of this soft recovery compels us to be practical in retaining our capital reserves and earnings. In our view, having extra capital on hand is a wise strategy as we work through this difficult time period and position the Bank to repay TARP funds to the Treasury at some point in the future.

If we do this important work toward full recovery the right way, with no shortcuts, we believe our shareholders will be better positioned to be rewarded for a sustainable, long-term period.

Our work toward a complete recovery also recognizes that the economy, be it nationally or locally, is going to take more time to heal, but it will recover. Meanwhile, the Federal Reserve's recent announced position to keep interest rates at historical lows through 2014 in an effort to rekindle economic activity is going to put further revenue pressure on community banks like ours.

There is a more complicated way to address the impact of today's rate climate, but simply put, we, as with other community banks with a retail branch system, practically cannot bring our interest expense costs down much lower. Certainly increased profitability for us is also achievable with our success in controlling other non-interest expenses, finding greater efficiencies and seeking higher levels of productivity. Recognizing the finite nature of this work, however, the most meaningful element of driving higher operating performance over the long haul lies in our ability to produce revenue growth, which for us is expanding our position with quality loans. To that end, up to this point, the zero interest rate environment engineered by the Fed has had little impact in stimulating loan demand, our primary source of sustaining an appropriate interest rate margin. Ultimately, we are confident that local consumer and business activity will pick up and loan demand for plant, equipment and payroll will resurface, but realistically it likely will be a slow process over the next 24 months and we will struggle to maintain what has always been a strong net interest margin, which is the largest source of revenue for community banks.

All recessions, even the current one, eventually come to an end. So, in dealing with the problems of yesterday and the challenges of today, we are preparing the Bank for a tomorrow. We have strengthened the Bank's capital position above regulatory expectations, we continue to maintain strong liquidity and we have significant untapped backup liquidity sources available to us as substantial strength to respond to the lending needs that will inevitably resurface as our markets slowly recover. Significant new investments in senior level managers and technology were made in 2011 that prepare us for increased regulatory risk expectations and for the delivery of financial services through emerging mobile banking platforms running on devices such as iPhones and other smart phones.

In preparing our Bank for the future, we recognize that to be the Bank we intend to be for decades to come, we must have a healthy community, which needs the leadership and sustaining energy that comes from our local non-profit organizations. To support this important work, we continue to invest heavily in our communities through charitable contributions and with the expenditure of time and effort to make a difference where we work and live.

While the journey ahead may at times still be challenging, it is important to recognize that our community bank model has always faced difficult obstacles and we believe we will continue to succeed and prosper. Community banks are essential to the prosperity of local economies largely because our model requires a personal touch focusing on strong relationships with our customers and our communities.

It is also important to recognize that our success is a credit to our hard-working, committed team of employees. They remain dedicated to keeping our Bank safe and sound. Our employees understand the importance of teamwork, sacrifice and commitment to superior customer service. We greatly appreciate the priority and commitment they have given to our Bank's success.

We would like to invite you to our Annual Shareholders Meeting on Friday, March 23, 2012 at 2:00 p.m. If you are unable to attend, we would request that your proxy vote be given to management.

If you have any specific questions you would like answered, please direct them in writing to:

Marlene Soiland
Corporate Secretary
Exchange Bank
P.O. Box 403
Santa Rosa, CA 95402

You may also contact the Chairman directly via email at reinkingb@exchangebank.com.

On behalf of our employees, we thank you, our shareholders, for the commitment and confidence you have in our Bank.

Sincerely,

C. William Reinking
Chairman

William R. Schrader
President and Chief Executive Officer

Exchange Bank

NOTICE OF ANNUAL SHAREHOLDERS MEETING
TO BE HELD MARCH 23, 2012

February 29, 2012

Dear Shareholder:

The regular annual meeting of the shareholders of Exchange Bank will be held at the Andrew J. Shepard Administrative Services Building, second floor, 444 Aviation Boulevard, Santa Rosa, California on **Friday, March 23, 2012** at **2:00 p.m.** for the following purposes:

1. To receive the Chief Executive Officer's report of operations for the year 2011.

2. To receive the report of the Nominating Committee and to vote on the election of the following nominees as members of the Board of Directors for the ensuing year:

    - C. W. Reinking
    - M. K. Soiland
    - J. M. Ryan
    - D. B. Benedetti
    - C. G. Tamayo
    - D G. Libarle
    - W. R. Schrader
    - R. W. Abbey

3. To transact such other business as may properly come before the meeting.

Those entitled to receive notice of and vote at the meeting are shareholders of record at the close of business on February 22, 2012.

We would appreciate you signing and returning the enclosed proxy in the enclosed postage paid envelope as soon as possible. If you attend the meeting in person, the proxy will be null and void, and you may vote and participate in the meeting as though you had not signed the proxy.

The following information is included in accordance with the By-Laws:

> Nominations for election of members of the Board of Directors may be made by the Board of Directors or by any shareholder of any outstanding class of voting stock of the Corporation entitled to vote for the election of directors. Notice of intention to

> make any nominations, other than by the Board of Directors, shall be made in writing and shall be received by the President of the Corporation no more than 60 days prior to any meeting of shareholders called for the election of directors, and no more than 10 days after the date the notice of such meeting is sent to shareholders pursuant to Article II, Section 2(a) of these By-Laws; provided, however, that if only 10 days' notice of the meeting is given to shareholders, such notice of intention to nominate shall be received by the President of the Corporation not later than the time fixed in the notice of the meeting for the opening of the meeting. Such notification shall contain the following information to the extent known to the notifying shareholder: (A) the name and address of each proposed nominee; (B) the principal occupation of each proposed nominee; (C) the number of shares of voting stock of the Corporation owned by each proposed nominee; (D) the name and residence address of the notifying shareholder; and (E) the number of shares of voting stock of the Corporation owned by the notifying shareholder. Nominations not made in accordance herewith shall be disregarded by the then Chairman of the meeting, and the Inspectors of Election shall then disregard all votes cast for each nominee.

If you have questions about the operations of the Bank, you may submit them in writing before the Annual Meeting. Any questions that cannot be answered within a reasonable time during the meeting will be responded to in a post meeting report mailed by the Corporate Secretary to all shareholders within 30 days of the Annual Meeting.

The following information is provided to you in accordance with the Federal Deposit Insurance Corporation:

> F.D.I.C. regulations require that certain financial information, supplementing that contained in your annual report, be made available upon request.

This additional data is available now. If you wish a copy of this information, please send a written request to my attention or you may call (707) 524-3121.

By Order of the Board of Directors,

Marlene Soiland

Marlene K. Soiland
Corporate Secretary

MKS/ks

TRANSACTIONS WITH DIRECTORS AND OFFICERS

The Bank has had and expects in the future to have banking transactions in the ordinary course of its business with some of its Directors and Officers and their associates, including transactions with corporations or partnerships of which such persons are directors, officers, controlling shareholders, or partners on substantially the same terms (including interest rates and collateral) as those prevailing for comparable transactions with others. Management believes that in 2011 such transactions did not involve more than the normal risk of collectability or present other unfavorable features. Loans to Directors and Executive Officers of the Bank are subject to limitations prescribed by the Financial Code of the State of California as well as the Federal Institutions Regulatory and Interest Rate Control Act of 1978.

In addition, these transactions are disclosed as required by law.

During calendar year 2011 the Bank engaged in transactions with Abbey, Weitzenberg, Warren & Emery, a California corporation, in which Richard W. Abbey, an Exchange Bank Director, has a material interest as a 12.5% shareholder. The amount of attorney's fees paid was in excess of $40,000.

EXCHANGE BANK
BOARD OF DIRECTORS

C. William Reinking

Mr. Reinking was elected to the Board in 1985 when he was appointed President and Chief Operating Officer. He has been with the Bank for 46 years. He retired in 2003 and at that time became Chairman of the Board. In 2008, he was again employed by the Bank as Chief Executive Officer and remained Chairman. On December 31, 2009, he retired again as Chief Executive Officer and remains as Chairman. In 2010, he was named a Doyle Trustee. Mr. Reinking is a graduate of the University of Oregon and the Pacific Coast Banking School. His community involvement, current and past, includes Becoming Independent, Canine Companions, Sonoma County Community Foundation, Chamber of Commerce, the Luther Burbank Center and the Active 20-30 Club.

Marlene K. Soiland

Ms. Soiland was elected to the Board in 1997 and is Corporate Secretary and Chair of the Board's Trust Committee. After graduation from Cal Poly in San Luis Obispo, she returned to Santa Rosa and her family business. She is currently President and owner of Soiland Management Co., Inc. Ms. Soiland is involved in several industry organizations such as the Sonoma County Alliance, Sonoma County Innovation Council, Institute for Family Business, and California Construction and Industrial Materials Association.

James M. Ryan

Mr. Ryan was elected to the Board in 1997 and named a Doyle Trustee in 2007. He now serves as Vice Chairman of the Board and Chairs the Board's Audit and Nominating Committees. He is a graduate of California State University Sacramento and is a licensed Real Estate Broker, Certified Public Accountant and a licensed General Contractor. Mr. Ryan is the owner and President of Ryan Mortgage Company, Inc. and Ryan Realty, Inc. in Santa Rosa. He has served as a Director of the American Red Cross, Sonoma County Chapter, and numerous trade associations.

Dante B. Benedetti

Mr. Benedetti was elected a Director in 2002 and named a Doyle Trustee in 2008. He is currently Chair of the Board's Compensation Committee. He attended Santa Rosa Junior College and graduated from Sonoma State University. Mr. Benedetti is the Past President of Clover Stornetta Farms, Inc. and is now Chairman of the Board of that company. Active in the community, he is on the President's Advisory Board at Santa Rosa Junior College and Sonoma State University, a former member of the Board at Sonoma County Community Foundation, Hanna Boys Center, California Dairy Institute, Culinary Institute of America, California Independent Grocers Association and the Sonoma County Probation Department Advisory Board.

Carlos G. Tamayo

Mr. Tamayo was elected a Director in 2004 and serves as Chair of the Board's Community Reinvestment Act Committee. He is a graduate of Arizona State University with a Masters Degree from American Graduate School of International Management. Mr. Tamayo is the President and Chairman of La Tortilla Factory, a family owned business founded in 1977. His community activities include the Salvation Army, Hispanic Chamber of Commerce, Lions Club, the Sonoma County Community Foundation and various trade groups.

Daniel G. Libarle

Mr. Libarle was elected to the Board in 2007 and serves as Chair of the Board's Loan and Corporate Governance Committees. A graduate of San Jose State University, he is President of their family owned business, Lace House Linen, Inc. The business has been in operation since 1915 in Petaluma. Mr. Libarle has previous banking experience as the founding Chairman of the Bank of Petaluma. That bank was bought by Greater Bay Bank and he served on their Board until it was bought by Wells Fargo Bank. He has been very active in his community. His involvement includes the Rotary Club, Boys & Girls Club, Chamber of Commerce, United Way and several trade groups.

William R. Schrader

Mr. Schrader was elected to the Board in 2008 when he was appointed President. Currently he is President and Chief Executive Officer. He joined the Bank in 1978 and has served as Senior Loan Officer and Chief Operating Officer. Mr. Schrader is a graduate of St. Mary's College and received his Master from Golden Gate University. He is also a graduate of the Pacific Coast School of Banking. His community involvement includes the YMCA, Diocesan School Board, the Santa Rosa Community Health Center, the Chamber of Commerce Education Leadership Committee and a Regent for Hanna Boys Center.

