FEDERAL DEPOSIT INSURANCE CORPORATION

Washington, D.C. 20429

FORM 10-K

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

For the fiscal year ended December 31, 2012

or

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

For the transition period from _____to _____

58485

(FDIC Certificate Number)

1st Capital Bank

(Exact name of registrant as specified in its charter)

California	20-8231967
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

5 Harris Ct., Building N, Suite 3, Monterey, California 93940

(Address of principal executive offices, Zip Code)

Registrant's telephone number, including area code: 831-264-4000

Securities registered pursuant to Section 12 (b) of the Act: None

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock, No Par Value

(Title of Class)

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

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

[ ] Large accelerated filer	[ ] Accelerated filer
[ ] Non-accelerated filer (Do not check if a smaller reporting company)	[X] Smaller reporting company

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: $28,419,291.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. As of March 28, 2013, the registrant had 3,243,293 shares of its common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE - The following documents are incorporated by reference into this Form 10-K: Part III, Items 10 through 14 from registrant’s definitive proxy statement for the 2013 Annual meeting of shareholders.

The Index to Exhibits is located at page 55.

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CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING STATEMENTS

Certain matters discussed or incorporated by reference in this Annual Report on Form 10-K including, but not limited to, matters described in "Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations," are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, Section 27A of the Securities Act of 1933, as amended, and subject to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may contain words related to future projections including, but not limited to, words such as "believe," "expect," "anticipate," "intend," "may," "will," "should," "could," "would," and variations of those words and similar words that are subject to risks, uncertainties and other factors that could cause actual results to differ significantly from those projected. Factors that could cause or contribute to such differences include, but are not limited to, the following: (1) the duration of financial and economic volatility and actions taken by the United States Congress and governmental agencies, including the United States Department of the Treasury, to deal with challenges to the U.S. financial system; (2) the risks presented by a continued economic recession, which could adversely affect credit quality, collateral values including real estate collateral, investment values, liquidity and loan originations and loan portfolio delinquency rates; (3) variances in the actual versus projected growth in assets and return on assets; (4) potential increasing loan losses; (5) potential increasing levels of expenses associated with resolving nonperforming assets as well as regulatory changes; (6) changes in the interest rate environment including interest rates charged on loans, earned on securities investments and paid on deposits and other borrowed funds; (7) competition effects; (8) potential declines in fee and other noninterest income earned associated with economic factors as well as regulatory changes; (9) general economic conditions nationally, regionally, and in the operating market areas of 1st Capital Bank could be less favorable than expected or could have a more direct and pronounced effect on 1st Capital Bank than expected and adversely affect the Bank's ability to continue internal growth and maintain earning assets in accordance with the Bank's business plan; (10) changes in the regulatory environment including government intervention in the U.S. financial system; (11) changes in business conditions and inflation; (12) changes in securities markets, public debt markets, and other capital markets; (13) potential data processing and other operational systems failures or fraud; (14) potential continued decline in real estate values in 1st Capital Bank's operating market areas; (15) the effects of uncontrollable events such as terrorism, the threat of terrorism or the impact of the military conflicts in Afghanistan and Iraq and the conduct of the war on terrorism by the United States and its allies, worsening financial and economic conditions, natural disasters, and disruption of power supplies and communications; (16) changes in accounting standards, tax laws or regulations and interpretations of such standards, laws or regulations; (17) the reputation of the financial services industry could experience further deterioration, which could adversely affect 1st Capital Bank's ability to access markets for funding and to acquire and retain customers; and (18) the efficiencies that 1st Capital Bank may expect to receive from any investments in personnel and infrastructure may not be realized, as well as other factors. The factors set forth under "Item 1A-Risk Factors" in this report and other cautionary statements and information set forth in this report should be carefully considered and understood as being applicable to all related forward-looking statements contained in this report, when evaluating the business prospects of 1st Capital Bank.

Forward-looking statements are not guarantees of performance. By their nature, they involve risks, uncertainties and assumptions. The future results and shareholder values may differ significantly from those expressed in these forward-looking statements. You are cautioned not to put undue reliance on any forward-looking statement. Any such statement speaks only as of the date of this report, and in the case of any documents that may be incorporated by reference, as of the date of those documents. We do not undertake any obligation to update or release any revisions to any forward-looking statements, to report any new information, future event or other circumstances after the date of this report or to reflect the occurrence of unanticipated events, except as required by law. However, your attention is directed to any further disclosures made on related subjects in our subsequent reports filed with the Federal Deposit Insurance Corporation on Forms 10-K, 10-Q and 8-K.

PART I

Item 1. Business

Introduction

1st Capital Bank (the "Bank") was incorporated December 12, 2006 and commenced operations April 16, 2007 as a California state-chartered financial institution licensed by the California Commissioner of Financial Institutions ("Commissioner") with its deposits insured by the Federal Deposit Insurance Corporation ("FDIC") up to the maximum legal limits permissible. On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act includes a permanent increase to $250,000 as the maximum FDIC insurance limit per depositor retroactive to January 1, 2008 and the extension of unlimited FDIC insurance for noninterest-bearing transaction accounts through December 31, 2012. On November 9, 2010, the FDIC implemented a final rule to permanently increase the maximum $250,000 insurance coverage under the Dodd-Frank Act. The unlimited insurance coverage for noninterest-bearing transaction accounts was not extended and terminated on December 31, 2012. The $250,000 maximum deposit insurance amount per depositor remains in effect.

The Bank operates as a community business bank from its headquarters office located at 5 Harris Ct., Building N, Suite 3, Monterey, California 93940 in the Ryan Ranch business park. The Bank also conducts business in its three branch offices located at 300 Bonifacio Place, Monterey, California 93940, 432 Broadway St., King City, California 93930 and 1097 South Main St., Salinas, California 93901.

The Bank provides a wide array of financial services to small and mid-market businesses, business service professionals, commercial property owners and residents throughout its primary market area of Monterey County. As primarily a business bank, the Bank extends commercial and industrial loans to its business clients. The Bank's loan portfolio includes commercial real estate loans that are collateralized primarily by industrial and small office buildings in its market area. The Bank also provides construction financing with an emphasis on owner-occupied properties. The Bank's credit services include the following:

- Loans to businesses and other service professionals;
- Term loans to finance equipment;
- Commercial lines of credit;
- Overdraft lines of credit;
- Accounts receivable and inventory financing;
- Loans qualifying under the SBA guarantee program;
- Commercial real estate loans;
- Construction loans;
- Home equity loans and lines of credit;
- Vehicle and recreational vehicle loans;
- Multifamily real estate loans;
- Commercial and industrial loans; and
- Letters of credit.

The Bank utilizes its technology systems to support deposit, checking and cash management services, as well as commercial transactions of its business depositors including the following:

- ACH transactions;
- Account analysis;
- Attorney/client trust accounts;
- Checking and savings accounts;
- Merchant services;
- Interest checking accounts;
- Certificates of deposit;
- Medical and educational savings accounts;
- Retirement accounts;
- Cash management services;
- Electronic bill presentment and payment;
- Check orders for customers;
- Customer service inquiries;
- Overdraft protection;
- Point of sale check conversion;
- Statement of account;
- Stop payment;
- Remote capture; and
- Telephone and wire transfers

The Bank conducts business at its headquarters and branch offices from 9:00 a.m. to 5:00 p.m. Monday through Thursday and from 9:00 a.m. to 6:00 p.m. on Friday. The Bank also maintains automated teller machines at its Salinas and King City branch offices, which are available for clients to transact business 24 hours per day each day of the week.

At December 31, 2012, the Bank had 55 full-time equivalent employees and 3 part-time employees. Our employees are not represented by a union and we believe our employee relations are very good.

The Bank's common stock is registered under the Securities Exchange Act of 1934, as amended. The Bank's common stock is not listed on any exchange, but is quoted on the OTC Bulletin Board and the OTC Markets under the symbol "FISB."

At December 31, 2012, the Bank had total assets of $329.4 million, including loans of $243.3 million, deposits of $294.7 million and shareholders' equity of $34.0 million.

Website Access

The Bank maintains a website where certain information about the Bank is posted including its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments thereto. These reports are free of charge and can be accessed through the address www.1stcapitalbank.com. Section 16 insider reports, including Beneficial Ownership filings and other information about the Bank may be obtained at the FDIC website at www.fdic.gov.

Competition

Competitive Data

At June 30, 2012, based on the most recent "Data Book Summary of Deposits in FDIC Insured Commercial and Savings Banks" report at that date, the competing commercial and savings banks had 32 offices in the cities of Monterey, King City and Salinas, California, where the Bank has its headquarters and three branch offices.

The Bank also competes with thrifts and, to a lesser extent, credit unions, finance companies and other financial service providers for deposit and loan customers. Larger banks may have a competitive advantage because of higher lending limits and major advertising and marketing campaigns. They also perform services, such as trust services, international banking, discount brokerage and insurance services, which the Bank is not authorized nor prepared to offer currently. The Bank has made arrangements with its correspondent banks and with others to provide some of these services for its customers. For borrowers requiring loans in excess of the Bank's legal lending limits, the Bank has offered, and intends to offer in the future, such loans on a participating basis with its correspondent banks and with other community banks, retaining the portion of such loans which is within its lending limits. As of December 31, 2012, the Bank's aggregate legal lending limits to a single borrower and such borrower's related parties were approximately $5,600,000 on an unsecured basis and approximately $9,400,000 on a fully secured basis based on capital and reserves of $37,914,000.

The Bank's business is concentrated in its service area, which primarily encompasses Monterey County. The economy of the Bank's service area is dependent upon agriculture, government, manufacturing, residential construction, tourism, retail sales, population growth and smaller service-oriented businesses.

Based upon the most recent "Data Book Summary of Deposits in FDIC Insured Commercial and Savings Banks" report dated June 30, 2012, there were 82 operating commercial and savings bank offices in Monterey County with total deposits of $7,411,452,000. This was an increase of $110,219,000 over the June 30, 2011 balances. The Bank held a total of $270,176,000 in deposits, representing approximately 3.65% of total commercial and savings banks deposits in Monterey County as of June 30, 2012.

General Competitive Factors

In order to compete with the major financial institutions in their primary service areas, the Bank uses to the fullest extent possible the flexibility which is accorded by its community bank status. This includes an emphasis on specialized services, local promotional activity, and personal contacts by their respective officers, directors and employees. The Bank also seeks to provide special services and programs for individuals in its primary service area who are employed in the agricultural, professional and business fields, such as loans for equipment, furniture, tools of the

trade or expansion of practices or businesses. In the event there are customers whose loan demands exceed their respective lending limits, the Bank seeks to arrange for such loans on a participation basis with other financial institutions. The Bank also assists those customers requiring services not offered by the Bank to obtain such services from correspondent banks.

Commercial banks compete with savings and loan associations, credit unions, other financial institutions and other entities for funds. For instance, yields on corporate and government debt securities and other commercial paper affect the ability of commercial banks to attract and hold deposits. Commercial banks also compete for loans with savings and loan associations, credit unions, consumer finance companies, mortgage companies and other lending institutions.

Banking is a business that depends on interest rate differentials. In general, the difference between the interest rate paid by a bank to obtain their deposits and other borrowings and the interest rate received by a bank on loans extended to customers and on securities held in a bank's portfolio comprise the major portion of a bank's earnings.

The interest rate differentials of a bank, and therefore its earnings, are affected not only by general economic conditions, both domestic and foreign, but also by the monetary and fiscal policies of the United States as set by statutes and as implemented by federal agencies, particularly the Federal Reserve Board ("FRB"). The FRB can and does implement national monetary policy, such as seeking to curb inflation and combat recession, by its open market operations in United States government securities, adjustments in the amount of interest free reserves that banks and other financial institutions are required to maintain, and adjustments to the discount rates applicable to borrowing by banks from the FRB. These activities influence the growth of bank loans, investments and deposits and also affect interest rates charged on loans and paid on deposits. The nature and timing of any future changes in monetary policies and their impact on the Bank is not predictable.

Supervision and Regulation

General

The Bank is extensively regulated by federal and state authorities. As a California chartered bank with accounts insured by the FDIC, the Bank will be regulated, supervised and examined by the California Commissioner of Financial Institutions ("Commissioner") and the FDIC. The Bank must also comply with regulations issued by the FRB. The regulations of the Commissioner, the FDIC and the FRB will govern most aspects of the Bank's business, including the making of periodic reports by the Bank, as well as the Bank's activities relating to dividends, investments, loans, borrowings, capital requirements, certain check-clearing activities, branching, mergers and acquisitions, reserves against deposits, the issuance of securities and numerous other areas.

On July 3, 2012, the California Legislature approved and adopted a reorganization plan proposed by Governor Jerry Brown that would restructure the California government with the goal of achieving more efficient, streamlined and cost-effective government. As part of the reorganization plan, the California Department of Financial Institutions ("DFI") and the California Department of Corporations ("DOC") would be merged into a newly created Department of Business Oversight ("DBO") with a single commissioner in charge of the DBO. The former DFI and DOC would become the Division of Financial Institutions and the Division of Corporations, respectively, under the DBO. As adopted, the reorganization plan is proposed to be effective beginning July 1, 2013, subject to further approval of implementing legislation. It is uncertain what effect such reorganization plan may have upon regulation of the Bank in the future.

The Bank is also subject to the requirements and restrictions of various consumer laws and regulations, as well as certain provisions of California law, insofar as they do not conflict with or are not preempted by federal banking laws. Supervision, legal action and examination of the Bank by the federal and state banking agencies are generally intended to protect depositors and are not intended for the protection of shareholders.