Richard W. Abbey

Mr. Abbey was appointed to the Board in 2010 and serves as Chair of the Board's Technology Committee. He received his degree from the University of California, Berkeley and his law degree from the University of California, Los Angeles. He has been a practicing attorney in Sonoma County since 1973 and presently has his own firm, Abbey, Weitzenberg, Warren and Emery. He has been the general counsel for the Exchange Bank since the mid 1980's. Mr. Abbey's community involvement activities include the Redwood Empire Food Bank, YMCA, Habitat for Humanity, the Santa Rosa Junior College Foundation and Schools Plus Enrichment Foundation.

EXCHANGE BANK AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2011 and 2010

Crowe Horwath.

Crowe Horwath LLP
Independent Member Crowe Horwath International

REPORT OF INDEPENDENT AUDITORS

To Stockholders and
Board of Directors
Exchange Bank and Subsidiaries
Santa Rosa, California

We have audited the accompanying consolidated balance sheet of Exchange Bank and Subsidiaries, ("the Bank") as of December 31, 2011, and the related consolidated statement of income and changes in stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit. The 2010 financial statements of Exchange Bank and Subsidiaries were audited by Perry-Smith LLP, who combined with Crowe Horwath LLP as of November 1, 2011, and whose report dated February 15, 2011 expressed an unqualified opinion on those financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Exchange Bank and Subsidiaries as of December 31, 2011, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We have also audited in accordance with attestation standards established by the American Institute of Certified Public Accountants, Exchange Bank and Subsidiaries' internal control over financial reporting as of December 31, 2011 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 22, 2012 expressed an unqualified opinion.

Crowe Horwath LLP

Crowe Horwath LLP

Sacramento, California
February 22, 2012

EXCHANGE BANK AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

December 31, 2011 and 2010

(In thousands, except share and par value amounts)

	2011	2010
ASSETS		
Cash and due from banks	$ 94,122	$ 39,551
Short-term investments	226	226
Total cash and cash equivalents	94,348	39,777
Available-for-sale investment securities	344,930	318,376
Loans and leases	1,052,754	1,051,833
Less allowance for loan and lease losses	(31,751)	(33,144)
Net loans and leases	1,021,003	1,018,689
Federal Home Loan Bank stock	7,068	8,438
Bank premises and equipment, net	17,772	17,606
Bank owned life insurance	33,907	32,741
Other real estate owned	8,781	17,070
Accrued interest receivable and other assets	72,594	68,084
Total assets	$ 1,600,403	$ 1,520,781
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$ 466,937	$ 424,371
Interest bearing	883,946	860,781
Total deposits	1,350,883	1,285,152
Federal Home Loan Bank advances and other long-term debt	41,000	47,000
Accrued interest payable and other liabilities	45,501	31,403
Total liabilities	1,437,384	1,363,555
Commitments and contingencies (Note 14)		
Stockholders' equity:		
Preferred stock, 1,000,000 shares authorized:		
Series A, noncumulative, $1,000 per share liquidation preference; 43,000 shares issued and outstanding	42,140	41,710
Series B, noncumulative, $1,000 per share liquidation preference; 2,150 shares issued and outstanding	2,150	2,150
Common stock, $2.50 par value; 3,000,000 shares authorized; 1,714,344 shares issued and outstanding	4,286	4,286
Additional paid-in capital	46,026	46,026
Retained earnings	73,561	64,155
Accumulated other comprehensive loss, net of taxes	(5,144)	(1,101)
Total stockholders' equity	163,019	157,226
Total liabilities and stockholders' equity	$ 1,600,403	$ 1,520,781

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

EXCHANGE BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2011 and 2010

(In thousands, except per share amounts)

	2011	2010
Interest income:		
Interest and fees on loans and leases	$ 61,896	$ 66,375
Interest on investment securities:		
Taxable	5,294	5,661
Exempt from Federal income taxes	3,661	4,084
Total interest income	70,851	76,120
Interest expense:		
Interest on deposits	3,162	4,792
Interest on borrowings	1,684	1,962
Total interest expense	4,846	6,754
Net interest income before provision for loan and lease losses	66,005	69,366
Provision for loan and lease losses	12,550	19,500
Net interest income after provision for loan and lease losses	53,455	49,866
Non-interest income:		
Service charges and fees	7,453	8,456
Trust income	4,685	4,781
Merchant discount and interchange fees	3,719	3,483
Income from bank owned life insurance	1,418	1,340
Other income	3,547	2,317
Total non-interest income	20,822	20,377
Non-interest expense:		
Salaries and employee benefits	28,813	27,406
Occupancy and equipment	7,345	6,888
Professional fees	6,656	5,932
Loss on sale of other real estate owned	551	3,141
FDIC assessments	2,907	3,094
Other expenses	10,392	9,820
Total non-interest expense	56,664	56,281
Income before provision for income taxes	17,613	13,962
Provision for income taxes	5,435	3,706
Net income	$ 12,178	$ 10,256
Basic and diluted earnings per common share	$ 5.74	$ 4.96

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

EXCHANGE BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Years Ended December 31, 2011 and 2010

(In thousands)

	Preferred Stock Series A	Preferred Stock Series B	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income (Net of Taxes)	Total Stockholders' Equity
Balance, January 1, 2010	$ 41,280	$ 2,150	$ 4,286	$ 46,026	$ 56,088	$ 320	$ 150,150
Comprehensive loss:							
Net Income					10,256		10,256
Other comprehensive income:							
Net change in unrealized gain on available-for-sale investment securities (net of $1,276 in tax benefits)						(1,815)	(1,815)
Defined benefit pension plans:							
Amortization of prior service costs included in net periodic pension costs (net of $126 in tax benefits)						(78)	(78)
Net gain arising during period (net of $435 in tax provision)						275	275
Change in unrealized gain on deferred compensation trust (net of $132 in tax provision)						197	197
Total comprehensive income							8,835
Preferred stock dividends					(1,759)		(1,759)
Accretion of preferred stock discount	430				(430)		
Balance, December 31, 2010	41,710	2,150	4,286	46,026	64,155	(1,101)	157,226
Comprehensive loss:							
Net Income					12,178		12,178
Other comprehensive income:							
Net change in unrealized gain on available-for-sale investment securities (net of $1,513 in tax provision)						1,982	1,982
Defined benefit pension plans:							
Amortization of prior service costs included in net periodic pension costs (net of $191 in tax benefits)						(233)	(233)
Net loss arising during period (net of $4,525 in tax benefit)						(5,520)	(5,520)
Change in unrealized gain on deferred compensation trust (net of $189 in tax benefit)						(272)	(272)
Total comprehensive income							8,135
Preferred stock dividends					(2,342)		(2,342)
Accretion of preferred stock discount	430				(430)		
Balance, December 31, 2011	$ 42,140	$ 2,150	$ 4,286	$ 46,026	$ 73,561	$ (5,144)	$ 163,019

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

EXCHANGE BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2011 and 2010

(In thousands)

	2011	2010
Cash flows from operating activities:		
Net Income	$ 12,178	$ 10,256
Adjustments to reconcile net income to net cash provided by operating activities:		
Valuation allowance on other real estate owned	1,680	2,648
Depreciation and amortization	2,487	2,507
Provision for loan losses	12,550	19,500
Gain on sale of Bank premises and equipment	(636)	
Gain on sale of loans	(1,075)	(525)
(Gain) loss on sale of other real estate owned	(1,261)	494
Accretion of discounts and amortization of premiums on investment securities	2,602	1,975
Net change in deferred loan origination fees	(216)	108
Net loans originated with intent to sell	(4,784)	(4,278)
Increase in bank owned life insurance, net of expenses	(1,166)	(1,223)
Changes in operating assets and liabilities:		
Accrued interest receivable and other assets	(6,023)	5,583
Accrued interest payable and other liabilities	8,074	(2,665)
Net cash provided by operating activities	24,410	34,380
Cash flows from investing activities:		
Proceeds from sale of other real estate owned	10,464	3,744
Proceeds from sale of Bank premises and equipment	818	
Proceeds from maturities of investment securities	198,405	166,478
Purchase of investment securities	(224,066)	(185,437)
Redemptions of Federal Home Loan Bank (FHLB) stock	1,370	1,056
Net (increase) decrease in loans and leases	(11,383)	19,122
Purchase of bank premises and equipment	(2,835)	(943)
Net cash (used in) provided by investing activities	(27,228)	4,020
Cash flows from financing activities:		
Net increase in demand, interest bearing and savings deposits	78,768	35,823
Net decrease in time deposits	(13,037)	(67,518)
Repayments of long-term FHLB advances	(6,000)	(4,000)
Cash paid for dividends	(2,342)	(1,759)
Net cash provided by (used in) financing activities	57,389	(37,454)
Increase in cash and cash equivalents	54,571	946
Cash and cash equivalents, beginning of year	39,777	38,831
Cash and cash equivalents, end of year	$ 94,348	$ 39,777
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Interest expense	$ 4,896	$ 7,020
Income taxes	$ 2,615	$ 3,112
Non-cash investing activity:		
Transfer of loans to other real estate owned	$ 2,593	$ 10,134

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Nature of Operations

Exchange Bank (the "Bank"), a California corporation, and its wholly-owned subsidiaries, A. J. Ventures, Inc. and AJV-Ripon LLC, conduct their business from their headquarters in Santa Rosa, California. The Bank is a full service bank providing a range of commercial and retail banking services to individuals and businesses. The Bank, through its loan portfolio, has geographically concentrated credit risk in Sonoma County. Additionally, the loan portfolio has a concentration in loans secured by real estate.

The accounting and reporting policies of the Bank and its subsidiaries conform with accounting principles generally accepted in the United States of America and prevailing practices within the financial services industry. A summary of the more significant accounting and reporting policies follows:

Principles of Consolidation

The consolidated financial statements include the accounts of the Bank and its wholly-owned subsidiaries, A. J. Ventures, Inc. and AJV-Ripon LLC. The subsidiaries are used to hold real estate properties acquired through, or in lieu of, loan foreclosure. All intercompany accounts and transactions have been eliminated upon consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan and lease losses, deferred tax assets and fair value of financial instruments are particularly subject to change.

Reclassifications

Certain reclassifications have been made to prior year's balances to conform to classifications used in 2011.

Cash and Cash Equivalents

For purposes of the consolidated statement of cash flows, the Bank considers all highly liquid investments with maturities of three months or less at date of acquisition to be cash equivalents. Cash equivalents include cash, due from banks, money market investments and Federal funds sold. Generally, Federal funds are sold for one-day periods.

The Bank maintains funds on deposit with the Federal Home Loan Bank (FHLB) and other federally insured financial institutions under correspondent banking agreements. Uninsured deposits with the FHLB and correspondent banks totaled $366 at December 31, 2011.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investment Securities

The Bank classifies its investment securities as either available-for-sale or held-to-maturity at the time of purchase. Available-for-sale investment securities are measured at fair value with a corresponding recognition of the net unrealized holding gain or loss, net of income taxes, within accumulated other comprehensive income (loss), which is a separate component of stockholders' equity, until realized. Held-to-maturity investment securities are measured at amortized cost, based on the Bank's positive intent and ability to hold such securities to maturity.

Premiums and discounts are amortized or accreted over the life of the related investment security as an adjustment to interest income using a method that approximates the interest method. Interest income is recognized when earned. Realized gains and losses on the sale of investment securities are computed using the specific identification method for determining the cost of investment securities sold.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Federal Home Loan Bank (FHLB) Stock

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loans and Leases

Loans that management has the ability and intent to hold for the foreseeable future or maturity or payoff are reported at the principal amounts outstanding, adjusted for unamortized discounts and premiums and net of deferred loan origination fees and costs, write-downs and the allowance for loan losses. Direct financing leases are carried net of unearned income. Income from leases is recognized by a method that approximates a level yield on the outstanding net investment in the lease.