Statutes, regulations and policies affecting the banking industry are frequently under review by Congress and state legislatures, and by the federal and state agencies charged with supervisory and examination authority over banking institutions. Changes in the banking and financial services industry are likely to occur in the future. Some of the changes may create opportunities for the Bank to compete in financial markets with less regulation. However, these changes also may create new competitors in geographic and product markets which have historically been limited by law to insured depository institutions such as the Bank. Changes in the statutes, regulations, or policies that affect the Bank cannot

necessarily be predicted and may have a material effect on the Bank's business and earnings. In addition, the federal and state banking agencies which have jurisdiction over the Bank have broad discretion in exercising their supervisory powers. For example, the FDIC has authority under federal law to prohibit a state bank from engaging in banking practices which it considers unsafe and unsound.

The laws of the State of California affect the Bank's business and operations. The California Financial Code provides that if the Commissioner believes that a bank is violating its articles of incorporation or state law, or is engaging in unsafe or injurious business practices, the Commissioner can order the bank to comply with the law or to cease the unsafe or injurious practices. The Commissioner has the power to suspend or remove bank officers, directors and employees who violate any law or regulation relating to the business of the bank or breach any fiduciary duty to the bank, engage in any unsafe and unsound practices related to the business of the bank, or are charged with or convicted of a felony involving dishonesty or breach of trust. The Commissioner also has authority to take possession of and to liquidate a bank, to appoint a conservator for a bank and to appoint the FDIC as receiver for a bank.

The FDIC can pursue an enforcement action against the Bank for unsafe and unsound practices in conducting its business, or for violations of any law, rule or regulation, any consent order with any agency, any condition imposed in writing by the agency, or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, cease-and-desist orders and written agreements, the termination of insurance of deposits, the imposition of civil money penalties and removal and prohibition orders against institution-affiliated parties.

In addition to the regulation and supervision outlined above, banks must be prepared for judicial scrutiny of their lending and collection practices. For example, some banks have been found liable for exercising remedies which their loan documents authorized upon the borrower's default. This has occurred in cases where the exercise of those remedies was determined to be inconsistent with the previous course of dealing between the bank and the borrower. As a result, banks have had to exercise increased caution, incur greater expense and face increased exposure to liability when dealing with delinquent loans.

The Bank's common stock is registered under Section 12(g) of the Securities Exchange Act of 1934, as amended, and is not listed for trading on any exchange, but is quoted on the OTC Bulletin Board under the symbol "FISB.ob." The Bank files periodic reports on Forms 10-K, 10-Q, and 8-K with the FDIC pursuant to Section 13 of the Securities Exchange Act of 1934, as amended.

The following is a discussion of many of the legal and regulatory requirements that govern the business and activities of the Bank.

Limitations on Dividends

Under California law the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, provided the conditions described below are satisfied.

The payment of cash dividends by the Bank will depend on various factors, including the earnings and capital requirements of the Bank and other financial conditions. The Bank's shareholders are entitled to receive dividends when and as declared by its Board of Directors, out of funds legally available therefore, subject to the restrictions set forth in the California Financial Code. The California Financial Code provides that a bank may not make a cash distribution within any one calendar year to its shareholders in excess of the lesser of (a) the bank's retained earnings; or (b) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank or by any majority-owned subsidiary of the bank to the shareholders of the bank during such period. However, a bank may, with the approval of the Commissioner, make a distribution to its shareholders in an amount not exceeding the greater of (a) its retained earnings; (b) its net income for its last fiscal year; or (c) its net income for its current fiscal year. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by the bank would be unsafe or unsound, the Commissioner may order the bank to refrain from making a proposed distribution. The Bank's retained earnings were $82,000 at December 31, 2012. Until expiration of the seven year de novo start-up period, the approval or non-objection of the FDIC may also be required for the Bank to pay cash dividends.

The Commissioner and the FDIC have authority to prohibit a bank from engaging in business practices which are considered to be unsafe or unsound. Depending upon the financial condition of a bank and upon other factors, the Commissioner or the FDIC could assert that payments of dividends or other payments by the Bank might be an unsafe or

unsound practice. The FDIC may also restrict the payment of dividends if, after the payment of such dividends, the bank would be included in one of the "undercapitalized" categories for capital adequacy purposes pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991.

The Bank has no present plans to declare or pay cash dividends in the foreseeable future. The Bank intends to retain earnings, if any, to enhance the Bank's capital in anticipation of future opportunities to include asset growth and lending limit capabilities.

Community Reinvestment Act

Under the Community Reinvestment Act ("CRA") regulations, the federal banking agencies determine a bank's CRA rating by evaluating its performance on lending, service and investment tests, with the lending test being the most important. The tests are applied in an "assessment context" that is developed by the agency for the particular institution. The assessment context takes into account demographic data about the community, the community's characteristics and needs, the institution's capacities and constraints, the institution's product offerings and business strategy, the institution's prior performance, and data on similarly situated lenders. Since the assessment context for each bank is developed by the banking agencies, a particular bank does not know until it is examined whether its CRA programs and efforts have been sufficient.

Large institutions are required to compile and report data on their lending activities to measure the performance of their loan portfolio. Some of this data is already required under other laws, such as the Equal Credit Opportunity Act. Small institutions (those with less than $250 million in assets) are examined using a "streamlined assessment method." The streamlined method focuses on the institution's loan to deposit ratio, degree of local lending, record of lending to borrowers and neighborhoods of differing income levels, and record of responding to complaints. All institutions have the option of being evaluated for CRA purposes in relation to their own pre-approved strategic plan. A strategic plan must be submitted to the institution's federal and state banking agencies three months before its effective date and must be published for public comment.

Capital Adequacy Guidelines

Risk-Based Capital. The federal banking agencies have adopted risk-based capital guidelines for insured banks. These guidelines require a minimum total risk-based capital ratio of 8%, with at least 4% in the form of Tier 1 capital. "Tier 1" capital consists of common equity, non-cumulative perpetual preferred stock and minority interests in the equity accounts of consolidated subsidiaries, if any. Tier 1 capital excludes goodwill and other specified intangibles, as well as the equity impact of adjusting available-for-sale securities to market value. In addition to the Tier 1 capital components, total capital also includes cumulative perpetual preferred stock, limited-life preferred stock, mandatory convertible securities, subordinated debt and general loan loss reserves up to a limit of 1.25% of risk-weighted assets.

The guidelines make regulatory capital requirements sensitive to the differences in risk profiles among banking institutions, take off-balance sheet items into account when assessing capital adequacy, and minimize disincentives to holding liquid low-risk assets.

The banking agencies have also instituted minimum leverage ratio guidelines for financial institutions. The leverage ratio guidelines require maintenance of a minimum ratio of 3% Tier 1 capital to adjusted quarterly average assets for the most highly rated institutions. Less highly rated institutions and institutions anticipating significant growth or subject to other significant risks are required to maintain capital levels ranging from 1% to 2% above the 3% minimum. In addition, as a de novo institution, the Bank is required to maintain a minimum leverage ratio of 8% during its de novo period of operations.

The federal banking agencies, including the FDIC, adopted regulations implementing a system of prompt corrective action under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"). The regulations establish five capital categories with the following characteristics: (1) "Well capitalized," consisting of institutions with a total risk-based capital ratio of 10% or greater, a Tier 1 risk-based capital ratio of 6% or greater and a leverage ratio of 5% or greater and which are not operating under an order, written agreement, capital directive or prompt corrective action directive; (2) "Adequately capitalized," consisting of institutions with a total risk-based capital ratio of 8% or greater, a Tier 1 risk-based capital of 4% or greater and a leverage ratio of 4% or greater and which do not meet the definition of a "well capitalized" institution; (3) "Undercapitalized," consisting of institutions with a total risk-based capital ratio of less than 8%, a Tier 1 risk-based capital ratio of less than 4%, or a leverage ratio of less than 4%;

(4) "Significantly undercapitalized," consisting of institutions with a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 3%, or a leverage ratio of less than 3%; and (5) "Critically undercapitalized," consisting of institutions with a ratio of tangible equity to total assets that is equal to or less than 2%.

The regulations establish procedures for the classification of financial institutions within the capital categories, for filing and reviewing capital restoration plans required under the regulations, and for the issuance of directives by the appropriate federal banking agency, among other matters. See "Prompt Corrective Action" below.

The appropriate federal banking agency, after notice and an opportunity for a hearing, is authorized to treat a well capitalized, adequately capitalized or undercapitalized insured depository institution as if it had a lower capital classification if it is in an unsafe and unsound condition or if it is engaging in an unsafe and unsound practices. Thus, an adequately capitalized institution can be subjected to the restrictions (described below) that are imposed on undercapitalized institutions (provided that a capital restoration plan cannot be required of the institution), and an undercapitalized institution can be subjected to the restrictions (also described below) applicable to significantly undercapitalized institutions. See "Prompt Corrective Action" described below.

An insured depository institution cannot make a capital distribution (as broadly defined to include, among other things, dividends, redemptions and other repurchases of stock), or pay management fees to any person or persons that control the institution, if it would be undercapitalized following the distribution. However, a federal banking agency may (after consultation with the FDIC) permit an insured depository institution to repurchase, redeem, retire or otherwise acquire its shares if (i) the action is taken in connection with the issuance of additional shares or obligations in at least an equivalent amount and (ii) the action will reduce the institution's financial obligations or otherwise improve its financial condition. An undercapitalized institution is generally prohibited from increasing its average total assets, and is also generally prohibited from making acquisitions, establishing new branches, or engaging in any new line of business except under an accepted capital restoration plan or with the approval of the FDIC. In addition, a federal banking agency has authority with respect to undercapitalized depository institutions to take any of the actions it is required to or may take with respect to a significantly undercapitalized institution (as described below) if it determines that those actions are necessary to carry out the purpose of FDICIA.

The federal banking agencies have adopted a joint agency policy statement to provide guidance on managing interest rate risk. The statement indicates that the adequacy and effectiveness of a bank's interest rate risk management process and the level of its interest rate sensitivity are critical factors in the agencies' evaluation of the bank's capital adequacy. If a bank has material weaknesses in its risk management process or high levels of risk exposure relative to its capital, the agencies will direct it to take corrective action. These directives may include recommendations or directions to raise additional capital, strengthen management expertise, improve management information and measurement systems, or reduce levels of risk exposure, or to undertake some combination of these actions.

At December 31, 2012, 1st Capital Bank was in compliance with the current risk-based capital guidelines.

Basel III Capital Proposal. On June 7, 2012, the federal banking agencies published notices of proposed rulemakings that would revise and replace the current capital requirements. The proposed rules implement the "Basel III" regulatory capital reforms released by the Basel Committee on Banking Supervision and changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed rules were subject to a comment period through October 22, 2012 and a projected effective date of January 1, 2013. After receipt of extensive comments and lobbying efforts on behalf of financial institutions, particularly smaller community banks, the federal banking agencies jointly issued a release on November 9, 2012 to delay the effective date of Basel III. No further effective date was announced pending further review by the federal banking agencies. Therefore, it is uncertain when the proposed rules may become effective and whether the proposed rules will be implemented in the form proposed or modified in response to comments or subject to other changes that may have a material impact upon the rules as originally proposed and their application to our Bank.

As originally proposed, the rules included new minimum capital ratio requirements to be phased in between January 1, 2013 and January 1, 2015, which would consist of the following: (i) a new common equity Tier 1 capital to total risk weighted assets ratio of 4.5%; (ii) a Tier 1 capital to total risk weighted assets ratio of 6% (increased from 4%); (iii) a total capital to total risk weighted assets ratio of 8% (unchanged from current rules); and (iv) a Tier 1 capital to adjusted average total assets ("leverage") ratio of 4%. Certain additional changes to the calculation of risk-weighted assets and Tier 1 capital components will affect the capital ratio requirements.

The proposed rules would have also established a "capital conservation buffer," which would require maintenance of a minimum of 2.5% of common equity Tier 1 capital to total risk weighted assets in excess of the regulatory minimum capital ratio requirements described above. The 2.5% buffer would increase the minimum capital ratios to (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new buffer requirement would be phased in between January 2016 and January 2019. An institution would be subject to tiered limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital ratio level fell below the buffer amount.

The federal banking agencies also proposed changes to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital ratios begin to show signs of weakness. These changes would take effect January 1, 2015 and would require insured depository institutions to meet the following increased capital ratio requirements in order to qualify as "well capitalized:" (i) a new common equity Tier 1 capital ratio of 6.5%; (ii) a Tier 1 capital ratio of 8% (increased from 6%); (iii) a total capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (increased from 4%).

Prompt Corrective Action

The FDIC has authority: (a) to request that an institution's primary federal banking agency take enforcement action against it based upon an examination by the FDIC or the agency, (b) if no action is taken within 60 days and the FDIC determines that the institution is in an unsafe and unsound condition or that failure to take the action will result in continuance of unsafe and unsound practices, to order that action be taken against the institution, and (c) to exercise this enforcement authority under "exigent circumstances" merely upon notification to the institution's primary federal banking agency. This authority gives the FDIC the same enforcement powers with respect to any institution and its subsidiaries and affiliates as the primary federal banking agency has with respect to those entities.

An undercapitalized institution is required to submit an acceptable capital restoration plan to its primary federal banking agency. The capital restoration plan must specify (a) the steps the institution will take to become adequately capitalized, (b) the capital levels to be attained each year, (c) how the institution will comply with any regulatory sanctions then in effect against the institution and (d) the types and levels of activities in which the institution will engage. The banking agency may not accept a capital restoration plan unless the agency determines, among other things, that the plan "is based on realistic assumptions, and is likely to succeed in restoring the institution's capital" and "would not appreciably increase the risk to which the institution is exposed."

FDICIA provides that the appropriate federal regulatory agency must require an insured depository institution that is significantly undercapitalized, or that is undercapitalized and either fails to submit an acceptable capital restoration plan within the time period allowed by regulation or fails in any material respect to implement a capital restoration plan accepted by the appropriate federal banking agency, to take one or more of the following actions: (a) sell enough shares, including voting shares, to become adequately capitalized; (b) merge with (or be sold to) another institution (or holding company), but only if grounds exist for appointing a conservator or receiver; (c) restrict specified transactions with banking affiliates as if the "sister bank" exception to the requirements of Section 23A of the Federal Reserve Act did not exist; (d) otherwise restrict transactions with bank or nonbank affiliates; (e) restrict interest rates that the institution pays on deposits to "prevailing rates" in the institution's "region"; (f) restrict asset growth or reduce total assets; (g) alter, reduce or terminate activities; (h) hold a new election of directors; (i) dismiss any director or senior executive officer who held office for more than 180 days immediately before the institution became undercapitalized, provided that in requiring dismissal of a director or senior executive officer, the agency must comply with procedural requirements, including the opportunity for an appeal in which the director or officer will have the burden of proving his or her value to the institution; (j) employ "qualified" senior executive officers; (k) cease accepting deposits from correspondent depository institutions; (l) divest non-depository affiliates which pose a danger to the institution; (m) be divested by a parent holding company, if applicable; and (n) take any other action which the agency determines would better carry out the purposes of the prompt corrective action provisions.

In addition to the foregoing sanctions, without the prior approval of the appropriate federal banking agency, a significantly undercapitalized institution may not pay any bonus to any senior executive officer or increase the rate of compensation for a senior executive officer without regulatory approval. If an undercapitalized institution has failed to submit or implement an acceptable capital restoration plan the appropriate federal banking agency is not permitted to approve the payment of a bonus to a senior executive officer.

Not later than 90 days after an institution becomes critically undercapitalized, the institution's primary federal banking agency must appoint a receiver or a conservator, unless the agency, with the concurrence of the FDIC, determines that the purposes of the prompt corrective action provisions would be better served by another course of action. Any alternative determination must be documented by the agency and reassessed on a periodic basis. Notwithstanding the foregoing, a receiver must be appointed after 270 days unless the FDIC determines that the institution has positive net worth, is in compliance with a capital plan, is profitable or has a sustainable upward trend in earnings, and is reducing its ratio of nonperforming loans to total loans, and unless the head of the appropriate federal banking agency and the chairperson of the FDIC certify that the institution is viable and not expected to fail.

The FDIC is required, by regulation or order, to restrict the activities of critically undercapitalized institutions. The restrictions must include prohibitions on the institution's doing any of the following without prior FDIC approval: entering into any material transactions not in the usual course of business, extending credit for any highly leveraged transaction; engaging in any "covered transaction" (as defined in Section 23A of the Federal Reserve Act) with an affiliate; paying "excessive compensation or bonuses;" and paying interest on "new or renewed liabilities" that would increase the institution's average cost of funds to a level significantly exceeding prevailing rates in the market.

Audit Requirements

Depository institutions are required to have an annual examination of their financial records. Depository institutions with assets greater than $500 million are required to have annual, independent audits and to prepare all financial statements in compliance with U.S. generally accepted accounting principles. Depository institutions are also required to have an independent audit committee comprised entirely of outside directors, independent of the institution's management.

The Bank's accounting and reporting policies are in accordance with accounting principles generally accepted in the United States (GAAP) and the practices prevalent in the banking industry. In addition, one of the conditions of the FDIC's approval of the Bank's application for deposit insurance provides that the Bank must obtain an annual audit of its financial statements by an independent public accountant.

Insurance Premiums and Assessments

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the "EESA") was signed into law. The EESA temporarily raised the limit on deposit insurance coverage provided by the FDIC from $100,000 to $250,000 per depositor. On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law, which, in part, permanently raised the maximum deposit insurance amount per depositor to $250,000.

On October 14, 2008, the FDIC implemented the Temporary Liquidity Guarantee Program (the "TLGP") to strengthen confidence and encourage liquidity in the financial system. The TLGP includes the Transaction Account Guarantee Program (the "TAGP"). The TAGP offered a full guarantee for noninterest-bearing transaction accounts held at FDIC-insured depository institutions. The unlimited deposit coverage was voluntary for eligible institutions and was in addition to the $250,000 FDIC deposit insurance per depositor that was included as part of the EESA. The TAGP coverage became effective on October 14, 2008 and continued for participating institutions until December 31, 2010. In addition to the existing risk-based deposit insurance premium assessed on such deposits, TAGP participants were to be assessed, on a quarterly basis, an annualized fee based on the participant's deposit insurance risk rating up to 25 basis points on balances in noninterest-bearing transaction accounts that exceed the existing deposit insurance limit of $250,000. The Bank elected to participate in the TAGP. On November 9, 2010, the FDIC issued a final rule implementing section 343 of the Dodd-Frank Act that provides for unlimited insurance coverage of noninterest-bearing transaction accounts. Beginning December 31, 2010, through December 31, 2012, all noninterest-bearing transaction accounts were fully insured, regardless of the balance of the account, at all FDIC-insured institutions. The unlimited insurance coverage was available to all depositors, including consumers, businesses, and government entities. This unlimited insurance coverage was separate from, and in addition to, the insurance coverage provided to a depositor's other deposit accounts held at an FDIC-insured institution.

In addition, the FDIC adopted a final rule revising its risk-based assessment system, effective April 1, 2009. The changes to the assessment system involved adjustments to the risk-based calculation of an institution's unsecured debt, secured liabilities and brokered deposits. The revisions effectively resulted in a range of possible assessments under the risk-based system of 7 to 77.5 basis points. Depending on any future losses that the FDIC Deposit Insurance

Fund ("DIF") may suffer due to failed institutions, additional significant premium increases might occur in order to replenish the DIF. The FDIC also imposed a special assessment of 5 basis points on all insured institutions. This emergency assessment was calculated based on the insured institution's assets at June 30, 2009 and paid on September 30, 2009. Based on our June 30, 2009 assets subject to the FDIC assessment, the Bank was assessed approximately $67,000 for the special assessment. On November 12, 2009, the FDIC announced a final rule to require most banks to prepay their estimated quarterly risk-based assessments for 2010, 2011 and 2012. This prepaid amount for the Bank was $748,000.

The Dodd-Frank Act signed into law on July 21, 2010 established a minimum designated reserve ratio of 1.35 percent of estimated insured deposits. The Dodd-Frank Act also mandates that the FDIC adopt a restoration plan should the DIF balance fall below 1.35 percent and provides for dividends to financial institutions should the DIF balance exceed 1.50 percent. On February 7, 2011, the FDIC Board of Directors adopted a final rule which redefines the deposit insurance assessment base as required by the Dodd-Frank Act; makes changes to insurance premium assessment rates; implements DIF dividend provisions; and revises the risk-based assessment system for large insured depository institutions (i.e., those institutions with at least $10 billion in total assets).

It is uncertain what effect the implementation of the changes to the insurance assessments will have upon the Bank; however, continued deterioration or lack of improvement in the economic conditions impacting financial institutions may necessitate further increases in premium assessments to maintain the DIF which could adversely impact the Bank's earnings.

Brokered Deposits

A bank cannot accept brokered deposits (defined to include payment of an interest rate more than 75 basis points above prevailing rates) unless (a) the bank is well capitalized or (b) the bank is adequately capitalized and receives a waiver from the FDIC. A bank that cannot receive brokered deposits also cannot offer "pass-through" insurance on employee benefit plan accounts. In addition, a bank that is adequately capitalized may not pay an interest rate on any deposit in excess of 75 basis points over prevailing market rates. These restrictions are not imposed on banks that are well capitalized.

Federal Reserve Borrowings

A Federal Reserve Bank may not make advances to an undercapitalized institution for more than 60 days in any 120-day period without a viability certification by a federal banking agency or by the Chairman of the FRB after an examination by the FRB. If an institution is deemed critically undercapitalized, an extension of Federal Reserve Bank credit cannot continue for five days without demand for payment unless the Federal Reserve Bank is willing to accept responsibility for any resulting loss to the FDIC. As a practical matter, this provision is likely to mean that Federal Reserve Bank credit will not be extended beyond the limitations in this provision.

Potential Enforcement Actions; Supervisory Agreements

Under federal law, banks and their institution-affiliated parties may be the subject of potential enforcement actions by the FDIC, the FRB or, for national banks, the Office of the Comptroller of the Currency, for unsafe and unsound practices in conducting their businesses, or for violations of any law, rule or regulation, any consent order with any agency, any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, cease-and-desist orders and written agreements, the termination of insurance of deposits, the imposition of civil money penalties and removal and prohibition orders against institution-affiliated parties.

In addition, California law provides the Commissioner with certain enforcement powers. For example, if it appears to the Commissioner that a bank is violating its articles of incorporation or state law, or is engaging in unsafe and unsound business practices, the Commissioner can order the bank to comply with the law or to cease the unsafe or injurious practices. The Commissioner also has the power to suspend or remove bank officers, directors and employees who violate any law, regulation or fiduciary duty to the bank, engage in any unsafe and unsound practices related to the business of the bank, or are charged with or convicted of a crime involving dishonesty or breach of trust. Furthermore, the Commissioner has the power to take possession of the property and business of the bank if (a) the tangible shareholders' equity of the bank is less than the greater of three percent of the bank's total assets or $1 million; (b) the bank has violated its articles of incorporation or any provision of California law; (c) the bank is conducting its business

in an unsafe and unsound manner; (d) the bank refuses to permit an examination of its books, papers and records; (e) any officer of the bank refuses to be examined under oath regarding the bank; (f) the bank is or is expected to become unable to pay its obligations as they become due; (g) the bank is in an unsafe and unsound condition, or (h) the bank neglects or refuses to observe an order of the Commissioner.

Interstate Banking

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Interstate Banking Act") established regulations for the interstate activities of banks and bank holding companies and a framework for nationwide interstate banking and branching. Since June 1, 1997, a bank in one state has generally been permitted to merge with a bank in another state without the need for explicit state law authorization. However, states were given the ability to prohibit interstate mergers with banks in their own state by "opting-out" (enacting state legislation applying to all out-of-state banks prohibiting such mergers) prior to June 1, 1997.

Since 1995, adequately capitalized and managed bank holding companies have been permitted to acquire banks located in any state, subject to two exceptions: first, a state may still prohibit bank holding companies from acquiring a bank which is less than five years old; and second, no interstate acquisition can be consummated by a bank holding company if the acquirer would control more than 10% of the deposits held by insured depository institutions nationwide or 30% or more of the deposits held by insured depository institutions in any state in which the target bank has branches.

A bank may also establish and operate *de novo* branches in any state in which the bank does not maintain a branch if that state has enacted legislation to expressly permit all out-of-state banks to establish branches in that state.

Among other things, the Interstate Banking Act amended the Community Reinvestment Act to require that in the event a bank has interstate branches, the appropriate federal banking agency must prepare for that institution a written evaluation of (i) the bank's record of CRA performance and (ii) the bank's CRA performance in each applicable state. Interstate branches are now prohibited from being used as deposit production offices. Also, a foreign bank is permitted to establish branches in any state other than its home state to the same extent that a bank chartered by the foreign bank's home state may establish such branches.

The Caldera, Weggeland, and Killea California Interstate Banking and Branching Act of 1995 (the "Caldera Act") implemented important provisions of the Interstate Banking Act discussed above and repealed California's previous interstate banking laws, which were largely preempted by the Interstate Banking Act. (Prior California law prohibited, among other things, an out-of-state bank holding company from establishing a *de novo* California bank except for the purpose of taking over the deposits of a closed bank. This restriction has been eliminated.)

As indicated above, the Interstate Banking Act generally permits a bank in one state to merge with a bank in another state without the need for explicit state law authorization. However, the Caldera Act expressly prohibits a foreign (other state) bank which does not already have a California branch office from (i) purchasing a branch office of a California bank (as opposed to purchasing the entire bank) and thereby establishing a California branch office or (ii) establishing a California branch on a *de novo* basis.

The Interstate Banking Act also requires, among other things, approval of the state bank supervisor of the target bank's home state for interstate acquisitions of banks by bank holding companies. The Caldera Act authorizes the Commissioner to approve such an interstate acquisition if the Commissioner finds that the transaction is consistent with certain criteria specified by law.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") signed into law by President Obama on July 21, 2010, includes provisions authorizing national and state banks to establish branch offices in other states to the same extent as a bank chartered by that state would be permitted to branch. Accordingly, banks may be able to enter new markets more freely.

The changes effected by the Interstate Banking Act, the Caldera Act and the Dodd-Frank Act are expected to continue to increase competition in the environment in which the Bank will operate to the extent that out-of-state financial institutions may directly or indirectly enter the Bank's market areas. It is not possible to predict the precise impact of such legislation on the Bank and the competitive environment in which it operates.

Financial Modernization

The Gramm-Leach-Bliley Financial Modernization Act of 1999, which became effective March 11, 2000 (the "GLB Act"), eliminates most barriers to affiliations among banks and securities firms, insurance companies, and other financial service providers, and enables full affiliations to occur between such entities. The legislation permits bank holding companies to become "financial holding companies" and thereby acquire securities firms and insurance companies and engage in other activities that are financial in nature. A bank holding company may become a financial holding company if each of its subsidiary banks is well capitalized under the FDICIA prompt corrective action provisions, is well managed, and has at least a satisfactory rating under the Community Reinvestment Act. A bank holding company becomes a financial holding company by filing a declaration that it wishes to do so. No regulatory approval is required for a financial holding company to acquire a company (other than a bank or savings association) that is engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the FRB.