The Bank charges fees for originating loans and leases. These origination and commitment fees, net of certain related direct loan and lease origination costs, are deferred. The net deferred fees or costs are recognized as an adjustment of yield over the contractual life of the loan or lease using the interest method. The unamortized balance of deferred fees and costs is reported as a component of net loans and leases.

For all classes of loans, interest is accrued daily based upon outstanding loan and lease balances. However, when, in the opinion of management, loans or leases become 90 days past due or are considered impaired and the future collectibility of interest and principal is in serious doubt, a loan or lease is placed on nonaccrual status and the accrual of interest income is suspended. Any interest accrued but unpaid is charged against income. Payments received are applied to reduce principal to the extent necessary to ensure collection. Subsequent payments on these loans or leases, or payments received on nonaccrual loans or leases for which the ultimate collectibility of principal is not in doubt, are applied first to earned but unpaid interest and then to principal. Generally, loans and leases are restored to accrual status when the obligation is brought current and has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.

Loan Sales and Servicing

Included in the portfolio are loans guaranteed by the Small Business Administration (SBA) that may be sold in the secondary market. Loans held for sale are carried at the lower of cost or market value. Fair value is determined by the specific identification method as of the balance sheet date or the date that the purchasers have committed to purchase the loans. At the time the loan is sold, the related right to service the loan is recorded at fair value with the Bank earning future servicing income. Gains and losses are recognized based on the difference between the selling price and the fair value of servicing assets or liabilities and the allocated carrying value of the loans sold. At December 31, 2011 and 2010 the balance of loans originated and unsold under the SBA program totaled $4,793 and $3,771, respectively. Management has determined that the unsold loans originated through the SBA program were not material for disclosure as held for sale at December 31, 2011 and 2010.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loan Sales and Servicing (Continued)

Loans held for sale subsequently transferred to the loan portfolio are transferred at the lower of cost or market value at the date of transfer. Any difference between the carrying amount of the loan and its outstanding principal balance is recognized as an adjustment to yield by the interest method.

Servicing rights acquired through 1) a purchase or 2) the origination of loans which are sold or securitized with servicing rights retained are recognized as separate assets or liabilities. Servicing assets or liabilities are recorded at fair value, and are subsequently amortized in proportion to and over the period of the related net servicing income or expense. SBA loans with unpaid balances of approximately $16,434 and $5,806 were being serviced for others at December 31, 2011 and 2010, respectively. Servicing assets at December 31, 2011 and 2010 were not significant.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses is an estimate of probable credit losses in the Bank's loan portfolio that have been incurred as of the balance-sheet date. For all loan classes the allowance is established through a provision for loan and lease losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components, specific reserves related to impaired loans and general reserves for inherent losses related to loans that are not impaired.

For all classes of the portfolio, a loan or lease is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Loans and leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Bank measures impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral.

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the Bank for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan and Lease Losses (Continued)

The determination of the general reserve for loans and leases that are not impaired is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors to include economic trends in the Bank's service areas, industry experience and trends, concentrations, estimated collateral values, the Bank's underwriting policies, the character of the loan portfolio, and probable losses inherent in the portfolio taken as a whole.

The Bank maintains a separate allowance for each portfolio segment (loan type). These portfolio segments include real estate – commercial, real estate – construction, commercial, lease financing and consumer loans. The allowance for loan and lease losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine the Bank's overall allowance, which is included on the consolidated balance sheet.

The Bank assigns a risk rating to all loans except pools of homogeneous loans and periodically performs detailed reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Bank and the Bank's regulators. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings can be grouped into five major categories, defined as follows:

Pass – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Substandard – A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan and Lease Losses (Continued)

Doubtful – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss – Loans classified as loss are considered uncollectible and charged off immediately.

The general reserve component of the allowance for loan and lease losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk, (2) historical losses and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

Real Estate–Commercial **–** This segment is comprised of loans used to finance the acquisition of commercial real property. These loans are secured by first liens against the underlying real property. The inherent risk is driven by the borrower's capacity to service the debt combined with the value of the property collateral relative to the loan balance. Economic trends including consumer spending, consumer confidence, market interest rates, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair a borrower's capacity to service the underlying debt.

Real Estate–Construction **–** This segment is comprised of loans used to acquire, develop, and/or construct residential housing or commercial property types, including office, industrial and retail. Inherent risk is high as this segment evidences construction risk and absorption risk. Economic trends including consumer spending, consumer confidence, business confidence, market interest rates, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair absorption and compromise the borrower's capacity to service the underlying debt.

Commercial – These loans are primarily for business purposes and are typically secured by personal property and in some cases by junior liens against real property. Credit risk is mitigated by financial covenants and financial reporting requirements. Economic trends including consumer spending, consumer confidence, market interest rates, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair a borrower's capacity to service the underlying debt.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan and Lease Losses (Continued)

Individual loans and receivables in homogeneous loan portfolio segments are not evaluated for specific impairment. Rather, the sole component of the allowance for these loan types is determined by collectively measuring impairment reserve factors based on management's assessment of the following for each homogeneous loan portfolio segment: (1) inherent credit risk, (2) historical losses and (3) other qualitative factors. These reserve factors are described in further detail below for each homogeneous loan portfolio segment.

Lease Financing – This segment is primarily comprised of smaller business purpose commitments used to finance an array of business equipment. Leases are amortized over a specific period of time. Economic trends including consumer spending, consumer confidence, market interest rates, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair a borrower's capacity to service the underlying debt.

Consumer **–** This segment is comprised of installment and home equity loans and lines used to finance direct consumer purchases and/or establish lines of credit for consumer purposes. Economic trends including consumer spending, consumer confidence, market interest rates, trends in housing values, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair a borrower's capacity to service the underlying debt.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Bank's primary regulators, the FDIC and the California Department of Financial Institutions, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Allowance for Off-Balance-Sheet Commitments

The Bank also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical loss data and utilization assumptions. The allowance for off-balance-sheet commitments is included in accrued interest payable and other liabilities on the consolidated balance sheet and is not significant.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Other Real Estate Owned

Real estate properties acquired through, or in lieu of, loan foreclosure are expected to be sold and are initially recorded at the fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for loan and lease losses. Subsequent declines in the fair value of real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense as incurred. Other real estate held by the Bank and its subsidiaries totaled $8,781 and $17,070 at December 31, 2011 and 2010, respectively.

Bank Premises and Equipment

Bank premises and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation and amortization are computed on the straight-line basis over the lesser of the life of the lease or the estimated useful lives of the assets, ranging from 3 to 10 years for furniture and equipment, 5 to 10 years for leasehold improvements and 10 to 40 years for premises. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred. The Bank evaluates premises and equipment for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

Bank Owned Life Insurance

The Bank has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Retirement Plan and Postretirement Healthcare Plan

The Bank has a defined benefit pension plan covering all qualified personnel employed for the minimum required term of one year. Benefits are based on years of service and compensation projected to the separation date. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. It is the Bank's policy to contribute annually an amount at least equal to the minimum required by law. During 2007, the Plan was amended to freeze future benefit accruals for participants who have less than 15 years of service and age plus years of service less than 60. The plan was also amended to limit cost-of-living adjustments for continuing active participants. The amendments are expected to significantly reduce Plan liability and future net period pension costs.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Retirement Plan and Postretirement Healthcare Plan (Continued)

In addition, the Bank sponsors a defined benefit postretirement healthcare plan that covers both salaried and nonsalaried employees. The Plan provides medical benefits through health maintenance organizations. The Plan is funded by a voluntary employee beneficiary association (VEBA) trust maintained by the Bank. The contribution level for a retiree is based on a percentage of premium that varies according to the retiree's years of service with the Bank. The Bank's contribution for dependents is 50% of the Bank's share of the retiree's annual premium. The portion paid by the Bank is limited to 200% of the 1991 premium. Future cost-sharing plans are not expected to change from the current stated policy in the written plan. In addition, for the group of retirees that retired prior to January 1, 1991, the retiree medical benefit will be paid fully by the Bank for the life of the retiree and dependent. For employees retiring prior to January 1, 1992, or active employees with more than 25 years of service as of December 31, 1991, the 200% limit on lifetime benefits will not apply and the Bank will pay 100% of the retiree's premium and 50% of the dependent's premium. Effective December 31, 2007, the Plan was amended to cover only active employees who have at least 15 years of service and age plus years of service more than 60. The Plan was also amended to limit the maximum reimbursement amount to grandfathered retirees. The amendments are expected to significantly reduce Plan liability and future net period pension costs.

The Pension Protection Act (PPA) of 2006 became effective in 2008 and reforms U.S. pension funding laws. Some key provisions of the PPA related to funding requirements include the requirement to fund 100% of all liabilities accrued to participants and beneficiaries; changes to the calculation of minimum required contributions; changes to interest rate assumptions used to value benefit obligations; and the requirement to use new mortality tables. Management has incorporated the provisions of the PPA within their accounting for their retirement plans. See Notes 12 and 13.

Other Postretirement Benefits

The Bank has established deferred compensation and salary continuation agreements providing nonqualified defined benefit retirement income for certain executive officers of the Bank. In connection with establishing these agreements, the Bank purchased single premium life insurance policies on each participant. The salary continuation agreements are accounted for by accruing a liability based upon the present value of each individual's benefit at retirement age and recognizing the related cost of these benefits over the term of employment. The single payment premium for the life insurance policies is recorded based on the cash surrender values of the policies adjusted for income earned on the investment and expense related to mortality costs.

The Bank also has endorsement split-dollar life insurance agreements with certain employees whereby the Bank has effectively agreed to maintain a life insurance policy during the employees' postretirement period. The Bank is accruing, over the employees' service period, a liability for the actuarial present value of future costs to maintain life insurance during the employees' postretirement period.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes

Income tax expense is the total of current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates which are expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. On the consolidated balance sheet, net deferred tax assets are included in accrued interest receivable and other assets.

The determination of the amount of deferred income tax assets which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change given economic conditions and other factors. The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. All available evidence, both positive and negative is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Based upon their analysis of available evidence, management determined that it is "more likely than not" that all of the deferred income tax assets as of December 31, 2011 and 2010 will be fully realized and therefore no valuation allowance was recorded.

The Bank uses a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The Bank recognizes interest and/or penalties related to income tax matters in income tax expense.

Earnings Per Share

Earnings per share is computed by dividing net income, less preferred stock dividends and accretion, by the weighted average number of shares outstanding during the year, which was 1,714,344 for 2011 and 2010. There were $2,343 and $1,759 in preferred stock dividends and accretion paid in 2011 and 2010, respectively. In addition, there were no dilutive securities; therefore, basic and diluted earnings per share are equivalent.

Advertising

Advertising costs are charged to expense in the period incurred and totaled $643 and $505 for the years ended December 31, 2011 and 2010, respectively.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Subsequent Events

The Bank considered all events occurring from December 31, 2011 through February 22, 2012, the date the consolidated financial statements were available to be issued for disclosure and accrual in these consolidated financial statements.