The GLB Act defines "financial in nature" to include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency activities; merchant banking activities; and other activities that the Board has determined to be closely related to banking. In addition, a national bank also may engage, through a financial subsidiary of the bank and subject to limitations on investment, in activities that are financial in nature, other than insurance underwriting, insurance company portfolio investment, real estate development and real estate investment. To be eligible to engage in such activities the bank must be well capitalized, well managed and have at least a satisfactory CRA rating. Also, in order to continue to engage in activities that are financial in nature without regulatory actions or restrictions, subsidiary banks of a financial holding company or national banks with financial subsidiaries must continue to be well capitalized and well managed. Failure to remain well capitalized and well managed can result in the imposition of regulatory actions or restrictions, which could include divestiture of the subsidiary. In addition, a financial holding company or a bank may not acquire a company that is engaged in activities that are financial in nature unless each of the subsidiary banks of the financial holding company or the bank has a CRA rating of satisfactory or better.

USA Patriot Act

The terrorist attacks on September 11, 2001 have affected the financial services industry and have already led to federal legislation that attempts to address certain issues involving financial institutions. In October 2001, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "Patriot Act").

Part of the Patriot Act is the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the "Anti-Terrorism Act"). The Anti-Terrorism Act authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to banks, bank holding companies, and/or other financial institutions. These measures may include enhanced recordkeeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements concerning the beneficial ownership of certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions.

Among its other provisions, the Anti-Terrorism Act requires each financial institution to: (i) establish an anti-money laundering program; (ii) establish due diligence policies, procedures and controls with respect to its private banking accounts and correspondent banking accounts involving foreign individuals and certain foreign banks; and (iii) avoid establishing, maintaining, administering, or managing correspondent accounts in the United States for, or on behalf of, a foreign bank that does not have a physical presence in any country. In addition, the Anti-Terrorism Act contains a provision encouraging cooperating among financial institutions, regulatory authorities and law enforcement authorities with respect to individuals, entities and organizations engaged in, or reasonably suspected of engaging in, terrorist acts or money laundering activities. The Anti-Terrorism Act expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours. The Anti-Terrorism Act also amends the Bank Holding Company Act of 1956, as amended, and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application under these acts. Additional regulations may be adopted to implement minimum standards to verify customer identity, to encourage cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible

money laundering or terrorist activities, to prohibit the anonymous use of "concentration accounts," and to require all covered financial institutions to have in place a Bank Secrecy Act compliance program.

Certain surveillance provisions of the Patriot Act were scheduled to expire on December 31, 2005, and actions to restrict the use of the Patriot Act surveillance provisions were filed by the ACLU and other organizations. On March 9, 2006, after temporary extensions of the Patriot Act, President Bush signed the "USA Patriot Improvement and Reauthorization Act of 2005" and the "USA Patriot Act Additional Reauthorizing Amendments Act of 2006," which reauthorized all expiring provisions of the Patriot Act and extended certain provisions related to surveillance and production of business records until December 31, 2009. The extended deadline for those provisions was subsequently further extended at various times during 2010 and 2011. On May 26, 2011, President Obama signed a further four year extension of the surveillance provisions.

The effects which the Patriot Act and any additional legislation enacted by Congress may have upon financial institutions is uncertain; however, such legislation could increase compliance costs for the Bank and other financial institutions.

Sarbanes-Oxley Act

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the "Act"). The Act established significant standards for corporate governance and accountability in response to various widely published corporate scandals. Among other matters, key provisions of the Act and rules promulgated by the Securities and Exchange Commission ("SEC") pursuant to the Act include the following:

- Expanded oversight of the accounting profession by creating a new independent public company oversight board to be monitored by the SEC.
- Revised rules on auditor independence to restrict the nature of non-audit services provided to audit clients and to require such services to be pre-approved by the audit committee.
- Improved corporate responsibility through mandatory listing standards relating to audit committees, certifications of periodic reports by the CEO and CFO and making issuer interference with an audit a crime.
- Enhanced financial disclosures, including periodic reviews for largest issuers and real time disclosure of material company information.
- Enhanced criminal penalties for a broad array of white collar crimes and increases in the statute of limitations for securities fraud lawsuits.
- Disclosure of whether a company has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, and disclosure of any amendments or waivers to such code of ethics.
- Disclosure of whether a company's audit committee of its board of directors has a member of the audit committee who qualifies as an "audit committee financial expert."
- A prohibition on insider trading during pension plan black-out periods.
- Disclosure of off-balance sheet transactions.
- A prohibition on personal loans to directors and officers.
- Conditions on the use of non-GAAP (generally accepted accounting principles) financial measures.
- Standards on professional conduct for attorneys requiring attorneys having an attorney-client relationship with a company, among other matters, to report "up the ladder" to the audit committee, another board committee or the entire board of directors certain material violations.
- Expedited filing requirements for Form 4 reports of changes in beneficial ownership of securities reducing the filing deadline to within 2 business days of the date a transaction triggers an obligation to report.
- Accelerated filing requirements for Forms 10-K and 10-Q by public companies which qualify as "accelerated filers" to a phased-in reduction of the filing deadline for Form 10-K reports and Form 10-Q reports.
- Disclosure concerning website access to reports on Forms 10-K, 10-Q and 8-K, and any amendments to those reports, as soon as reasonably practicable after such reports and material are filed with or furnished to the SEC.
- Rules requiring national securities exchanges and national securities associations to prohibit the listing of any security whose issuer does not meet audit committee standards established pursuant to the Act.
- Reporting on internal controls over financial reporting.

In light of the corporate governance practices that emerged as a result of the Act, FDIC guidance regarding the Act and regulations thereunder, and the registration of the Bank's common stock under Section 12(g) of the Securities Exchange Act of 1934, as amended, the Bank has implemented certain corporate governance practices consistent with the Act and which incorporate certain standards under the Nasdaq listing rules. Such corporate governance matters include (i) the establishment of a Corporate Governance and Nominating Committee, (ii) the adoption of charters for the Corporate Governance and Nominating Committee, Audit and Compliance Committee, and the Human Resource and Compensation Committee, (iii) designation of an audit committee financial expert for the Audit and Compliance Committee, (iv) adoption of a code of ethics and an insider trading policy to supplement the Bank's pre-existing codes of conduct, and (iv) adoption of the Nasdaq standard related to the definition of director independence.

Corporate Disclosure Act

Effective January 1, 2003, the California Corporate Disclosure Act (the "CCD Act") required publicly traded corporations incorporated or qualified to do business in California to disclose information about their past history, auditors, directors and officers. Effective September 28, 2004, the CCD Act, as currently in effect and codified at California Corporations Code Section 1502.1, requires the Bank to file with the California Secretary of State and disclose within 150 days after the end of its fiscal year certain information including the following:

- The name of a company's independent auditor and a description of services, if any, performed for a company during the previous two fiscal years and the period from the end of the most recent fiscal year to the date of filing;
- The annual compensation paid to each director and the five most highly compensated non-director executive officers (including the CEO) during the most recent fiscal year, including all plan and non-plan compensation for all services rendered to a company as specified in Item 402 of Regulation S-K such as grants, awards or issuance of stock, stock options and similar equity-based compensation;
- A description of any loans made to a director at a "preferential" loan rate during the company's two most recent fiscal years, including the amount and terms of the loans;
- Whether any bankruptcy was filed by a company or any of its directors or executive officers within the previous 10 years;
- Whether any director or executive officer of a company has been convicted of fraud during the previous 10 years; and
- A description of any material pending legal proceedings other than ordinary routine litigation as specified in Item 103 of Regulation S-K and a description of such litigation where the company was found legally liable by a final judgment or order.

Check Clearing Act

The Check Clearing for the 21st Century Act ("Check 21") was signed into law in 2003 and became effective on October 28, 2004. The law facilitates check truncation by creating a new negotiable instrument called a "substitute check" which permits banks to truncate original checks, to process check information electronically and to deliver "substitute checks" to banks that want to continue receiving paper checks. Check 21 is intended to reduce the dependence of the check payment system on physical transportation networks (which can be disrupted by terrorist attacks of the type which occurred on September 11, 2001) and to streamline the collection and return process. The law does not require banks to accept checks in electronic form nor does it require banks to use the new authority granted by the Act to create "substitute checks."

Limitation on Activities

FDICIA prohibits state-chartered banks and their subsidiaries from engaging, as principal, in activities not permissible to national banks and their subsidiaries, unless the FDIC determines the activity poses no significant risk to the Bank Insurance Fund (subsequently, the Deposit Insurance Fund) and the state bank is and continues to be adequately capitalized. Similarly, state bank subsidiaries may not engage, as principal, in activities impermissible to subsidiaries of national banks. This prohibition extends to acquiring or retaining any investment, including those that would otherwise be permissible under California law.

Regulation W

The FRB adopted Regulation W which implements sections 23A and 23B of the Federal Reserve Act. Sections 23A and 23B and Regulation W limit the risks to a bank from transactions between the bank and its affiliates and limit the ability of a bank to transfer to its affiliates the benefits arising from the bank's access to insured deposits, the payment system and the discount window and other benefits of the Federal Reserve System. The statute and rule impose quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate (and a nonaffiliate if an affiliate benefits from the transaction). However, certain transactions that generally do not expose a bank to undue risk or abuse the safety net are exempted from coverage under Regulation W.

Historically, a subsidiary of a bank was not considered an affiliate for purposes of Sections 23A and 23B, since their activities were limited to activities permissible for the bank itself. The GLB Act authorized "financial subsidiaries" that may engage in activities not permissible for a bank. These financial subsidiaries are now considered affiliates. Certain transactions between a financial subsidiary and another affiliate of a bank are also covered by sections 23A and 23B under Regulation W.

Regulation W has certain exemptions, including:

- For state-chartered banks, an exemption for subsidiaries lawfully conducting nonbank activities before issuance of the final rule.
- An exemption for extensions of credit by a bank under a general purpose credit card where the borrower uses the credit to purchase goods or services from an affiliate of the bank, so long as less than 25% of the aggregate amount of purchases with the card are purchases from an affiliate of the bank (a bank that does not have nonfinancial affiliates is exempt from the 25% test).
- An exemption for loans by a bank to a third party secured by securities issued by a mutual fund affiliate of the bank (subject to a number of conditions).
- An exemption that would permit a banking organization to engage more expeditiously in internal reorganization transactions involving a bank's purchase of assets from an affiliate (subject to a number of conditions).

The final rule contains new valuation rules for a bank's investments in, and acquisitions of, affiliates.

The FRB expects examiners and other supervisory staff to review intercompany transactions closely for compliance with the statutes and Regulation W and to resolve any violations or potential violations quickly.

Tying Arrangements and Transactions with Affiliated Persons

A bank is prohibited from tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with some exceptions, a bank may not condition an extension of credit on a promise by its customer to obtain other services provided by it, its holding company or other subsidiaries (if any), or on a promise by its customer not to obtain other services from a competitor.

Directors, officers and principal shareholders of the Bank, and the companies with which they are associated, may have banking transactions with the Bank in the ordinary course of business. Any loans and commitments to loan included in these transactions must be made in compliance with the requirements of applicable law, on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons of similar creditworthiness, and on terms not involving more than the normal risk of collectability or presenting other unfavorable features.

Change in Executive Officers or Directors

Banks and bank holding companies may be required to file a notice with their primary federal banking agency before adding or replacing a member of the board of directors or hiring or changing the responsibilities of a senior executive officer. Notice is required if the bank or holding company is failing to meet its minimum capital standards or is otherwise in a "troubled condition," as defined in FDIC regulations. In addition, for a period of seven years after opening for business, the Bank may not make any changes in its executive officers or directors without the prior approval of the Commissioner.

Acquisitions of Control

Under applicable federal and state laws, it is unlawful for a person to purchase or otherwise acquire beneficial ownership of shares of common or preferred stock of the Bank, without the prior approval of the Commissioner and a notice of non-disapproval from the FDIC, if the acquisition would give the person, or any group of persons acting together (a "Group"), control of the Bank. The applicable government regulations defined "control" for these purposes to mean the direct or indirect power (i) to vote 25% or more of the Bank's outstanding shares, or (ii) to direct or cause the direction of the management and policies of the Bank, whether through ownership of voting securities, by contract or otherwise; provided that no individual will be deemed to control the Bank solely on accord of being a director, officer or employee of the Bank. Persons who directly or indirectly own or control 10% or more of a bank's outstanding shares are presumed to control the bank.

Consumer Laws and Regulations

In addition to the other laws and regulations discussed herein, the Bank must also comply with consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, and the Fair Housing Act, among others. These laws and regulations mandate disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing regulatory compliance and customer relations efforts.

Self-Test Privilege Under ECOA

The regulations promulgated by the FRB under the Equal Credit Opportunity Act ("ECOA") create a legal privilege for information developed by creditors as a result of "self-tests" they voluntarily conduct to determine the level of their compliance with ECOA. The privilege prohibits the use of self-test information by government agencies for examination purposes and by private litigants in any proceeding which alleges violations of the ECOA. The privilege applies only if the institution takes appropriate corrective action to address possible violations that are discovered in the test.

Risk Management

The federal banking agencies examine banks and bank holding companies with respect to their management of different categories of risk sensitivity. Categories of risk identified by the agencies include legal risk, operational risk, market risk, credit risk, interest rate risk, price risk, foreign exchange risk, transaction risk, compliance risk, strategic risk, credit risk, liquidity risk, and reputation risk. This examination approach causes banking agencies to focus on risk management procedures, rather than simply examining every asset and transaction. This approach supplements rather than replaces existing rating systems based on the evaluation of an institution's capital, assets, management, earnings and liquidity. It is not clear what effect, if any, this examination approach will have on the Bank.

Economic Conditions and Monetary Policies

The earnings and growth of the Bank will be affected by general economic conditions, both domestic and international, and by the monetary and fiscal policies of the United States Government and its agencies, particularly the FRB. One function of the FRB is to regulate the national supply of bank credit to mitigate recessionary and inflationary pressures. Among the instruments of monetary policy used to implement those objectives are open market transactions in United States Government securities, changes in the discount rate on member bank borrowings, and changes in reserve requirements held by depository institutions. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. However, the effect, if any, of these policies on the future business and earnings of the Bank cannot be accurately predicted.

Money Laundering Control Act

The Money Laundering Control Act of 1986 provides sanctions for the failure to report high levels of cash deposits to non-bank financial institutions. Federal banking agencies possess the power to revoke the charter or appoint a conservator for any institution convicted of money laundering. Offending state-chartered banks could lose their deposit insurance, and bank officers could face lifetime bans from working in financial institutions. The Community

Development Act, which includes a number of provisions that amend the Bank Secrecy Act, allows the Secretary of the Treasury to exempt specified currency transactions from reporting requirements and permits the federal banking agencies to impose civil money penalties on banks for violations of the currency transaction reporting requirements.

Safety and Soundness Standards

Federal banking agencies have adopted a Safety and Soundness Rule and Interagency Guidelines Prescribing Standards for Safety and Soundness (the "Guidelines"). The Guidelines create standards for a wide range of operational and managerial matters including (a) internal controls, information systems, and internal audit systems; (b) loan documentation; (c) credit underwriting; (d) interest rate exposure; (e) asset growth; (f) compensation and benefits; and (g) asset quality and earnings.

The Community Development Act required the agencies to prescribe standards prohibiting as an unsafe and unsound practice the payment of excessive compensation that could result in material financial loss to an institution, and to specify when compensation, fees or benefits become excessive. The Guidelines characterize compensation as excessive if it is unreasonable or disproportionate to the services actually performed by the executive officer, employee, director or principal shareholder being compensated.

Federal banking agencies have stated that the Guidelines are meant to be flexible and general enough to allow each institution to develop its own systems for compliance. With the exception of the standards for compensation and benefits, a failure to comply with the Guidelines' standards does not necessarily constitute an unsafe and unsound practice or condition. On the other hand, an institution in conformance with the standards may still be found to be engaged in an unsafe and unsound practice or to be in an unsafe and unsound condition.

Although meant to be flexible, an institution that falls short of the Guidelines' standards may be requested to submit a compliance plan or be subjected to regulatory enforcement actions. Generally, the federal banking agencies will request that a compliance plan be provided if an institution's failure to meet one or more of the standards is of sufficient severity to threaten the safe and sound operation of the institution. An institution must file a compliance plan within 30 days of request by its primary federal banking agency, which is the FDIC in the case of the Bank. The Guidelines provide for prior notice of and an opportunity to respond to the agency's proposed order. An enforcement action may be commenced if, after being notified that it is in violation of a safety and soundness standard, the institution fails to submit an acceptable compliance plan or fails in any material respect to implement an accepted plan. The Federal Deposit Insurance Act provides the agencies with a wide range of enforcement powers. An agency may, for example, obtain an enforceable cease and desist order in the United States District Court, or may assess civil money penalties against an institution or its affiliated parties.

State Bank Sales of Non-Deposit Investment Products

Securities and insurance activities of state non-member banks, as well as the activities of their subsidiaries and affiliates, are governed by guidelines and regulations issued by the securities and banking agencies. These agencies have taken the position that bank sales of alternative investment products, such as mutual funds, annuities and insurance products, raise substantial bank safety and soundness concerns involving consumer confusion over the nature of the products offered, as well as the potential for mismanagement of sales programs which could expose a bank to liability under the antifraud provisions of federal securities and insurance laws.

Accordingly, the agencies have issued guidelines that require, among other things, the establishment of a compliance and audit program to monitor a bank's nondeposit investment product sales activities and its compliance with applicable securities and insurance laws; the provision of full disclosures to customers about the risks of nondeposit investment products, including the possible loss of the customer's principal investment; and the conduct of securities and insurance activities of bank subsidiaries or affiliates in separate and distinct locations. In addition, the guidelines prohibit bank employees involved in deposit-taking activities from selling investment products or giving investment advice. Banks are also required to establish a qualitative standard for the selection and marketing of the investments offered by the bank, and to maintain appropriate documentation regarding the suitability of investments recommended to bank customers.

Identity Theft Prevention

The FDIC, the other federal banking agencies, and the Federal Trade Commission issued final rules and guidelines effective January 1, 2008, subject to mandatory compliance as of November 1, 2008, implementing sections 114 and 315 of the Fair and Accurate Credit Transactions Act of 2003 to require financial institutions and other creditors to develop and implement a written identity theft prevention program. The program must include reasonable policies and procedures for detecting, preventing, and mitigating identity theft in connection with certain new and existing covered accounts. Covered accounts are defined as (i) an account primarily for personal, family, or household purposes (i.e., consumer accounts), or (ii) any other account for which there is a reasonably foreseeable risk to customers or the safety and soundness of the financial institution or creditor from identity theft. The program must be appropriate to the size and complexity of the financial institution or creditor and the nature and scope of its activities and should be designed to:

- identify relevant patterns, practices, and specific forms of activity that are "red flags" of possible identity theft and incorporate those red flags into the program;
- detect the occurrence of red flags incorporated into the program;
- respond appropriately to any red flags that are detected to prevent and mitigate identity theft; and
- ensure that the program is updated periodically to reflect changes in risks to customers or to the safety and soundness of the financial institution or creditor from identity theft.

The regulations include guidelines that each financial institution must consider and, to the extent appropriate, include in its program and steps that must be taken to administer the program including (i) obtaining approval of the program by the board of directors or a committee of the board, (ii) ensuring oversight of the development, implementation and administration of the program, (iii) training staff, and (iv) overseeing service provider arrangements. The guidelines contemplate that existing fraud prevention procedures may be incorporated into the program.

Regulatory Developments in Response to Economic Volatility

In response to global credit and liquidity issues involving a number of financial institutions, the United States government, particularly the United States Department of the Treasury (the "U.S. Treasury") and the federal banking agencies, have taken a variety of extraordinary measures designed to restore confidence in the financial markets and to strengthen financial institutions, including capital injections, guarantees of bank liabilities and the acquisition of illiquid assets from banks.

Emergency Economic Stabilization Act. On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the "EESA") was signed into law. Pursuant to the EESA, the U.S. Treasury was granted the authority to take a range of actions for the purpose of stabilizing and providing liquidity to the U.S. financial markets and has implemented several programs, including the purchase by the U.S. Treasury of certain troubled assets from financial institutions under the Troubled Asset Relief Program" (the "TARP") and the direct purchase by the U.S. Treasury of equity securities of financial institutions under the Capital Purchase Program (the "CPP"). The EESA also temporarily raised the limit on deposit insurance coverage provided by the FDIC from $100,000 to $250,000 per depositor.

Capital Purchase Program. On October 24, 2008, the U.S. Treasury announced plans to direct $250 billion of the TARP funding into the CPP to acquire preferred stock investments in bank holding companies and banks. Bank holding companies and banks eligible to participate as a Qualifying Financial Institution ("QFI") in the CPP were required to enter into agreements with the U.S. Treasury containing various standard terms and conditions. The Bank did not participate in the CPP.

Temporary Liquidity Guarantee Program. Among other programs and actions taken by the U.S. Treasury and other regulatory agencies, the FDIC implemented the Temporary Liquidity Guarantee Program (the "TLGP") to strengthen confidence and encourage liquidity in the financial system. The TLGP is comprised of the Debt Guarantee Program (the "DGP") and the Transaction Account Guarantee Program (the "TAGP"). The DGP guaranteed all newly issued senior unsecured debt (e.g., promissory notes, unsubordinated unsecured notes and commercial paper) up to prescribed limits issued by participating entities beginning on October 14, 2008 and continuing through April 30, 2010. For eligible debt issued by that date, the FDIC provided the guarantee coverage until the earlier of the maturity date of the debt or June 30, 2012. The TAGP offered full guarantee for noninterest-bearing transaction accounts held at FDIC-insured depository institutions. The unlimited deposit coverage was voluntary for eligible institutions and was in addition to the $250,000 FDIC deposit insurance per account that was included as part of the EESA. In addition to the risk-based deposit insurance premium paid on deposits, TAGP participants were assessed, on a quarterly basis, an annualized 25

basis points fee on balances in noninterest-bearing transaction accounts that exceeded the existing deposit insurance limit of $250,000. The TAGP coverage became effective on October 14, 2008 and terminated on December 31, 2010 for all participating institutions. The Bank participated in the TAGP through December 31, 2010.

On November 9, 2010, the FDIC issued a final rule implementing section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") that made permanent the $250,000 deposit insurance limit per depositor and provided unlimited insurance coverage for noninterest-bearing transaction accounts from December 31, 2010 through December 31, 2012. The unlimited insurance coverage was available to all depositors, including consumers, businesses, and government entities. This unlimited insurance coverage was separate from, and in addition to, the insurance coverage provided to a depositor's other deposit accounts held at an FDIC-insured institution. The unlimited insurance coverage for noninterest-bearing transaction accounts was not extended and terminated on December 31, 2012. The $250,000 maximum deposit insurance amount per depositor remains in effect.

Financial Stability Plan. On February 10, 2009, the U.S. Treasury announced a Financial Stability Plan (the "FSP") as a comprehensive approach to strengthening the financial system and credit crisis. The Plan included a Capital Assistance Program (the "CAP") intended to serve as a bridge to raising private capital and to ensure sufficient capital to preserve or increase lending in a worse-than-expected economic deterioration. Eligibility to participate in the CAP was consistent with the criteria for QFI's under the CPP. Eligible institutions with consolidated assets in excess of $100 billion was able to obtain capital under the CAP, subject to a supervisory review process and comprehensive stress test assessment of the losses that could occur over a two year period in the future across a range of economic scenarios, including conditions more severe than anticipated or as typically used in capital planning processes. Eligible institutions with consolidated assets below $100 billion were able to obtain capital under the CAP after a supervisory review. As announced, the CAP included issuance of a convertible preferred security to the U.S. Treasury at a discount to the participating institution's stock price as of February 9, 2009, subject to a dividend to be determined. The security instrument was designed to incentivize institutions to replace the CAP capital with private capital or redeem it. Institutions participating in the CPP under TARP might also be permitted to exchange their CPP preferred stock for the convertible preferred CAP security. The Bank did not participate in the CAP.

American Recovery and Reinvestment Act. On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (the "ARRA") was signed into law. Section 7001 of the ARRA amended Section 111 of the EESA in its entirety. While the U.S. Treasury was required to promulgate regulations to implement the restrictions and standards set forth in Section 7001, the ARRA, among other things, significantly expanded the executive compensation restrictions previously imposed by the EESA. Such restrictions applied to any entity that received financial assistance under the TARP, and generally continued to apply for as long as any obligation arising from financial assistance provided under the TARP, including preferred stock issued under the CPP, remains outstanding. These ARRA restrictions do not apply to any TARP recipient during such time when the federal government (i) only holds any warrants to purchase common stock of such recipient or (ii) holds no preferred stock or warrants to purchase common stock of such recipient. Since the Bank determined not to participate in the CPP, the executive compensation restrictions and standards set forth in Section 7001 of the ARRA are not applicable to the Bank.

Term Asset-Backed Securities Loan Facility. On March 3, 2009, the U.S, Treasury and the FRB announced the Term Asset-Backed Securities Loan Facility (the "TALF"). The TALF is one of the programs under the Financial Stability Plan announced by the U.S. Treasury on February 10, 2009. The TALF was intended to help stimulate the economy by facilitating securitization activities which allow lenders to increase the availability of credit to consumers and businesses. Under the TALF, the Federal Reserve Bank of New York ("FRBNY") would lend up to $200 billion to provide financing to investors as support for purchases of certain AAA-rated asset-backed securities ("ABS") including auto loans, credit card loans, student loans, SBA-guaranteed small business loans, rental, commercial, and government vehicle fleet leases, small ticket equipment, heavy equipment, and agricultural equipment loans and leases. The FRBNY indicated an intention to cease making new loans on June 30, 2010, but loans collateralized by certain types of ABS were scheduled to cease on March 31, 2010, subject to extension of the TALF by the FRB.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The Dodd-Frank Act is intended to restructure the regulation of the financial services sector by, among other things, (i) establishing a framework to identify systemic risks in the financial system implemented by a newly created Financial Stability Oversight Council and other federal banking agencies; (ii) expanding the resolution authority of the federal banking agencies over troubled financial institutions; (iii) authorizing changes to capital and liquidity requirements; (iv)

changing deposit insurance assessments; and (v) enhancing regulatory supervision to improve the safety and soundness of the financial services sector. The Dodd-Frank Act is expected to have a significant impact upon our business as its provisions are implemented over time. Below is a summary of certain provisions of the Dodd-Frank Act which, directly or indirectly, may affect the Bank.

- *Changes to Capital Requirements.* The federal banking agencies are required to establish minimum leverage and risk-based capital requirements for banks and bank holding companies which will not be lower and could be higher than current regulatory capital and leverage standards for insured depository institutions. Under these requirements, trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than $15 billion in assets. The Dodd-Frank Act requires capital requirements to be countercyclical so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction consistent with safety and soundness.

- *Enhanced Regulatory Supervision.* The Dodd-Frank Act increases regulatory oversight, supervision and examination of banks, bank holding companies and their respective subsidiaries by the appropriate regulatory agency.