Adoption of New Accounting Standards

In April 2011, the Financial Accounting Standards Board (FASB) amended existing guidance for assisting a creditor in determining whether a restructuring is a troubled debt restructuring. The amendments clarify the guidance for a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. With regard to determining whether a concession has been granted, the ASU clarifies that creditors are precluded from using the effective interest method to determine whether a concession has been granted. In the absence of using the effective interest method, a creditor must now focus on other considerations such as the value of the underlying collateral, evaluation of other collateral or guarantees, the debtor's ability to access other funds at market rates, interest rate increases and whether the restructuring results in a delay in payment that is insignificant. This guidance is effective for interim and annual reporting periods beginning after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. For purposes of measuring impairment on newly identified troubled debt restructurings, the amendments should be applied prospectively for the first interim or annual period beginning on or after June 15, 2011. The adoption of this amendment did not have a significant impact on the Bank's consolidated financial statements.

In May 2011, the FASB issued an amendment to achieve common fair value measurement and disclosure requirements between U.S. and International accounting principles. Overall, the guidance is consistent with existing U.S. accounting principles; however, there are some amendments that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The amendments in this guidance are effective for interim and annual reporting periods beginning after December 15, 2011. The Bank is currently evaluating the impact of this amendment on the consolidated financial statements.

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The amendments in this guidance are effective as of the beginning of a fiscal reporting year, and interim periods within that year, that begins after December 15, 2011. Early adoption is permitted; however, management chose not to adopt this amendment. The adoption of this amendment will change the presentation of the components of comprehensive income for the Bank as part of the consolidated statement of shareholder's equity.

(In thousands, except per share amounts)

2. FAIR VALUE MEASUREMENTS

Fair Value of Financial Instruments

The estimated carrying amounts and fair values of the Company's financial instruments are as follows:

	December 31, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 94,348	$ 94,348	$ 39,777	$ 39,777
Available-for-sale investment securities	344,930	344,930	318,376	318,376
Loans and leases, net	1,021,003	1,047,184	1,018,689	1,021,977
Accrued interest receivable	7,211	7,211	7,237	7,237
Financial liabilities:				
Deposits	1,350,883	1,352,939	1,285,152	1,285,524
Federal Home Loan Bank advances	29,000	32,777	35,000	38,024
Subordinated debentures	12,000	11,873	12,000	11,874
Accrued interest payable	352	352	458	458

These estimates do not reflect any premium or discount that could result from offering the Bank's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

The following methods and assumptions were used to estimate the fair value of financial instruments. For cash and cash equivalents, variable-rate loans and leases, accrued interest receivable and payable, demand deposits and short-term FHLB advances, the carrying amount is estimated to be fair value. For available-for-sale investment securities, fair values are based on quoted market prices, quoted market prices for similar securities and indications of value provided by brokers. The fair values for fixed-rate loans and leases are estimated using discounted cash flow analyses, using interest rates currently being offered at each reporting date for loans with similar terms to borrowers of comparable creditworthiness. Fair values for fixed-rate certificates of deposit are estimated using discounted cash flow analyses using interest rates offered at each reporting date by the Bank for certificates with similar remaining maturities. The fair value of subordinated debentures and long-term FHLB advances are determined based on the current market for like-kind instruments of a similar maturity and structure. The fair values of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements and are not significant and, therefore, not included in the above table.

2. FAIR VALUE MEASUREMENTS (Continued)

Fair Value Measurements

Fair Value Hierarchy

The Bank groups its assets and liabilities measured at fair value within three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. Valuations within these levels are based upon:

Level 1 – Quoted market prices for identical instruments traded in active exchange markets.

Level 2 – 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 or can be corroborated by observable market data.

Level 3 – Model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect the Bank's estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include management judgment and estimation which may be significant.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

(In thousands, except per share amounts)

2. FAIR VALUE MEASUREMENTS (Continued)

Fair Value Measurements (Continued)

Assets Recorded at Fair Value

The following tables present information about the Bank's assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2011 and 2010:

Recurring Basis

	2011			
Description	Fair Value	Level 1	Level 2	Level 3
Debt securities:				
U.S. Government agencies	$ 153,165		$ 153,165	
Obligations of states and political subdivisions	127,936		127,936	
Government sponsored entities mortgage-backed securities	55,743		55,743	
U.S. Treasuries	2,549		2,549	
Other securities	5,537		5,537	
Total assets measured at fair value	$ 344,930	$ -	$ 344,930	$ -

	2010			
Description	Fair Value	Level 1	Level 2	Level 3
Debt securities:				
U.S. Government agencies	$ 120,333		$ 120,333	
Obligations of states and political subdivisions	132,812		132,812	
Government sponsored entities mortgage-backed securities	55,895		55,895	
U.S. Treasuries	3,583		3,583	
Other securities	5,753		5,753	
Total assets measured at fair value	$ 318,376	$ -	$ 318,376	$ -

Fair values for available-for-sale investment securities are based on quoted market prices for similar securities. During the years ended December 31, 2011 and 2010, there were no significant transfers between Level 1 and Level 2.

(In thousands, except per share amounts)

2. FAIR VALUE MEASUREMENTS (Continued)

Fair Value Measurements (Continued)

Assets Recorded at Fair Value (Continued)

Non-recurring Basis

The Bank may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market value that were recognized at fair value which was below cost at the reporting date.

	2011				
	Fair Value	Level 1	Level 2	Level 3	Total Losses
Impaired loans:					
Real estate – commercial	$ 28,507			$ 28,507	$ 2,031
Real estate – construction	19,014			19,014	7,092
Commercial	7,380			7,380	135
Lease financing	33			33	4
Consumer	1,842			1,842	211
Other real estate owned	8,781			8,781	3,406
Total assets measured at fair value on a non-recurring basis	$ 65,557	$ -	$ -	$ 65,557	$ 12,879

	2010				
	Fair Value	Level 1	Level 2	Level 3	Total Losses
Impaired loans:					
Real estate – commercial	$ 25,695		$ 25,695		$ 4,335
Real estate – construction	24,953		24,953		6,812
Commercial	3,913		3,913		1,282
Lease financing	405		405		81
Consumer	1,134		1,134		196
Other real estate owned	17,070		17,070		2,713
Total assets measured at fair value on a non-recurring basis	$ 73,170	$ -	$ 73,170	$ -	$ 15,419

Impaired loans are collateral dependent and have been adjusted to fair value based on the estimated fair value of the underlying collateral, less estimated selling costs. If the Bank determines that the value of an impaired loan is less than the recorded investment in the loan, the carrying value is adjusted through a charge-off recorded through the allowance for loan and lease losses. Total losses of $9,473 and $12,706 represent impairment charges recognized during the years ended December 31, 2011 and 2010, respectively related to the above impaired loans.

2. FAIR VALUE MEASUREMENTS (Continued)

Fair Value Measurements (Continued)

Assets Recorded at Fair Value (Continued)

Non-recurring Basis (Continued)

Other real estate owned has been adjusted to estimated fair value, less estimated selling costs. At the time of foreclosure, assets are recorded at the estimated fair value less estimated selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan and lease losses. After foreclosure, management periodically obtains updated valuations of the foreclosed assets and, if additional impairments are deemed necessary, the impairment is recorded in other expenses on the consolidated statement of operations. Total losses of $3,406 and $2,713 represent impairment charges recognized during the year ended December 31, 2011 and 2010, respectively related to the above other real estate owned.

The following methods were used to estimate the fair value of each class of assets above:

Impaired Loans – The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned (OREO) – OREO is measured at fair value, less costs to sell. Fair values are based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

(In thousands, except per share amounts)

3. AVAILABLE-FOR-SALE INVESTMENT SECURITIES

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2011 and 2010 consisted of the following:

	2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Government agencies	$ 152,841	$ 418	$ (94)	$ 153,165
Obligations of states and political subdivisions	120,703	7,244	(11)	127,936
Government sponsored entities mortgage-backed securities	53,139	2,604		55,743
U.S. Treasuries	2,530	19		2,549
Other securities	5,337	200		5,537
	$ 334,550	$ 10,485	$ (105)	$ 344,930

	2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Government agencies	$ 120,185	$ 485	$ (337)	$ 120,333
Obligations of states and political subdivisions	128,925	4,763	(876)	132,812
Government sponsored entities mortgage-backed securities	53,468	2,504	(77)	55,895
U.S. Treasuries	3,568	20	(5)	3,583
Other securities	5,345	408		5,753
	$ 311,491	$ 8,180	$ (1,295)	$ 318,376

Net unrealized gains on available-for-sale investment securities totaling $10,380 and $6,885 were recorded, net of $4,364 and $2,851 in tax liabilities, as accumulated other comprehensive income within stockholders' equity at December 31, 2011 and 2010, respectively. There were no sales of available-for-sale investments during the years ended December 31, 2011 and 2010. There were no transfers of available-for-sale investment securities for the years ended December 31, 2011 and 2010.

(In thousands, except per share amounts)

3. AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

Available-for-sale investment securities with unrealized losses at December 31, 2011 and 2010 are summarized and classified according to the duration of the loss period as follows:

	2011		2010	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Less than twelve months:				
U.S. Government agencies	$ 1,983	$ (94)	$ 47,832	$ (337)
Obligations of states and political subdivisions	68,607	(11)	20,531	(876)
Government sponsored entities mortgage-backed securities			7,773	(77)
U.S. Treasuries			1,014	(5)
	$ 70,590	$ (105)	$ 77,150	$ (1,295)

For the years ended December 31, 2011 and 2010, no securities were in a loss position for more than twelve months.

U.S. Government Agencies

Management believes that the unrealized losses on the Bank's investment in U.S. Government agencies is caused by the fluctuation in interest rates and is not attributable to changes in credit quality. Management intends to hold these investments until at least a recovery of fair value or until maturity. The Bank does not consider these investments to be other-than-temporarily impaired at December 31, 2011.

Obligations of States and Political Subdivisions

Management believes that the unrealized losses on the Bank's investment in obligations of states and political subdivisions are a result of the fluctuation in interest rates. The contractual cash flows of these investments are considered a general obligation of, or supported by specific revenues of, a state or local municipality and the Bank intends to hold these investments until at least a recovery of fair value or until maturity. Therefore, the Bank expects to collect all amounts due and does not consider these securities to be other-than-temporarily impaired at December 31, 2011.

(In thousands, except per share amounts)

3. AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

Contractual Maturities

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

	Amortized Cost	Estimated Fair Value
Within one year	$ 25,786	$ 26,130
After one year through five years	137,982	142,236
After five years through ten years	117,643	120,821
	281,411	289,187
Investment securities not due at a single maturity date:		
Government sponsored entities mortgage-backed securities	53,139	55,743
	$ 334,550	$ 344,930

The only significant concentration of investment securities (greater than 10% of stockholders' equity) in any individual security issuer at December 31, 2011 is certain U.S. Government sponsored entities mortgage-backed securities such as Federal National Mortgage Association and Federal Home Loan Mortgage Corporation and certain U.S. Government agencies such as Federal Home Loan Bank.

Investment securities with amortized costs of $180,490 and $179,872 and fair values of $188,278 and $186,813 as of December 31, 2011 and 2010, respectively, were pledged to secure public and trust deposits, FHLB borrowing arrangements (see Note 8) and for other purposes required or permitted by law.