- *Consumer Protection.* The Dodd-Frank Act creates the Consumer Financial Protection Bureau ("CFPB") within the Federal Reserve System. The CFPB is responsible for establishing and implementing rules and regulations under various federal consumer protection laws governing certain consumer products and services. The CFPB has primary enforcement authority over large financial institutions with assets of $10 billion or more, while smaller institutions will be subject to the CFPB's rules and regulations through the enforcement authority of the federal banking agencies. States are permitted to adopt consumer protection laws and regulations that are more stringent than those laws and regulations adopted by the CFPB and state attorneys general are permitted to enforce consumer protection laws and regulations adopted by the CFPB.

- *Deposit Insurance.* The Dodd-Frank Act permanently increases the deposit insurance limit for insured deposits to $250,000 per depositor and extends unlimited deposit insurance to noninterest-bearing transaction accounts through December 31, 2012. Other deposit insurance changes under the Dodd-Frank Act include (i) amendment of the assessment base used to calculate an insured depository institution's deposit insurance premiums paid to the Deposit Insurance Fund ("DIF") by elimination of deposits and substitution of average consolidated total assets less average tangible equity during the assessment period as the revised assessment base; (ii) increasing the minimum designated reserve ratio of the DIF from 1.15 percent to 1.35 percent of the estimated amount of total insured deposits; (iii) eliminating the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds; and (iv) repeal of the prohibition upon the payment of interest on demand deposits to be effective one year after the date of enactment of the Dodd-Frank Act. In December 2010, pursuant to the Dodd-Frank Act, the FDIC increased the reserve ratio of the DIF to 2.0 percent effective January 1, 2011.

- *Transactions with Affiliates.* The Dodd-Frank Act enhances the requirements for certain transactions with affiliates under Section 23A and 23B of the Federal Reserve Act, including an expansion of the definition of "covered transactions" and increasing the amount of time for which collateral requirements regarding covered transactions must be maintained.

- *Transactions with Insiders.* Insider transaction limitations are expanded through the strengthening of loan restrictions to insiders and the expansion of the types of transactions subject to the various limits, including derivative transactions, repurchase agreements, reverse repurchase agreements and securities lending or borrowing transactions. Restrictions are also placed on certain asset sales to and from an insider to an institution, including requirements that such sales be on market terms and, in certain circumstances, approved by the institution's board of directors.

- *Enhanced Lending Limitations.* The Dodd-Frank Act strengthens the existing limits on a depository institution's credit exposure to include credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions.

- *Debit Card Interchange Fees.* The Dodd-Frank Act requires that the amount of any interchange fee charged by a debit card issuer with respect to a debit card transaction must be reasonable and proportional to the cost incurred by the issuer. Within nine months of enactment of the Dodd-Frank Act, the Federal Reserve Board is required to establish standards for reasonable and proportional fees which may take into account the costs of preventing fraud. The restrictions on interchange fees, however, do not apply to banks

that, together with their affiliates, have assets of less than $10 billion.

- *Interstate Branching.* The Dodd-Frank Act authorizes national and state banks to establish branch offices in other states to the same extent as a bank chartered by that state would be permitted to branch. Previously, banks could only establish branch offices in other states if the host state expressly permitted out-of-state banks to establish branch offices in that state. Accordingly, banks may be able to enter new markets more freely.

- *Charter Conversions.* Effective one year after enactment of the Dodd-Frank Act, depository institutions that are subject to a cease and desist order or certain other enforcement actions issued with respect to a significant supervisory matter are prohibited from changing their federal or state charters, except in accordance with certain notice, application and other procedures involving the applicable regulatory agencies.

- *Compensation Practices*. The Dodd-Frank Act provides that the appropriate federal banking regulators must establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company or other "covered financial institution" that provides an insider or other employee with "excessive compensation" or could lead to a material financial loss to such firm. In June 2010, prior to the enactment of the Dodd-Frank Act, the federal bank regulatory agencies jointly issued the *Interagency Guidance on Sound Incentive Compensation Policies* ("Guidance"), which requires that financial institutions establish metrics for measuring the risk to the financial institution of such loss from incentive compensation arrangements and implement policies to prohibit inappropriate risk taking that may lead to material financial loss to the institution. Together, the Dodd-Frank Act and the Guidance may impact our compensation policies and arrangements.

- *Corporate Governance.* The Dodd-Frank Act will enhance corporate governance requirements to include (i) requiring publicly traded companies to give shareholders a non-binding vote on executive compensation at their first annual meeting taking place six months after the date of enactment and at least every three years thereafter and on so-called "golden parachute" payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders; (ii) authorizing the SEC to promulgate rules that would allow shareholders to nominate their own candidates for election as directors using a company's proxy materials; (iii) directing the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1.0 billion, regardless of whether or not the company is publicly traded; and (iv) authorizing the SEC to prohibit broker discretionary voting on the election of directors and on executive compensation matters.

Many of the requirements under the Dodd-Frank Act will be implemented over an extended period of time. Therefore, the nature and extent of regulations that will be issued by various regulatory agencies and the impact such regulations will have on the operations of financial institutions such as ours is unclear. Such regulations resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

Small Business Jobs Act of 2010/Small Business Lending Fund. On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010 (the "SBJ Act"), which, among other matters, authorizes the U.S. Treasury to buy up to $30 billion in preferred stock or subordinated debt issued by community banks (or their bank holding companies provided 90% of the funds received are downstreamed to the bank subsidiary) with assets less that $10 billion pursuant to the Small Business Lending Fund (the "SBLF") created under the SBJ Act. Funds received as capital investments will qualify as Tier 1 capital. The SBLF investments are intended to increase the availability of credit for small businesses and thereby induce the creation of jobs in support of economic recovery.

The participating banks (or bank holding companies) will pay an annual dividend on the preferred stock or subordinated debt purchased by the U.S. Treasury in an amount which ranges between 5% and 1% during the initial measurement period of approximately two years determined by reducing the dividend rate 1% for every 2.5% increase in the bank's small business lending up to a lending increase of 10%. The dividend rate will be adjusted quarterly during the initial period. If a participant's lending activity does not increase in the initial period, the dividend rate will increase thereafter to 7%. After 4.5 years, the dividend rate increases to 9% until the SBLF funds are repaid. The Bank did not participate in the SBLF.

On December 23, 2010, the federal banking agencies jointly issued guidance on underwriting standards for small business loans originated under the SBLF which require adherence to safe and sound credit standards and risk management processes. It is uncertain whether the SBLF will have the intended effect of creating jobs in sufficient numbers to positively impact the economic recovery.

Impact of Legislation and Regulations

In addition to legislative changes, the various federal and state banking agencies frequently propose rules and regulations to implement and enforce already existing legislation. It cannot be predicted whether or in what form any such rules or regulations will be enacted or the effect that such regulations may have on the Bank. However, in light of the current conditions in the U.S. financial markets and economy, Congress and banking agencies have increased their focus on the regulation of the financial services industry. The Bank anticipates that additional regulations will likely increase the Bank's expenses, which may adversely impact the Bank's results of operations, financial condition, future prospects, profitability, and stock price.

Item 1A. Risk Factors

The Bank conducts business in an environment that includes certain risks described below which could have a material adverse effect on the Bank's business, results of operations, financial condition, future prospects and stock price. You are also referred to the matters described under the heading "Cautionary Statements Regarding Forward-Looking Statements," in "Item 1 - Business" and "Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report on Form 10-K for additional information regarding factors that may affect the Bank's business.

- **The Bank has a limited operating history.**

The Bank commenced business on April 16, 2007 and therefore has a limited operating history. The available historical data upon which an investor might rely in making a decision to invest in the Bank's common stock is therefore also limited and unreliable as an indicator of future performance. The Bank may or may not successfully manage its initial operating phase or so-called "de novo" period of operations, which is currently defined by applicable banking agency regulations to continue for seven years after commencement of operations. Although the Bank has reported profitability based on earnings for the years ending December 31, 2010, 2011and 2012, such profitability does not guarantee continued profitability in the future.

- **There is limited trading in the Bank's common stock.**

There is limited trading in and no established public trading market for the Bank's common stock. The Bank's common stock is not listed on any exchange. The purchasers for the common stock will likely be existing shareholders. The Bank has no present plans to assist shareholders wishing to sell their common stock to find a purchaser. The common stock of the Bank is currently quoted on the OTC Bulletin Board, but there are no current plans to register the common stock under the Securities Act of 1933 or to list the common stock for trading on the Nasdaq Stock Market or other exchange. The purchase of the Bank's common stock is suitable only for investors who have no need for liquidity of their investment, and who understand and can afford the high financial risks of investment in the common stock.

- **The price of our common stock may fluctuate significantly, and this may make it difficult for you to resell shares of common stock owned by you at times or at prices you find attractive.**

The stock market and, in particular, the market for financial institution stocks, has experienced significant volatility during the economic downturn. In some cases, the markets have produced downward pressure on stock prices for certain issuers without regard to those issuers' underlying financial strength. As a result, trading volume fluctuations and other factors may cause significant price variations to occur. This may make it difficult for you to resell shares of common stock owned by you at times or at prices you find attractive. The low trading volume in our common shares means that our shares may have less liquidity than other publicly traded companies. We cannot ensure that the volume of trading in our common shares will be maintained or will increase in the future.

The trading price of the shares of our common stock will depend on many factors, which may change from time to time and which may be beyond our control including, without limitation, our financial condition,

performance, creditworthiness and prospects, future sales or offerings of our equity or equity related securities, and other factors identified above in the forward-looking statement discussion in Part I, Item 1 of this Annual Report on Form 10-K under the heading "Cautionary Statements Regarding Forward-Looking Statements" and below. These broad market fluctuations have adversely affected and may continue to adversely affect the market price of our common stock. Among the additional factors that could affect our stock price are:

- actual or anticipated quarterly fluctuations in our operating results and financial condition;
- changes in financial estimates or publication of research reports and recommendations by financial analysts or actions taken by rating agencies with respect to our common stock or those of other financial institutions;
- failure to meet analysts' revenue or earnings estimates;
- speculation in the press or investment community generally or relating to our reputation, our market area, our competitors or the financial services industry in general;
- strategic actions by us or our competitors, such as acquisitions, restructurings, dispositions or financings;
- actions by our current shareholders, including sales of common stock by existing shareholders and/or directors and executive officers;
- fluctuations in the stock price and operating results of our competitors;
- future sales of our equity, equity-related or debt securities;
- changes related to dividends or share repurchases;
- proposed or adopted regulatory changes or developments;
- anticipated or pending investigations, proceedings, or litigation that involves or affects us;
- trading activities in our common stock, including short-selling;
- domestic and international economic factors unrelated to our performance; and
- general market conditions and, in particular, developments related to market conditions for the financial services industry.

A significant decline in our stock price could result in substantial losses for individual shareholders.

- **The Bank's directors and executive officers own a substantial portion of the common stock.**

Members of the Bank's Board of Directors and its executive officers own as a group approximately 357,000 shares (including 59,500 shares of nonvested restricted stock awards), which represents approximately 10.8% of the 3,310,503 shares of the Bank's outstanding common stock at December 31, 2012. In addition, options to purchase or receive through vesting 274,368 shares equal to approximately 8.3% of the Bank's outstanding common stock at December 31, 2012 have been granted to directors and executive officers of the Bank as a group. Substantial ownership of the Bank's common stock by directors and executive officers could make it difficult for other shareholders to replace directors and executive officers if they want to do so.

- **The issuance of additional shares could have a dilutive effect on the existing holders of our common stock and adversely affect the market price of our common stock.**

Our articles of incorporation provide the authority to issue without further shareholder approval, 20,000,000 shares of common stock, no par value per share, of which 3,310,503 shares were issued and outstanding at December 31, 2012. Under the Bank's 2007 Equity Incentive Plan, at December 31, 2012, employees and directors of the Bank had outstanding stock options to purchase 493,039 shares of the Bank's common stock and had been granted 59,500 shares of restricted stock. As of December 31, 2012, 383,440 shares of common stock remained available for awards of stock options and restricted stock under the 2007 Equity Incentive Plan.

We are not restricted from issuing additional shares of common stock or securities that are convertible into or exchangeable for, or that represent the right to receive, common stock. We periodically evaluate opportunities to access the capital markets taking into account our regulatory capital ratios, financial condition and other relevant considerations, and subject to market conditions, we may decide in the future to pursue capital raising actions. Such actions could include, among other things, the issuance of additional shares of common stock in public or private transactions in order to further increase our capital levels for strategic opportunities or other reasons.

The issuance of any additional shares of common stock or securities convertible into or exchangeable for common stock or that represent the right to receive common stock, or the exercise of such securities including, without limitation, securities issued upon exercise of outstanding stock option or restricted stock awards under our 2007 Equity Incentive Plan, could be substantially dilutive to shareholders of our common stock. Holders of our shares of

common stock have no preemptive rights that entitle holders to purchase their pro rata share of any offering of shares of any class or series and, therefore, such sales or offerings could result in increased dilution to our shareholders. The market price of our common stock could decline as a result of sales of shares of our common stock or the perception that such sales could occur.

- **There are no present plans to pay dividends.**

The Bank has no present plans to declare or pay dividends in the foreseeable future. The Bank intends to retain earnings, if any, to enhance the Bank's capital position. Additionally, both California and federal law regulate the payment of dividends.

- **The Bank must compete with other financial institutions.**

Major banks dominate the commercial banking industry in California and, more specifically, in the Bank's primary service area of Monterey County. By virtue of their larger capitalization, these institutions have substantially greater lending limits than the Bank and may be able to perform some functions for their customers, including trust services, investment services and international banking, which the Bank is not be equipped to offer directly (although the Bank may offer some of these services through correspondent banks). In addition to commercial banks, the Bank will compete with other traditional and non-traditional financial institutions and investment companies, such as savings and loan associations, credit unions, stock brokerage firms, insurance companies and money market funds, in obtaining deposits, making loans, and providing other financial services. It is uncertain whether the Bank's efforts to compete with these other financial institutions will be successful. Areas of competition include interest rates for loans and deposits, efforts to obtain deposits, and range and quality of products and services provided, including new technology-driven products and services. Technological innovation continues to contribute to greater competition in domestic and international financial services markets as technological advances, such as Internet-based banking services that cross traditional geographic bounds, enable more companies to provide financial services. If the Bank is unable to attract and retain banking customers, it may be unable to continue its loan growth and level of deposits, which may adversely affect its results of operations, financial condition and future prospects.

- **The Bank's business is exposed to lending risks.**

The Bank engages primarily in commercial, consumer and real estate lending. There is a risk that some of the Bank's borrowers will not repay their loans. The ability of borrowers to repay their loans can be adversely affected by factors beyond the control of the Bank, including the continuing deterioration of local and general economic and market conditions. The Bank has a number of large commercial loans to individuals or affiliated groups and a substantial portion of the Bank's loans are secured by liens on real estate. At December 31, 2012, approximately 63% of the Bank's loan portfolio consisted of real estate related loans. The deteriorating economic conditions during the recent economic downturn in California and in the Bank's operating markets has contributed to an overall decline in real estate values. A continuing substantial decline in real estate values in the Bank's primary operating markets could occur as a result of worsening economic conditions, or other events beyond the Bank's control. Such a decline in values could have an adverse impact on the Bank by limiting repayment of defaulted loans through sale of the real estate collateral and by likely increasing the number of defaulted loans to the extent that the financial condition of its borrowers is adversely affected by such a decline in values. These same factors may adversely affect the value of real estate as collateral. The Bank will maintain an allowance for loan losses to reflect the level of probable incurred losses determined by management to be inherent in the loan portfolio. However, the level of the allowance and the amount of the provisions will only be estimates based on management's judgment, and actual losses incurred might exceed the amount of the allowance or require substantial additional provisions to the allowance. Such circumstances could adversely affect the Bank's results of operations, financial condition, future prospects and stock price.

- **The Bank has a concentration risk in real estate related loans.**

At December 31, 2012, approximately 63% of the Bank's loan portfolio consisted of real estate related loans. Substantially all of the Bank's real property collateral is located in its operating market, Monterey County. The deteriorating economic conditions during the recent economic downturn in California and in the Bank's operating market has contributed to an overall decline in real estate values. A continuing substantial decline in real estate values in the Bank's primary market area could occur as a result of worsening economic conditions, or other events including natural disasters such as earthquakes, fires, and floods. Such a decline in values could have an adverse impact on the Bank by limiting repayment of defaulted loans through sale of the real estate collateral and by likely increasing the number of

defaulted loans to the extent that the financial condition of its borrowers is adversely affected by such a decline in values. The adverse effects of the foregoing matters upon the Bank's real estate loan portfolio could necessitate a material increase in the provision for loan losses which could adversely affect the Bank's results of operations, financial condition, future prospects and stock price.

- **The Bank's allowance for loan losses may not be adequate to cover actual losses.**

Like all financial institutions, the Bank maintains an allowance for loan losses to provide for loan defaults and non-performance, but its allowance for loan losses may not be adequate to cover actual loan losses. In addition, future provisions for loan losses could materially and adversely affect the Bank's operating results. The Bank's allowance for loan losses is based on prior experience, the experience of peer banks (as the Bank's loan portfolio continues to season and the Bank's history is developed) as well as an evaluation of the inherent risks in the current portfolio including qualitative factors. The amount of future loan losses is susceptible to changes in economic, operating and other conditions, including changes in the local and California real estate market and interest rates that may be beyond the Bank's control, and these losses may exceed current estimates. Federal banking agencies, as an integral part of their examination process, review the Bank's loans and allowance for loan losses. Although we believe that the Bank's allowance for loan losses is adequate to cover current losses, we cannot predict whether the Bank will have to further increase the allowance for loan losses or whether state and federal banking agencies will require an increase to this allowance. Any of these occurrences could materially and adversely affect the Bank's earnings.

- **The Bank's income will partly depend on interest rate differentials**

The operating income and net income of the Bank will depend to a great extent on the difference between the income the Bank receives from its loans, securities and other assets, and the interest expenses it pays on its deposits and other liabilities. These rates are highly sensitive to many factors, including competition, general economic and political conditions and the policies of the FRB and other governmental authorities. Changes in the interest rate environment may reduce the Bank's net interest income. It is expected that the Bank will continue to realize income from the differential or "spread" between the interest earned on loans, securities and other interest-earning assets, and interest paid on deposits, borrowings and other interest-bearing liabilities. Net interest spreads are affected by the difference between the maturities and repricing characteristics of interest-earning assets and interest-bearing liabilities. In addition, loan volume and yields are affected by market interest rates on loans, and rising interest rates generally are associated with a lower volume of loan originations. It is uncertain whether we can minimize the Bank's interest rate risk as a result of these factors. In addition, an increase in the general level of interest rates may adversely affect the ability of certain borrowers to pay the interest on and principal of their obligations. Accordingly, changes in levels of market interest rates could materially and adversely affect the Bank's net interest spread, asset quality, loan origination volume and overall profitability.

- **In the future we may be required to recognize impairment with respect to investment securities, including the FHLB stock we hold.**

Our securities portfolio currently includes securities with unrecognized losses. We may continue to observe declines in the fair market value of these securities. We evaluate the securities portfolio for any other than temporary impairment each reporting period, as required by generally accepted accounting principles, and as of December 31, 2012, we did not recognize any securities as other than temporarily impaired. Future evaluations of the securities portfolio may require us to recognize an impairment charge with respect to these and other holdings. In addition, as a condition to membership in the Federal Home Loan Bank of San Francisco (the "FHLB"), we are required to purchase and hold a certain amount of FHLB stock. Our stock purchase requirement is based, in part, upon the outstanding principal balance of advances from the FHLB. At December 31, 2012, we held stock in the FHLB totaling $1,027,000. The FHLB stock held by us is carried at cost and is subject to recoverability testing under applicable accounting standards. To date, the FHLB has not discontinued the distribution of dividends on its shares. The FHLB's dividend paying practices may not continue. As of December 31, 2012, we did not recognize an impairment charge related to our FHLB stock holdings. Future negative changes to the financial condition of the FHLB may require us to recognize an impairment charge with respect to such holdings.

- **The Bank's capital levels will affect its lending limits and operations.**

Under applicable governmental regulations, the Bank is permitted to make unsecured loans to any single borrower or group of related borrowers in an amount that will not exceed 15% of its total capital less unrealized

gains on available for sale investments, net of taxes, plus the allowance for loan losses, and secured loans in an amount that, when combined with unsecured loans made to the same borrower or group of related borrowers, will not exceed 25% of its total capital less unrealized gains on available for sale investments, net of taxes, plus the allowance for loan losses (the "lending limits"). These lending limits make it more difficult for the Bank to attract borrowers who have lending requirements in excess of those lending limits and, as a result, the future success of the Bank will depend on, among other things, its ability to increase capital (and thereby the amount of the loans it will be able to make to borrowers) by selling additional shares of stock, or issuing subordinated notes that are senior in priority to the common stock, but junior in priority to depositors and creditors of the Bank (which are known as "capital notes"), and generating and retaining earnings. The Bank has no plans at this time to sell any additional shares or issue capital notes.

- **The Bank may not be successful in raising additional capital.**

If additional capital is necessary in the future, it is unpredictable whether the Bank's efforts to raise such additional capital will be successful. The inability to raise additional capital when needed or at prices and terms acceptable to the Bank could adversely affect the Bank's results of operations, financial condition, future prospects and stock price.

- **Government regulation and intervention to stabilize the U.S. financial system may affect the Bank's operations.**

The Bank's operations are governed by the requirements of extensive state and federal regulation, supervision and legislation, and the laws that govern the Bank and its operations may change from time to time. Applicable laws and regulations provide for the regular examination and supervision of financial institutions; affect the cost of funds through reserve requirements and assessments on assets; limit the kinds of investments a bank or bank holding company can make and the kinds of activities in which it can engage; and grant the banking agencies broad enforcement authority in case of violations. These laws and regulations will increase the Bank's cost of doing business and will have an adverse impact on the ability of the Bank to compete efficiently with other financial services providers that are not similarly regulated.

Recent legislation including the Emergency Economic Stabilization Act of 2008 (the "EESA"), signed into law by President Bush on October 3, 2008, and the American Recovery and Reinvestment Act of 2009 (the "ARRA"), signed into law by President Obama on February 17, 2009, each included programs intended to help stabilize the United States financial system. However, the degree to which such legislation has helped to resolve the volatility of capital and credit markets or improve capital and liquidity problems confronting the financial system remains uncertain. The failure of the EESA or ARRA and other legislation to mitigate or eliminate such volatility and problems affecting the financial markets and a continuation or worsening of such conditions could limit the Bank's access to capital or sources of liquidity in amounts and at times necessary to conduct operations in compliance with applicable regulatory requirements.

In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") signed into law by President Obama on July 21, 2010, is expected to have a broad impact on the financial services sector, including significant regulatory and compliance changes. Many of the Dodd-Frank Act requirements will be implemented over an extended period of time and due to the uncertainty associated with the manner in which they will be implemented by the various regulatory agencies, the full extent of the impact such requirements will have on our operations is not clear. Changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business.

These legislative and regulatory proposals and future legislation or regulation may impose additional requirements and restrictions on the Bank in a manner that will increase its costs of doing business and otherwise adversely affect its results of operations, financial condition, future prospects and stock price.

- **General economic conditions and other events may adversely affect the Bank.**

The banking business is affected by general economic and political conditions, both domestic and international, and by governmental monetary and fiscal policies. Conditions such as inflation, recession, unemployment, volatile interest rates, short money supply, scarce natural resources, weather, natural disasters such as earthquakes and

drought, international disorders, and other events beyond the Bank's control may adversely affect the Bank's results of operations, financial condition, future prospects, and stock price.

The economic conditions in the United States in general and within California and in our operating markets may continue to deteriorate. Unemployment nationwide and in California has increased significantly through this economic downturn and is anticipated to remain elevated for the foreseeable future. As of December 31, 2012, the unemployment rate nationwide was 7.8% compared to 8.5% at December 31, 2011 and 9.4% at December 31, 2010. As of December 31, 2012, the unemployment rate in California was 9.8% down from 11.1% at December 31, 2011 and 12.5% at December 31, 2010. The unemployment rate in the Bank's primary market area of Monterey County was 13.1%, 14.9% and 12.2% as of year-end 2012, 2011 and 2010, respectively. These unemployment statistics may not reflect the full extent of unemployment conditions nationwide, in California and in the Bank's primary markets to the extent such statistics exclude persons who are no longer seeking employment, among other factors.

Availability of credit and consumer spending, real estate values, and consumer confidence have all been adversely affected. The volatility of the capital markets and the credit, capital and liquidity problems that have confronted the United States financial system have not been fully resolved despite massive government expenditures and legislative efforts to stabilize the United States financial system. These conditions may not be fully resolved in the foreseeable future. The State of California is continuing to experience significant budgetary and fiscal difficulties. The Bank conducts banking operations principally in Northern California and primarily in Monterey County. As a result, the Bank's financial condition, results of operations and cash flows are subject to changes in the economic conditions in California, particularly in Northern California and Monterey County. The Bank's business results are dependent in large part upon the business activity, population, income levels, deposits and real estate activity in Northern California and Monterey County, and adverse economic conditions could have material adverse effects upon the Bank.

It is uncertain whether conditions in the United States and California economies will further deteriorate. A further deterioration in economic conditions locally, regionally or nationally, could result in a further economic downturn in Northern California and Monterey County and prolong the following consequences, any of which could further adversely affect the Bank's business:

- loan delinquencies and defaults may increase;
- problem assets and foreclosures may increase;
- demand for loans and the Bank's other products and services may decline;
- low cost or noninterest-bearing deposits may decrease;
- collateral for loans may decline in value, in turn reducing customers' borrowing power, and reducing the value of assets and collateral as sources of repayment of existing loans; and
- volatile securities market conditions could adversely affect valuations of investment portfolio assets.

- **Events beyond the control of the Bank may have an adverse effect upon us.**

Events described above in this "Item 1A – Risk Factors" and under the heading "Cautionary Statements Regarding Forward-Looking Statements" in "Item 1 – Business" and "Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report on Form 10-K include events beyond the control of the Bank. Such events include, but are not limited to, deterioration of economic conditions nationally, regionally and in the market areas in which the Bank conducts business; events of terrorism and the effects of the conflicts in Afghanistan and Iraq and the worldwide efforts to combat terrorism; financial and economic volatility and governmental actions in response; natural disasters such as earthquakes, floods, fires, and similar adverse weather occurrences; disruption of energy, power supplies and communications equipment such as telephones, cellular phones, computers, and other forms of electronic equipment or media; widespread, adverse public health occurrences, and similar events. The effects of such events could result in disruptions in the business of the Bank, which could have an adverse effect upon the Bank's results of operations, financial condition, future prospects and stock price by, among other matters, reducing the demand for loans and other products and services offered by the Bank, increasing nonperforming loans, and requiring increases in the amounts reserved for loan losses.