(In thousands, except per share amounts)

4. LOANS AND LEASES

Loans and leases are reported net of deferred loan origination fees and costs of $326 in 2011 and $542 in 2010 and consist of the following:

	December 31, 2011	December 31, 2010
Real estate – commercial	$ 668,766	$ 649,105
Real estate – construction	92,399	100,932
Commercial	161,708	162,169
Lease financing	35,406	39,793
Consumer	94,475	99,834
Total	1,052,754	1,051,833
Less: Allowance for loan and lease losses	(31,751)	(33,144)
	$ 1,021,003	$ 1,018,689

The components of the Bank's leases receivable are as follows:

	December 31, 2011	December 31, 2010
Future lease payments receivable	$ 39,468	$ 45,111
Residual interests	268	300
Unearned income	(4,330)	(5,618)
Net lease financing receivable	$ 35,406	$ 39,793

Future lease payments receivable are as follows:

Year Ending December 31,	
2012	$ 2,232
2013	6,719
2014	10,317
2015	9,362
2016	8,776
Thereafter	2,062
	$ 39,468

Certain loans have been pledged to secure borrowing arrangements (see Note 8).

(In thousands, except per share amounts)

4. LOANS AND LEASES (Continued)

Activity in the allowance for loan and lease losses for the years ended December 31, 2011 and 2010 was as follows:

	2011	2010
Balance, beginning of year	$ 33,144	$ 28,781
Provision for loan and lease losses	12,550	19,500
Loans charged-off	(15,471)	(17,533)
Recoveries	1,528	2,396
Balance, end of year	$ 31,751	$ 33,144

The following tables show the activity of the allowance for loan and lease losses for the year ended December 31, 2011 by portfolio segment, and the allocation of the allowance for loan and lease losses at December 31, 2011 and 2010 by portfolio segment and by impairment methodology:

	December 31, 2011					
	Real Estate – Commercial	Real Estate – Construction	Commercial	Lease Financing	Consumer	Total
Allowance for Credit Losses						
Beginning balance	$ 17,500	$ 4,000	$ 9,140	$ 860	$ 1,644	$ 33,144
Provision for loan and lease losses	6,405	3,289	944	494	1,418	12,550
Loans charged-off	(7,896)	(4,055)	(1,164)	(608)	(1,748)	(15,471)
Recoveries	156	52	740	296	284	1,528
Ending balance allocated to portfolio segments	$ 16,165	$ 3,286	$ 9,660	$ 1,042	$ 1,598	$ 31,751
Ending balance: individually evaluated for impairment	$ 3,704	$ 1,677	$ 724	$ 138	$ 295	$ 6,538
Ending balance: collectively evaluated for impairment	$ 12,461	$ 1,609	$ 8,936	$ 904	$ 1,303	$ 25,213
Loans						
Ending balance	$ 668,766	$ 92,399	$ 161,708	$ 35,406	$ 94,475	$ 1,052,754
Ending balance: individually evaluated for impairment	$ 34,116	$ 20,795	$ 9,105	$ 1,393	$ 1,870	$ 67,279
Ending balance: collectively evaluated for impairment	$ 634,650	$ 71,604	$ 152,603	$ 34,013	$ 92,605	$ 985,475

(In thousands, except per share amounts)

4. LOANS AND LEASES (Continued)

	December 31, 2010					
	Real Estate – Commercial	Real Estate – Construction	Commercial	Lease Financing	Consumer	Total
Allowance for Credit Losses						
Ending balance allocated to portfolio segments	$ 17,500	$ 4,000	$ 9,140	$ 860	$ 1,644	$ 33,144
Ending balance: individually evaluated for impairment	$ 4,849	$ 1,026	$ 816	$ 80	$ 137	$ 6,908
Ending balance: collectively evaluated for impairment	$ 12,651	$ 2,974	$ 8,324	$ 780	$ 1,507	$ 26,236
Loans						
Ending balance	$ 649,105	$ 100,932	$ 162,169	$ 39,793	$ 99,834	$ 1,051,833
Ending balance: individually evaluated for impairment	$ 29,990	$ 23,542	$ 7,854	$ 1,888	$ 1,148	$ 64,422
Ending balance: collectively evaluated for impairment	$ 619,115	$ 77,390	$ 154,315	$ 37,905	$ 98,686	$ 987,411

The following tables show the loan portfolio allocated by management's internal risk ratings at December 31, 2011 and 2010:

	December 31, 2011 Commercial Credit Exposure Credit Risk Profile by Internally Assigned Grade				
	Real Estate – Commercial	Real Estate – Construction	Commercial	Lease Financing	Total
Grade:					
Pass	$ 582,660	$ 60,089	$ 124,276	$ 33,915	$ 800,940
Special Mention	36,458	19,147	11,066	621	67,292
Substandard	49,648	13,163	26,366	870	90,047
Total	$ 668,766	$ 92,399	$ 161,708	$ 35,406	$ 958,279

	December 31, 2011 Consumer Credit Exposure Credit Risk Profile Based on Payment Activity	
	Consumer	Total
Grade:		
Performing	$ 94,475	$ 94,475
Non-performing		
Total	$ 94,475	$ 94,475

(In thousands, except per share amounts)

4. LOANS AND LEASES (Continued)

	December 31, 2010 Commercial Credit Exposure Credit Risk Profile by Internally Assigned Grade				
	Real Estate – Commercial	Real Estate – Construction	Commercial	Lease Financing	Total
Grade:					
Pass	$ 545,536	$ 47,562	$ 121,114	$ 36,923	$ 751,135
Special Mention	45,279	22,521	13,549	1,723	83,072
Substandard	58,290	30,849	27,506	1,147	117,792
Total	$ 649,105	$ 100,932	$ 162,169	$ 39,793	$ 951,999

	December 31, 2010 Consumer Credit Exposure Credit Risk Profile Based on Payment Activity	
	Consumer	Total
Grade:		
Performing	$ 99,028	$ 99,028
Non-performing	806	806
Total	$ 99,834	$ 99,834

The following tables show an aging analysis of the loan portfolio by the time past due at December 31, 2011 and 2010:

	December 31, 2011					
	30-89 Days Past Due	Greater Than 90 Days	Nonaccrual	Total Past Due	Current	Total Loans
Real estate – commercial	$ 389		$ 21,963	$ 22,352	$ 646,414	$ 668,766
Real estate – construction			15,378	15,378	77,021	92,399
Commercial	530	$ 3	2,037	2,570	159,138	161,708
Lease financing	392	11	280	683	34,723	35,406
Consumer	72			72	94,403	94,475
Total	$ 1,383	$ 14	$ 39,658	$ 41,055	$ 1,011,699	$ 1,052,754

	December 31, 2010					
	30-89 Days Past Due	Greater Than 90 Days	Nonaccrual	Total Past Due	Current	Total Loans
Real estate – commercial	$ 341		$ 19,149	$ 19,490	$ 556,722	$ 576,212
Real estate – construction			14,199	14,199	88,896	103,095
Commercial	33		1,793	1,826	230,059	231,885
Lease financing	763	$ 28	473	1,264	39,543	40,807
Consumer	260		20	280	99,554	99,834
Total	$ 1,397	$ 28	$ 35,634	$ 37,059	$ 1,014,774	$ 1,051,833

(In thousands, except per share amounts)

4. LOANS AND LEASES (Continued)

The following tables show information related to impaired loans at and for the years ended December 31, 2011 and 2010:

	December 31, 2011				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:	-	-	-	-	-
With an allowance recorded:					
Real estate – commercial	$ 35,845	$ 37,396	$ 3,704	$ 35,751	$ 1,988
Real estate – construction	$ 20,795	$ 34,106	$ 1,677	$ 23,382	$ 472
Commercial	$ 7,776	$ 7,938	$ 724	$ 5,714	$ 402
Lease financing	$ 1,455	$ 1,393	$ 138	$ 1,488	$ 82
Consumer	$ 1,483	$ 1,530	$ 295	$ 1,246	$ 55
Total:					
Real estate – commercial	$ 35,845	$ 37,396	$ 3,704	$ 35,751	$ 1,988
Real estate – construction	$ 20,795	$ 34,106	$ 1,677	$ 23,382	$ 472
Commercial	$ 7,776	$ 7,938	$ 724	$ 5,714	$ 402
Lease financing	$ 1,445	$ 1,393	$ 138	$ 1,488	$ 82
Consumer	$ 1,483	$ 1,530	$ 295	$ 1,246	$ 55

	December 31, 2010				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Consumer	$ 118	$ 117		$ 108	
With an allowance recorded:					
Real estate – commercial	$ 35,656	$ 36,224	$ 4,849	$ 32,738	$ 3,366
Real estate – construction	$ 25,969	$ 39,202	$ 1,026	$ 23,843	$ 479
Commercial	$ 3,652	$ 3,698	$ 816	$ 3,353	$ 299
Lease financing	$ 1,521	$ 1,521	$ 80	$ 1,397	
Consumer	$ 892	$ 916	$ 102	$ 819	$ 52
Total:					
Real estate – commercial	$ 35,656	$ 36,224	$ 4,849	$ 32,738	$ 3,366
Real estate – construction	$ 25,969	$ 39,202	$ 1,026	$ 23,843	$ 479
Commercial	$ 3,652	$ 3,698	$ 816	$ 3,353	$ 299
Lease financing	$ 1,521	$ 1,521	$ 80	$ 1,397	
Consumer	$ 1,010	$ 1,033	$ 102	$ 927	$ 52

Non-accrual loans totaled $39,658 and $35,634 at December 31, 2011 and 2010, respectively. Accruing loans that were past due 90 days or more totaled $14 at December 31, 2011 as compared to $28 at December 31, 2010.

4. LOANS AND LEASES (Continued)

Included in the impaired loans above are 101 and 75 loans in the amount of $56,274 and $47,306 that were considered to be troubled debt restructurings at December 31, 2011 and December 31, 2010, respectively.

For the years ended December 31, 2011 and 2010, the average recorded investment in impaired loans was $67,581 and $62,258, respectively. The Bank had $6,538 of specific allowance for loan and lease losses on impaired loans with a recorded investment of $67,534 at December 31, 2011 as compared to $6,908 of specific allowance for loan and lease losses on impaired loans with a recorded investment of $67,808 at December 31, 2010. Interest income on a cash basis was not significant. Foregone interest on non-accrual loans was $2,781 for the year ended December 31, 2011, compared with $2,874 for the year ended December 31, 2010.

Salaries and employee benefits totaling $1,654 and $1,125 have been deferred as loan and lease origination costs for the years ended December 31, 2011 and 2010, respectively.

The Bank has allocated $5,427 and $6,251 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2011 and 2010. The Bank has committed to lend additional amounts totaling up to $3,795 and $3,299 as of December 31, 2011 and 2010 to customers with outstanding loans that are classified as troubled debt restructurings.

During the period ending December 31, 2011, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 12 months to 5 years. Modifications involving an extension of the maturity date were for periods ranging from 6 months to 24 months.

(In thousands, except per share amounts)

4. LOANS AND LEASES (Continued)

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ended December 31, 2011:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Real estate – commercial	22	$ 17,968	$ 17,968
Real estate – construction	3	3,867	3,867
Commercial	6	4,181	4,181
Lease financing	7	430	430
Consumer	2	92	92
Total	40	$ 26,538	$ 26,538

The troubled debt restructurings described above increased the allowance for loan losses by $1,472 and resulted in no charge offs during the period ended December 31, 2011.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the period ended December 31, 2011:

	Number of Loans	Recorded Investment
Troubled debt restructurings that subsequently defaulted:		
Real estate – commercial	2	$ 779
Consumer	2	32
Total	4	$ 811

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

The troubled debt restructurings that subsequently defaulted described above did not increase the allowance for loan losses and did not result in charge offs during the period ended December 31, 2011.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Bank's internal underwriting policy.

(In thousands, except per share amounts)

5. FEDERAL HOME LOAN BANK STOCK

As a member of the Federal Home Loan Bank of San Francisco (FHLB), the Bank is required to own capital stock in an amount specified by regulation. At December 31, 2011 and 2010, the Bank owned 70,684 and 84,379 shares of $100 par value FHLB stock respectively. The stock is carried at cost and is redeemable at par with certain restrictions. The amount of stock required to be held is adjusted periodically based on a determination made by the FHLB.

6. BANK PREMISES AND EQUIPMENT

Bank premises and equipment consist of the following:

	December 31,	
	2011	2010
Land	$ 2,709	$ 2,815
Buildings	22,268	23,673
Leasehold improvements	6,575	6,545
Equipment	18,963	18,523
Construction in progress	546	645
	51,061	52,201
Less: accumulated depreciation and amortization	(33,289)	(34,595)
	$ 17,772	$ 17,606

Depreciation and amortization expense were $2,487 and $2,507 for the years ended December 31, 2011 and 2010, respectively.

7. INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following:

	December 31,	
	2011	2010
Savings	$ 238,463	$ 218,349
Money market	198,600	195,819
NOW accounts	178,065	164,758
Time, $100,000 or more	158,576	164,083
Other time	110,242	117,772
	$ 883,946	$ 860,781

(In thousands, except per share amounts)

7. INTEREST-BEARING DEPOSITS (Continued)

The Bank's other time deposits included brokered deposits which totaled $10,646 or 0.8% and $11,141 or 0.9% of total deposits, respectively, for the years ended December 31, 2011 and 2010. Brokered deposits were entirely under the Certificate of Deposit Account Registry Service (CDARS) program, which allows the Bank's deposit customers to have the entire balance of their certificate of deposit account insured by the FDIC. There were no wholesale brokered certificates of deposit at December 31, 2011 and 2010.

Aggregate annual maturities of time deposits at December 31, 2011 are as follows:

Year Ending December 31,	
2012	$ 201,562
2013	16,061
2014	13,133
2015	23,924
2016	14,138
	$ 268,818

8. FEDERAL HOME LOAN BANK ADVANCES AND OTHER LONG-TERM DEBT

Federal Home Loan Bank Advances

The Bank may borrow from the Federal Home Loan Bank, on either a short-term or long-term basis, up to 30% of its assets provided that adequate collateral has been pledged. As of December 31, 2011, the Bank has pledged investment securities with a carrying value of $67,371 and loans with a carrying value of $533,290 to secure this borrowing arrangement.

The following is a summary of the Bank's outstanding advances from the Federal Home Loan Bank of San Francisco and the weighted-average interest rate at December 31, 2011 and 2010:

2011		2010	
Amount	Weighted Average Rate	Amount	Weighted Average Rate
$ 29,000	4.50%	$ 35,000	4.48%

(In thousands, except per share amounts)

8. FEDERAL HOME LOAN BANK ADVANCES AND OTHER LONG-TERM DEBT (Continued)

Federal Home Loan Bank Advances (Continued)

The annual maturities of the advances were as follows:

Year Ending	Amount	Weighted Average Rate
2012	$ 3,000	4.77%
2013	8,000	3.97%
2014	2,000	4.43%
2015	2,000	4.52%
2016	2,000	4.72%
Thereafter	12,000	4.75%
	$ 29,000	4.50%

Subordinated Debentures

On June 15, 2005, the Bank issued $12,000 of Floating Rate Junior Subordinated Debentures due June 15, 2020. The purpose for issuing this subordinated debt, which qualifies as capital under regulatory risk-based capital standards, was to increase the Bank's Tier 2 capital. The Bank is not considered the primary beneficiary of the trust (variable interest entity); therefore, the trust is not consolidated in the Bank's financial statements, but rather the subordinated debentures are shown as a liability. The interest rate on the debentures is reset quarterly at the 3 Month LIBOR rate plus 1.80%, which was 2.15% at December 31, 2011. Payment on the debentures is interest only, payable quarterly, with all principal due at maturity. The Bank has the right to redeem all or any part of the debentures in multiples of $1 on any interest payment date on or after the interest payment date in June 2011. The bonds may be redeemed at par at a minimum of at least 30 and not more than 60 days prior to the redemption date. In addition, the Bank's ability to pay dividends is subject to certain covenants contained in the indenture related to the Bank's issuance of the debentures. The Bank is in compliance with all covenants as of December 31, 2011.

Lines of Credit

The Bank has no unsecured lines of credit with its correspondent banks as of December 31, 2011 and 2010.

(In thousands, except per share amounts)

9. INCOME TAXES

The benefit from income taxes for the years ended December 31, 2011 and 2010 consisted of the following:

	Federal	State	Total
2011			
Current	$ 500	$ 698	$ 1,198
Deferred	3,116	1,121	4,237
Provision for income taxes	$ 3,616	$ 1,819	$ 5,435
2010			
Current	$ 2,997	$ 2,201	$ 5,198
Deferred	(707)	(785)	(1,492)
Provision for income taxes	$ 2,290	$ 1,416	$ 3,706

Deferred tax assets (liabilities) are comprised of the following at December 31, 2011 and 2010:

	2011	2010
Deferred tax assets:		
Allowance for loan losses	$ 11,278	$ 14,127
Deferred compensation	5,327	5,165
Postretirement benefits	2,145	1,388
Restructuring reserve	694	695
Net operating loss	3,221	3,221
Tax credits	5,883	4,917
Nonaccrual interest	1,033	1,860
Bank premises and equipment		440
OREO property	1,985	1,432
State taxes	294	770
Other	595	
Total deferred tax assets	32,455	34,015
Deferred tax liabilities:		
Deferred loan costs	(621)	(469)
Unrealized gains on available-for-sale investment securities	(4,364)	(2,851)
Prepaid expenses	(308)	(343)
Pension expenses	(28)	(2,428)
FHLB stock dividends	(427)	(510)
Bank premises and equipment	(81)	
Other	(578)	(331)
Total deferred tax liabilities	(6,407)	(6,932)
Net deferred tax assets	$ 26,048	$ 27,083

(In thousands, except per share amounts)

9. INCOME TAXES (Continued)

The effective tax rate, as a percentage of income before income taxes, differs from the statutory Federal income tax rate as follows:

	Year Ended December 31,	
	2011	2010
Federal income tax expense, at statutory rate	35.0%	35.0%
State franchise tax, net of Federal tax effect	6.8	7.0
Tax-exempt interest on obligations of states and political subdivisions	(7.3)	(10.2)
Cash surrender value of life insurance	(2.8)	(4.0)
Tax credits	(1.7)	(2.1)
Other	0.9	0.8
Effective tax rate	30.9%	26.5%

The Bank files income tax returns in the United States jurisdiction and the State of California jurisdiction. The Bank is no longer subject to Federal income tax examinations by tax authorities for years before 2008. The Bank is no longer subject to California income tax examinations by tax authorities for years before 2007.

For the year ended December 31, 2011, the Bank has available for carryover $45,708 million of state net operating losses. The state net operating losses expire in 2030. The Bank also has available for carryover $3,542 of federal minimum tax credits and $2,341 of federal general business credits. The general business credits expire beginning in 2027. The minimum tax credits may be carried forward indefinitely.

The Bank recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2011 and 2010, the Bank recognized no interest or penalties.

10. RELATED PARTY TRANSACTIONS

During the normal course of business, the Bank enters into transactions with related parties, including Directors and executive officers. The following is a summary of the aggregate activity involving related party borrowers during 2011:

Balance, January 1, 2011	$ 10,906
Disbursements	4,146
Amounts repaid	(2,243)
Balance, December 31, 2011	$ 12,809
Undisbursed commitments to related parties, December 31, 2011	$ 4,240

(In thousands, except per share amounts)

11. COMPREHENSIVE (LOSS) INCOME

Comprehensive (loss) income includes net (loss) income and other comprehensive income (loss). Other comprehensive income (loss) for the Bank includes unrealized gains and losses on investment securities classified as available-for-sale, and changes in the funded status of defined benefit pension plans and the deferred compensation trust.

Components of other comprehensive (loss) income and related tax effects for the years ended December 31, 2011 and 2010 are as follows:

	2011	2010
Change in unrealized gain on available-for-sale investment securities	$ 3,495	$ (3,091)
Tax effect	(1,513)	1,276
Changes in unrealized gain on available-for-sale investment securities, net of tax	1,982	(1,815)
Changes in defined benefit pension plan liabilities	(10,469)	506
Tax effect	4,716	(309)
Changes in defined benefit pension plans, net of tax	(5,753)	197
Change in deferred compensation trust liabilities	(461)	329
Tax effect	189	(132)
Changes in deferred compensation trust, net of tax	(272)	197
Other comprehensive income (loss)	$ (4,043)	$ (1,421)

12. RETIREMENT PLAN

The following presents the reconciliations of plan benefit obligations and plan assets from beginning of year to end of year. The Bank uses a December 31 measurement date for the Plan.

	2011	2010
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 36,857	$ 33,833
Service cost	751	691
Interest cost	1,895	1,888
Benefits paid	(1,471)	(1,532)
COLA amendment	2,430	
Actuarial loss	5,384	1,977
Benefit obligation at end of year	$ 45,846	$ 36,857

(In thousands, except per share amounts)

12. RETIREMENT PLAN

	2011	2010
Change in plan assets:		
Fair value of plan assets at beginning of year	$ 43,097	$ 39,291
Employer contribution	4,000	
Benefits paid	(1,471)	(1,532)
Actual return on plan assets	288	5,338
Fair value of plan assets at end of year	$ 45,914	$ 43,097
Funded status at end of year	$ 68	$ 6,240

Amounts recognized in accumulated other comprehensive income at December 31 consist of:

	2011	2010
Net actuarial loss	$ 17,631	$ 9,943
Prior service cost (credit)	674	(2,039)
	$ 18,305	$ 7,904

The accumulated benefit obligation was $45,846 and $36,857 at December 31, 2011 and 2010. The Bank expects to contribute $500 to the Plan in 2012.

The following presents the Plan investments, including their fair value and method of fair value determination, as of December 31, 2011 and 2010.

2011	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and equivalents	$ 1,297	$ 1,297		
Equity securities:				
U.S. large-cap (a)	18,700	18,700		
U.S. large-cap balanced fund (b)	6,818	6,818		
U.S. small-cap (c)	2,270	2,270		
International large-cap (d)	4,450	4,450		
Fixed income securities:				
U.S. Government agencies (e)	1,326		$ 1,326	
U.S. corporate bond funds (f)	2,067	2,067		
U.S. Total Bond Market fund (g)	8,986	8,986		
Total	$ 45,914	$ 44,588	$ 1,326	$ -

(In thousands, except per share amounts)

12. RETIREMENT PLAN (Continued)

2010	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash	$ 81	$ 81		
Equity securities:				
U.S. large-cap (a)	1,629	1,629		
U.S. small-cap (b)	223	223		
International large-cap (c)	364	364		
Fixed income securities:				
Obligations of states and political subdivisions (d)	465		$ 465	
Total	$ 2,762	$ 2,297	$ 465	$ -

(a) This category comprises low-cost equity index funds not actively managed that track the S&P 500, as well as actively managed funds that track the Russell 100 value index.
(b) This category includes a tactical asset allocation fund with a target of approximately 60% equities and 40% bonds. The allocation between a passively managed U.S. large cap equity fund and a long term bond fund is actively managed to overweight the broad asset class deemed to be most undervalued on a relative basis.
(c) This category represents low-cost actively managed and broadly diversified U.S. small cap equity funds.
(d) This category represents low cost index enhanced and broadly diversified Non U.S. large cap international funds.
(e) This category represents individual government agency fixed income debentures of a short to intermediate term to maturity.
(f) This category represents low-cost actively managed U.S. investment grade bond funds.
(g) This category represents a low-cost bond index fund passively managed to track the broad U.S. fixed income markets.

In accordance with the "Prudent Expert" rule, the Plan attempts to achieve a balance of risk and reward that will provide the Plan with the greatest risk-adjusted return on assets. The maximization of risk-adjusted return is accomplished by broadly diversifying assets within the major financial asset classes and by maintaining a discipline to the target asset allocation of the Plan. The Plan is managed through a relatively passive approach to asset allocation. The Investment Manager maintains the policy asset allocation listed below except for those unusual and well documented market related events that may dictate otherwise. Stated below is the policy asset allocation at market values of Plan assets. This is the long term asset allocation desired by the Board, which should approximate the actual average asset allocation over a three to five year period. In practice asset allocation is monitored on a monthly basis and at such time as any of the minimum or maximum target asset allocations are pierced, a rebalancing transaction is required to bring all asset allocations back to policy target ranges.

(In thousands, except per share amounts)

12. RETIREMENT PLAN (Continued)

Also stated are the maximum and minimum asset allocation levels at market for each asset category.

	Minimum	Policy	Maximum
Equity	50%	65%	80%
Fixed income	25%	35%	45%
Cash and equivalents	0%	0%	5%

The allocation by asset category of the pension plan assets at December 31 is as follows:

	2011	2010
Asset category:		
Equity	70%	75%
Fixed income	27%	24%
Other	3%	1%
Total	100%	100%

The primary investment objective for the Plan assets is to achieve maximum rates of return commensurate with safety of principal, given the asset mix, credit quality and diversification guidelines and restrictions approved by the retirement committee. The asset allocation is reviewed quarterly to determine whether the portfolio mix is within an acceptable range of target allocation. Target asset allocations are based on asset and liability studies with the goal to enhance the expected return of the retirement portfolio while maintaining acceptable levels of risk.

The components of 2011 and 2010 net periodic benefit cost are as follows:

	2011	2010
Service cost	$ 751	$ 691
Interest cost	1,895	1,888
Expected return on plan assets	(3,397)	(3,101)
Amortization of unrecognized prior service cost	(283)	(283)
Amortization of unrecognized actuarial loss	803	808
Total net periodic cost	$ (229)	$ 3
Net loss (gain)	$ 8,492	$ (208)
Prior service cost	2,430	
Amortization of prior service cost	283	283
Amortization of net gain	(804)	(808)
Total recognized in other comprehensive income	10,401	(733)
Total recognized in net periodic benefit cost and other comprehensive income	$ 10,172	$ (730)

(In thousands, except per share amounts)

12. RETIREMENT PLAN (Continued)

The estimated net loss and prior service costs for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year are $521 and $525 as of December 31, 2011 and 2010, respectively.

The weighted average assumptions used to determine benefit obligations at December 31:

	2011	2010
Discount rate	4.25%	5.25%
Rate of compensation increase	4.00%	4.00%

The weighted average assumptions used to determine net periodic benefit cost at December 31:

	2011	2010
Discount rate	5.25%	5.75%
Rate of compensation increase	4.00%	4.00%
Expected return of plan assets	8.00%	8.00%

The expected return on retirement plan assets is developed using inflation expectations and risk factors to arrive at a long-term nominal expected return for each asset class. The nominal expected return for each asset class is then weighted based on the target asset allocation to develop the expected long-term rate of return on plan assets.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows:

Year Ending December 31,	Pension Benefits
2012	$ 1,427
2013	$ 1,592
2014	$ 1,800
2015	$ 1,967
2016	$ 2,129
2017 through 2021	$ 12,193

(In thousands, except per share amounts)

13. POSTRETIREMENT HEALTHCARE PLAN

The following presents the postretirement healthcare plan's combined funded status:

	2011	2010
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 4,773	$ 4,727
Service cost	70	70
Interest cost	234	244
Benefits paid	(315)	(301)
Plan participant contribution	60	48
Actuarial loss (gain)	546	(15)
Benefit obligation at end of year	$ 5,368	$ 4,773
Change in plan assets:		
Fair value of plan assets at beginning of year	$ 2,762	$ 2,681
Employer contribution		
Other payments	(38)	41
Plan participant contribution	60	48
Benefits paid	(315)	(301)
Actual return on plan assets	(64)	293
Fair value of plan assets at end of year	$ 2,405	$ 2,762
Plan assets less benefit obligation at end of year	$ (2,963)	$ (2,011)

Amounts recognized in accumulated other comprehensive income at December 31 consist of:

	2011	2010
Net actuarial loss	$ 1,438	$ 738
Prior service cost (credit)	(488)	558)
	$ 950	$ 180

The accumulated benefit obligation was $5,368 and $4,773 at December 31, 2011 and 2010. The Bank expects to contribute $1,500 to the Plan in 2012.

	2011	2010
Components of net periodic benefit costs:		
Service cost	$ 70	$ 70
Interest cost	234	244
Expected loss on plan assets	(144)	(140)
Amortization of unrecognized prior service cost	(70)	(70)
Amortization of net actuarial loss	53	52
Total net periodic benefit cost	$ 143	$ 156

(In thousands, except per share amounts)

13. POSTRETIREMENT HEALTHCARE PLAN (Continued)

	2011	2010
Net loss (gain)	$ 753	$ (168)
Amortization of net gain	(53)	(52)
Amortization of prior service cost	70	70
Total recognized in other comprehensive income	770	(150)
Total recognized in net periodic benefit cost and other comprehensive income	$ 913	$ 6

The estimated net loss and prior services costs for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost cover the next fiscal year are $149 and $(70) as of December 31, 2011 and 2010, respectively.

The following table represents the assumed health care trend rates at December 31:

	2011	2010
Health care trend rate assumed for next year	5.50%	5.50%
Rate to which the cost trend rate is assumed to decline	5.50%	5.50%
Year that the rate reaches the ultimate trend rate	2010	2010

The following presents the Plan investments, including their fair value and method of fair value determination, as of December 31, 2011 and 2010.

2011	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash	$ 24	$ 24		
Equity securities:				
U.S. large-cap (a)	1,517	1,517		
U.S. small-cap (b)	188	188		
International large-cap (c)	309	309		
Fixed income securities:				
Obligations of states and political subdivisions (d)	367		$ 367	
Total	$ 2,405	$ 2,038	$ 367	$ -

(In thousands, except per share amounts)

13. POSTRETIREMENT HEALTHCARE PLAN (Continued)

2010	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash	$ 81	$ 81		
Equity securities:				
U.S. large-cap (a)	1,629	1,629		
U.S. small-cap (b)	223	223		
International large-cap (c)	364	364		
Fixed income securities:				
Obligations of states and political subdivisions (d)	465		$ 465	
Total	$ 2,762	$ 2,297	$ 465	$ -

(a) This category comprises low-cost equity index funds not actively managed that track the S&P 500.
(b) This category represents low-cost actively managed and broadly diversified U.S. small cap equity funds.
(c) This category represents low cost index enhanced and broadly diversified Non U.S. large cap international funds.
(d) This category represents individual tax exempt state, municipalities and local government agency fixed income debentures of a short to intermediate term to maturity.

In accordance with the "Prudent Expert" rule, the Plan attempts to achieve a balance of risk and reward that will provide the Plan with the greatest risk-adjusted return on assets. The maximization of risk-adjusted return is accomplished by broadly diversifying assets within the major financial asset classes and by maintaining a discipline to the target asset allocation of the Plan. The Plan is managed through a relatively passive approach to asset allocation. The Investment Manager maintains the policy asset allocation listed below except for those unusual and well documented market related events that may dictate otherwise. Stated below is the policy asset allocation at market values of plan assets. This is the long term asset allocation desired by the Board, which should approximate the actual average asset allocation over a three to five year period. In practice, asset allocation is monitored on a monthly basis and at such time as any of the minimum or maximum target asset allocations are pierced, a rebalancing transaction is required to bring all asset allocations back to policy target ranges.

(In thousands, except per share amounts)

13. POSTRETIREMENT HEALTHCARE PLAN (Continued)

Also stated are the maximum and minimum asset allocation levels at market for each asset category.

	Minimum	Policy	Maximum
Equity	70%	80%	90%
Fixed income	10%	20%	30%
Cash and equivalents	0%	0%	20%

The allocation by asset category of the postretirement healthcare plan assets at December 31 is as follows:

	2011	2010
Asset category:		
Equity	84%	80%
Fixed income	15%	17%
Other	1%	3%
Total	100%	100%

The primary investment objective for the Plan's assets is to achieve maximum rates of return commensurate with safety of principal, given the asset mix, credit quality and diversification guidelines and restrictions approved by the retirement committee. The asset allocation is reviewed quarterly to determine whether the portfolio mix is within an acceptable range of target allocation. Target asset allocations are based on asset and liability studies with the goal to enhance the expected return of the retirement portfolio while maintaining acceptable levels of risk. The target asset allocation for the portfolio is 80% equity and 20% fixed income.

The Bank uses a December 31 measurement date for the Plan. For measurement purposes, the healthcare trend rate of 5.5% was used in 2011 and 2010. They will remain at that level thereafter except where the Bank's contribution limit applies. The healthcare cost trend rate assumptions have a significant effect on the amounts reported, but their impact is lessened because the Bank limits its annual increase at twice the 1991 average premium rate. To illustrate, increasing the assumed healthcare cost trend rates by 1.0% in each year would not change the accumulated postretirement benefit obligation as of December 31, 2011 or December 31, 2010. In addition, the aggregate of the service and interest components of net periodic postretirement benefit cost would not change as of December 31, 2011 or December 31, 2010.

Further, decreasing the assumed healthcare cost trend rates by 1.0% in each year would not change the accumulated postretirement benefit obligation as of December 31, 2011 or 2010. In addition, the aggregate service and interest components of net periodic postretirement benefit cost for the year would not change as of December 31, 2011 or December 31, 2010.

(In thousands, except per share amounts)

13. POSTRETIREMENT HEALTHCARE PLAN (Continued)

The weighted average assumptions used to determine benefit obligations at December 31 are as follows:

	2011	2010
Discount rate	4.00%	5.00%
Rate of compensation increase	N/A	N/A

The weighted average assumptions used to determine net periodic benefit cost at December 31 are as follows:

	2011	2010
Discount rate	5.00%	5.50%
Expected return of plan assets	5.50%	5.50%
Rate of compensation increase	N/A	N/A

The expected return on retirement plan assets is developed using inflation expectations and risk factors to arrive at a long-term nominal expected return for each asset class. The nominal expected return for each asset class is then weighted based on the target asset allocation to develop the expected long-term rate of return on plan assets.

The plan assets are invested in a 501(c)(9) Voluntary Employees' Beneficiary Association trust which is subject to unrelated business income tax. The plan assets were funded by the Bank initially on December 31, 1991 and periodic contributions have been made since then. As of December 31, 2011, these investments included liquid investments, fixed income debt securities and equity securities.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 was signed into law on December 8, 2003. The Plan was designed to provide only for healthcare premiums and, consequently, the measures of the postretirement benefit obligations and net periodic postretirement benefit cost do not reflect effects of the Act.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

Year Ending December 31,	Pension Benefits
2012	$ 310
2013	$ 320
2014	$ 332
2015	$ 349
2016	$ 363
2017 through 2021	$ 1,864

(In thousands, except per share amounts)

14. COMMITMENTS AND CONTINGENCIES

Financial Instruments With Off-Balance-Sheet Risk

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments represent commitments to originate fixed and variable rate loans and lines of credit and involve, to varying degrees, elements of interest rate risk and credit risk in excess of the amount recognized in the Bank's consolidated balance sheet. The Bank's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments to originate loans and lines of credit as it does for on-balance sheet instruments.

The following financial instruments represent off-balance-sheet credit risk:

	December 31,	
	2011	2010
Commitments to extend credit	$ 193,912	$ 193,086
Standby letters of credit	35,755	41,151
Total loan commitments	$ 229,667	$ 234,237

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but may include deposit accounts, accounts receivable, inventory, equipment and deeds of trust on residential real estate, land held for development and income-producing commercial properties.

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to customers.

The fair value of the liability related to commitments to extend credit and standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at December 31, 2011 and 2010. The Bank recognizes these fees as revenue over the term of the commitment or when the commitment is used.

(In thousands, except per share amounts)

14. COMMITMENTS AND CONTINGENCIES (Continued)

Leases

The Bank leases certain branch premises under operating lease agreements. The leases expire on various dates through 2028 and have renewal options for up to five years. At December 31, 2011, minimum commitments under these noncancellable leases with initial or remaining terms of one year or more are as follows:

Year Ending December 31,		
2012	$	1,540
2013		1,515
2014		1,471
2015		1,287
2016		998
Thereafter		1,990
	$	8,801

Rent expense under operating leases was $1,686 and $1,631 for the years ended December 31, 2011 and 2010, respectively.

Federal Reserve Requirement

Federal Reserve Board regulations require the Bank to maintain reserve balances on deposit with the Federal Reserve Bank. The average amount of reserves required at the Federal Reserve Bank for the years ended December 31, 2011 and 2010 were $3,103 and $3,091, respectively.

Correspondent Banking Agreements

The Bank maintains funds on deposit with other federally insured financial institutions under correspondent banking agreements. The Bank was participating in the Federal Deposit Insurance Corporation's (FDIC) Transaction Account Guarantee Program. Under that program, through December 31, 2010, all noninterest-bearing transaction accounts were fully guaranteed by the FDIC for the entire amount in the account. Coverage under the Transaction Account Guarantee Program was in addition to and separate from the coverage available under the FDIC's general deposit insurance rules. Although coverage under the Transaction Account Guarantee Program expired December 31, 2010, the FDIC adopted a final rule amending its deposit insurance regulations on November 15, 2010 to implement Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act providing for unlimited deposit insurance for noninterest-bearing transaction accounts for two years starting December 31, 2010.

14. COMMITMENTS AND CONTINGENCIES (Continued)

Contingencies

The Bank is involved in legal proceedings arising in the normal course of business. In the opinion of management, the outcomes of such proceedings will not have a material adverse effect on the Bank's financial position or results of operations.

Postretirement Benefits

The Bank has salary continuation agreements in place to provide nonqualified defined benefit retirement income for certain executive officers of the Bank. In connection with establishing these agreements, the Bank purchased split-dollar single premium life insurance policies on each participant. The agreements provide that each executive will receive annual benefits over their lifetime commencing with the month following their normal retirement date.

The Bank accrues for these future benefits from the effective date of the agreements until the executives' expected final payment dates in a systematic and rational manner. As of December 31, 2011 and 2010, the Bank had accrued $9,406 and $9,220, respectively, for potential benefits payable. This payable approximates the then present value of the benefits expected to be provided at retirement. The expense recognized under these agreements totaled $691 and $691 for the years ended December 31, 2011 and 2010, respectively.

The Bank has also established a deferred compensation plan for certain members of management for the purpose of providing the opportunity to defer compensation. At December 31, 2011 and 2010, the liability for accrued deferred compensation, including interest earned, totaled $3,237 and $3,244, respectively.

The Bank has also executed split-dollar life insurance agreements with certain employees in connection with the salary continuation agreements and deferred compensation plan whereby the Bank has effectively agreed to maintain a life insurance policy during the employees' postretirement period. The Bank had accrued a liability at December 31, 2011 and 2010 in the amount of $2,136 and $2,011, respectively, representing the actuarial present value of the costs to maintain life insurance during the employees' postretirement period.

The cash surrender value of life insurance purchased in connection with these agreements totaled $33,907 and $32,741 as of December 31, 2011 and 2010, respectively.

14. COMMITMENTS AND CONTINGENCIES (Continued)

Restructuring Activities

During 2008, the Bank recorded a restructuring liability of $2,129, included in interest payable and other liabilities, consisting of estimated discounted future costs of closing/restructuring two branch operations. In 2009, the Bank decided to keep one of the two branches and as a result reversed $998 of the liability.

The primary categories of future costs are lease payments for branch buildings net of estimated future sublease income, the book value of unamortized tenant improvements, the book value of furniture and equipment net of estimated salvage proceeds, and other direct costs associated with restructuring these operations. These future costs will be charged against the liability each month as they are incurred. The restructuring liability totaled $1,078 and $1,132 at December 31, 2011 and December 31, 2010, respectively.

15. REGULATORY MATTERS

Troubled Asset Relief Program (TARP)

On December 19, 2008, the Bank entered into a Letter Agreement (the "Purchase Agreement") with the United States Department of the Treasury (Treasury), pursuant to which the Bank issued and sold (i) 43,000 shares of the Bank's Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series A (the "Series A Preferred Stock") for a purchase price of $43,000 and (ii) warrants to purchase 2,150 shares of the Bank's Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B stock, (the "Series B Preferred Stock") for $0.01 per warrant. The Series B Preferred Stock has a redemption cost of $1,000 per share for a total of $2,150. The Treasury exercised the warrants on December 19, 2008.

The Series A Preferred Stock qualifies as Tier 1 capital and will pay non-cumulative dividends quarterly at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series B Preferred Stock also qualifies as Tier 1 capital and will pay non-cumulative dividends at a rate of 9% per annum until redemption. Either series may be redeemed by the Bank after three years; however, the Series B Preferred Stock may not be redeemed until after all the Series A Preferred Stock has been redeemed. Prior to the end of three years, the Series A Preferred Stock and the Series B Preferred Stock may be redeemed by the Bank only with proceeds from the sale of qualifying equity securities of the Bank (a Qualified Equity Offering).

15. REGULATORY MATTERS (Continued)

Troubled Asset Relief Program (TARP) (Continued)

The Series A Preferred Stock and the Series B Preferred Stock were issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. Neither the Series A Preferred Stock nor the Series B Preferred Stock will be subject to any contractual restrictions on transfer, except that the Treasury and its transferees shall not effect any transfer of the Series A or Series B Preferred Stock which would require the Bank to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Exchange Act.

The Series A and Series B Preferred Stock are non-voting, other than class voting rights on (i) any authorization or issuance of shares ranking senior to the Series A and Series B Preferred Stock, (ii) any amendment to the rights of the Series A and Series B Preferred Stock, or (iii) any merger, exchange or similar transaction which would adversely affect the rights of the Series A and Series B Preferred Stock.

If dividends on the Series A and Series B Preferred Stock are not paid in full for six dividend periods, whether or not consecutive, the holders of the Series A and Series B Preferred Stock will have the right to elect two directors. The right to elect directors will end when full dividends have been paid for four consecutive dividend periods.

In the Purchase Agreement, the Bank agreed that, until such time as the Treasury ceases to own any debt or equity securities of the Bank acquired pursuant to the Purchase Agreement, the Bank will take all necessary action to ensure that its benefit plans with respect to its senior executive officers comply with Section 111(b) of the Emergency Economic Stabilization Act of 2008 (the "EESA") as implemented by any guidance or regulation under the EESA that has been issued and is in effect as of the date of issuance of the Series A Preferred Stock and the Series B Preferred Stock, and has agreed to not adopt any benefit plans with respect to, or which covers, its senior executive officers that do not comply with the EESA, and the applicable executives have consented to the foregoing. Furthermore, the Purchase Agreement allows the Treasury to unilaterally amend the terms of the agreement.

With respect to dividends on the Bank's common stock, the Treasury's consent shall be required for any increase in common dividends per share until the third anniversary of the date of its investment unless prior to such third anniversary the Series A Preferred Stock and the Series B Preferred Stock are redeemed in whole or the Treasury has transferred all of the Senior Preferred Series A Preferred Stock and Series B Preferred Stock to third parties. After the third anniversary and prior to the tenth anniversary, the Treasury's consent shall be required for any increase in aggregate common dividends per share greater than 3% per annum; provided that no increase in common dividends may be made as a result of any dividend paid in common shares, any stock split or similar transaction. From and after the tenth anniversary, the Bank shall be prohibited from paying common dividends or repurchasing any equity securities or trust preferred securities until all equity securities held by the Treasury are redeemed in whole or the Treasury has transferred all of such equity securities to third parties.

15. REGULATORY MATTERS (Continued)

Troubled Asset Relief Program (TARP) (Continued)

Furthermore, for as long as any Series A Preferred Stock or Series B Preferred Stock is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking pari passu with the Series A Preferred Stock or Series B Preferred Stock, or common shares (other than in the case of pari passu preferred shares, dividends on a pro rata basis with the Series A Preferred Stock or Series B Preferred Stock), nor may the Bank repurchase or redeem any junior preferred shares, preferred shares ranking pari passu with the Series A Preferred Stock or Series B Preferred Stock, unless (i) in the case of non-cumulative Series A Preferred Stock and the non-cumulative Series B Preferred Stock the full dividend for the latest completed dividend period has been declared and paid in full.

The Bank recorded a discount on the Series A Preferred Stock at approximately the liquidation preference of the Series B Preferred Stock, which approximates the relative fair value of the two instruments. The discount recorded on the Series A Preferred Stock will be amortized on the level-yield method over five years.

Dividend Restrictions

The Bank is subject to restrictions on declaring dividends without the prior approval of the California Department of Financial Institutions and the FDIC.

Regulatory Capital

The Bank is subject to certain regulatory capital requirements administered by the FDIC. Failure to meet these minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Bank's consolidated financial statements.

Under capital adequacy guidelines, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. These quantitative measures are established by regulation and require that minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets be maintained. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The Bank is also subject to additional capital guidelines under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. The most recent notification from the FDIC categorized the Bank as well capitalized under these guidelines. Management believes that the Bank met all its capital adequacy requirements to which they are subject to as of December 31, 2011 and 2010. As a result of a regulatory examination in 2009, the Bank also became subject to a Tier 1 capital to average assets ratio of 9%. At December 31, 2011 and 2010, this ratio was 9.9% and 9.2%, respectively.

(In thousands, except per share amounts)

15. REGULATORY MATTERS (Continued)

Regulatory Capital (Continued)

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Minimum Amount	Minimum Ratio	Minimum Amount	Minimum Ratio
December 31, 2011						
Total capital (to risk-weighted assets)	$ 182,902	15.2%	$ 96,275	8.0%	$ 120,344	10.0%
Tier 1 capital (to risk-weighted assets)	$ 155,647	12.9%	$ 48,137	4.0%	$ 72,206	6.0%
Tier 1 capital (to average assets)	$ 155,647	9.9%	$ 62,384	4.0%	$ 77,978	5.0%
December 31, 2010						
Total capital (to risk-weighted assets)	$ 164,135	13.4%	$ 97,681	8.0%	$ 122,101	10.0%
Tier 1 capital (to risk-weighted assets)	$ 139,046	11.4%	$ 48,840	4.0%	$ 73,261	6.0%
Tier 1 capital (to average assets)	$ 139,046	9.2%	$ 60,280	4.0%	$ 75,350	5.0%