- **The Bank's business is dependent on its key personnel.**

The Bank's results of operations, financial condition, and future prospects are highly dependent on its directors, executive officers and other key personnel. The success of the Bank does, to some extent, depend on the continued service of its directors and continued employment of the executive officers, in addition to the Bank's ability to attract and retain experienced banking professionals to serve the Bank in other key positions. The unexpected loss of the services of any of these individuals could have a detrimental effect on the Bank.

- **Technology implementation problems or computer system failures could adversely affect the Bank.**

The Bank's business and future prospects are highly dependent on the ability to implement changes in technology that affect the delivery of banking services such as the increased demand for computer access to bank accounts and the availability to perform banking transactions electronically. The Bank's ability to compete will depend upon its ability to continue to adapt technology on a timely and cost-effective basis to meet such demands. In addition, the business and operations of the Bank will be susceptible to adverse effects from computer failures, communication and energy disruption, and the activities including fraud of unethical individuals with the technological ability to cause disruptions or failures of the Bank's data processing system.

- **Information security breach or other technology difficulties could adversely affect the Bank.**

The Bank cannot be certain that implementation of safeguards will eliminate the risk of vulnerability to technological difficulties or failures or ensure the absence of a breach of information security. The Bank will rely on the services of various vendors who provide data processing and communication services to the banking industry. Nonetheless, if information security is compromised or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and the Bank could be exposed to claims from its customers as a result. The occurrence of any of these events could adversely affect the Bank's business.

- **The Bank's controls over financial reporting and its related governance procedures may fail or be circumvented.**

Management regularly reviews and updates the Bank's internal control over financial reporting, disclosure controls and procedures, and corporate governance policies and procedures. The Bank maintains controls and procedures to mitigate risks such as processing system failures and errors, and customer or employee fraud, and maintains insurance coverage for certain of these risks. Any system of controls and procedures, however well designed and operated, is based in part on certain assumptions and can provide only a reasonable, not absolute, prospect that the objectives of the system are met. Events could occur which are not prevented or detected by the Bank's internal controls or are not insured against or are in excess of the Bank's insurance limits. Any failure or circumvention of the Bank's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Bank's business.

- **The effects of legislation in response to current credit conditions may adversely affect the Bank.**

Legislation that has or may be passed at the federal level and/or by California in response to current conditions affecting credit markets could cause the Bank to experience higher credit losses if such legislation reduces the amount that the Bank's borrowers are otherwise contractually required to pay under existing loan contracts. Such legislation could also result in the imposition of limitations upon the Bank's ability to foreclose on property or other collateral or make foreclosure less economically feasible. Such events could result in increased loan losses and require a material increase in the allowance for loan losses and thereby adversely affect the Bank's results of operations, financial condition, future prospects, profitability and stock price.

- **The effects of changes to FDIC insurance coverage limits and assessments are uncertain and increased premiums may adversely affect the Bank.**

The FDIC charges insured financial institutions premiums to maintain the Deposit Insurance Fund ("DIF"). Recent economic conditions have resulted and may continue to result in bank failures. In such event, the FDIC would take control of failed banks and guarantee payment of deposits up to applicable insured limits from the DIF. Insurance premium assessments to insured financial institutions may increase as necessary to maintain adequate funding of the DIF.

The Emergency Economic Stabilization Act of 2008 included a provision for an increase in the amount of deposits insured by the FDIC under its general deposit insurance rules to $250,000 per depositor. On October 14, 2008, the FDIC announced the Temporary Liquidity Guarantee Program, which included the Transaction Account Guarantee Program (the "TAGP"). Under the TAGP, 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 TAGP was in addition to and separate from the coverage available under the FDIC's general deposit insurance rules. In addition to the

TAGP, on July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act includes a permanent increase to $250,000 as the maximum FDIC insurance limit per depositor retroactive to January 1, 2008 and the extension of unlimited FDIC insurance for noninterest-bearing transaction accounts effective December 31, 2010 through December 31, 2012. On November 9, 2010, the FDIC implemented a final rule to permanently increase the maximum $250,000 insurance coverage under the Dodd-Frank Act. The unlimited insurance coverage for noninterest-bearing transaction accounts was not extended and terminated on December 31, 2012. The $250,000 maximum deposit insurance amount per depositor remains in effect.

The Dodd-Frank Act also established a minimum designated reserve ratio for the DIF of 1.35 percent of estimated insured deposits. The Dodd-Frank Act mandates that the FDIC adopt a restoration plan should the DIF balance fall below 1.35 percent and provides for dividends to financial institutions should the DIF balance exceed 1.50 percent. On February 7, 2011, the FDIC Board of Directors adopted a final rule which redefines the deposit insurance assessment base as required by the Dodd-Frank Act; makes changes to insurance premium assessment rates; implements DIF dividend provisions; and revises the risk-based assessment system for large insured depository institutions (i.e., those institutions with at least $10 billion in total assets). It is uncertain what effect the implementation of the changes to the insurance assessments will have upon the Bank; however, continued deterioration or lack of improvement in the economic conditions impacting financial institutions may necessitate further increases in premium assessments to maintain the DIF which could adversely impact the Bank's earnings.

It is also not clear how depositors will respond regarding the $250,000 per depositor maximum deposit insurance coverage and the termination of unlimited insurance coverage for noninterest-bearing transaction accounts. Some depositors may reduce the amount of uninsured deposits held at the Bank and/or the level of insured deposits if concerns regarding bank failures persist, which could affect the level and composition of the Bank's deposit portfolio and thereby directly impact the Bank's funding costs and net interest margin.

The Bank's funding costs may also be adversely affected in the event that the activities of the FRB and the U.S. Treasury to provide liquidity for the banking system and improvement in capital markets are curtailed or unsuccessful. Such events could reduce liquidity in the markets, thereby increasing funding costs to the Bank or reducing the availability of funds to the Bank to finance its existing operations and thereby adversely affect the Bank's results of operations, financial condition, future prospects, profitability and stock price.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties

The Bank conducts operations in its headquarters office located at 5 Harris Ct., Building N, Suite 3, Monterey, California 93940, and in three branch offices located at 300 Bonifacio Place, Monterey, California 93940, 432 Broadway St., King City, California 93930 and 1097 South Main St., Salinas, California 93901.

The headquarters office consists of approximately 8,015 square feet of office space under a lease dated December 22, 2006 as amended by amendments dated August 21, 2008 and August 28, 2012 to expire in October 2014. The lease rate is approximately $11,093 per month. There is not renewal term.

The Monterey branch office consists of approximately 6,993 square feet of office space under a lease dated January 1, 2012, amended to expire in January of 2021, with two five year renewal options. The lease rate is approximately $14,405 per month, subject to a three percent adjustment increase each year for each renewal term.

The Salinas branch office consists of approximately 3,777 square feet of office space under a lease dated October 1, 2012, with an initial term of five years and three five-year renewal options The lease rate is approximately $7,227 per month, subject to a three percent adjustment increase each year for each renewal term.

The King City branch office consists of approximately 2,712 square feet of office space under a lease dated March 1, 2013 with an initial term of five years with one five-year renewal option. The lease rate is approximately $3,906 per month, subject to a three percent adjustment increase each year for each renewal term.

Item 3. Legal Proceedings

There are no material legal proceedings adverse to the Bank to which any director, officer, affiliate of the Bank, or 5% shareholder of the Bank, or any associate of any such director, officer, affiliate or 5% shareholder of the Bank is a party, and none of the above persons has a material interest adverse to the Bank.

From time to time, the Bank may be a party to claims and legal proceedings arising in the ordinary course of business. The Bank's management is not aware of any material pending legal proceedings to which it may be a party or has recently been a party, which will have a significant adverse effect on the financial condition or results of operations of the Bank.

Item 4. Mine Safety Disclosures

Not Applicable.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

There is limited trading in and no established public trading market for the Bank's common stock. The Bank's common stock is not listed on any exchange, but is quoted on the OTC Bulletin Board and the OTC Markets under the symbol "FISB." The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions. As of March 28, 2013, there were 3,310,503 shares of the Bank's common stock outstanding. Wedbush Morgan Securities and RBC Dain Rauscher have facilitated trades in the Bank's common stock. The high and low bid quotations for the Bank's common stock for each full quarterly period of the Bank's operations for the years ended December 31, 2012 and 2011 are listed in the chart below.

Calendar Year	High	Low
2012		
First Quarter	$ 9.75	$ 9.50
Second Quarter	$ 9.10	$ 9.10
Third Quarter	$13.95	$12.99
Fourth Quarter	$11.84	$11.80
2011		
First Quarter	$ 9.56	$ 7.84
Second Quarter	$ 8.92	$ 8.20
Third Quarter	$13.68	$ 8.58
Fourth Quarter	$11.61	$ 9.56

The high and low bid quotations for the Bank's common stock were $12.25 and $12.01 as of March 27, 2013.

Holders

As of March 28, 2013 there were approximately 920 shareholders of record of the Bank's common stock. There are no other classes of common equity outstanding.

Dividends and Dividend Policy

The Bank's shareholders are entitled to receive dividends when and as declared by its board of directors, out of funds legally available therefore, subject to the restrictions set forth in the California Financial Code. The California Financial Code provides that a bank may not make a cash distribution within any one calendar year to its shareholders in excess of the lesser of (a) the bank's retained earnings; or (b) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank or by any majority-owned subsidiary of the bank to the shareholders of the bank during such period. However, a bank may, with the approval of the Commissioner, make a distribution to its shareholders in an amount not exceeding the greater of (a) its retained earnings; (b) its net income for its last fiscal year;

or (c) its net income for its current fiscal year. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by the bank would be unsafe or unsound, the Commissioner may order the bank to refrain from making a proposed distribution. The FDIC may also restrict the payment of dividends if such payment would be deemed unsafe or unsound or if after the payment of such dividends, the bank would be included in one of the "undercapitalized" categories for capital adequacy purposes pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991.

The Bank has not paid cash dividends since it commenced operations and does not anticipate the payment of cash dividends in the foreseeable future. Payment of dividends in the future will be determined by the Board of Directors after consideration of various factors including the profitability and capital adequacy of the Bank. In addition, the Bank's retained earnings were $82,000 at December 31, 2012. Until expiration of the seven year de novo start-up period, the approval or non-objection of the FDIC may also be required for the Bank to pay cash dividends.

Item 6. Selected Financial Data

The following table presents selected financial data concerning the business of the Bank. This information is designed to enhance the reader's understanding of the Bank's financial condition and the results of its operations and should be read in conjunction with the Financial Statements, the notes thereto, and Management's Discussion and analysis included in this report.

Selected Financial Data

For the Year Ended	2012	2011	2010	2009	2008
STATEMENT OF OPERATIONS DATA:					
Interest Income	$ 12,601,000	$ 11,151,000	$ 9,178,000	$ 7,214,000	$ 5,188,000
Interest Expense	824,000	980,000	1,251,000	1,718,000	1,517,000
Net interest Income	11,777,000	10,171,000	7,927,000	5,496,000	3,671,000
Provision for loan loss	994,000	665,000	642,000	529,000	962,000
Net Interest Income After Provision for Loan Losses	10,783,000	9,506,000	7,285,000	4,967,000	2,709,000
Noninterest Income	909,000	144,000	116,000	106,000	69,000
Noninterest Expense	8,720,000	7,407,000	6,247,000	5,778,000	4,902,000
Income (Loss) before Income Tax Provision (Benefit)	2,972,000	2,243,000	1,154,000	(705,000)	(2,124,000)
Income Tax Provision (Benefit)	1,166,000	(895,000)	148,000	1,000	1,000
Net Income (Loss)	$ 1,806,000	$ 3,138,000	$ 1,006,000	$ (706,000)	$ (2,125,000)
Net Earnings (Loss) Per Share - Basic	$ 0.56	$ 0.97	$ 0.31	$ (0.22)	$ (0.66)
Net Earnings (Loss) Per Share - Diluted	$ 0.54	$ 0.97	$ 0.31	$ (0.22)	$ (0.66)
AVERAGE BALANCE SHEET DATA:					
Average Total Assets	$299,207,000	$232,602,000	$ 199,507,000	$157,373,000	$102,425,000
Average Total Loans	$220,552,000	$189,421,000	$ 153,235,000	$121,997,000	$ 76,547,000
Average Total Deposits	$266,048,000	$201,202,000	$ 170,416,000	$129,607,000	$ 73,947,000
Average Total Shareholders' Equity	$ 32,836,000	$ 30,442,000	$ 27,887,000	$ 27,228,000	$ 28,082,000
As of December 31:	2012	2011	2010	2009	2008
BALANCE SHEET DATA:					
Total Assets	$329,349,000	$288,315,000	$ 226,834,000	$192,298,000	$131,442,000
Total Loans	$243,253,000	$200,582,000	$ 176,987,000	$134,812,000	$103,416,000
Total Deposits	$294,654,000	$255,583,000	$ 197,277,000	$164,232,000	$103,417,000
Total Shareholders' Equity	$ 34,001,000	$ 31,813,000	$ 28,474,000	$ 27,275,000	$ 27,386,000
SELECTED RATIOS:					
Income (Loss) on Average Assets	0.60%	1.35%	0.50%	(0.45%)	(2.07%)
Income (Loss) on Average Equity	5.50%	10.31%	3.61%	(2.59%)	(7.57%)
Average Equity to Average Assets	10.97%	13.09%	13.98%	17.30%	27.42%
Average Loans to Average Deposits	82.90%	94.14%	89.92%	94.13%	103.52%
Allowance for Loan Loss as a Percent of Total Loans	1.77%	1.66%	1.54%	1.54%	1.50%
Net Interest Margin	4.10%	4.54%	4.10%	3.59%	3.71%
Efficiency Ratio	68.74%	71.81%	77.67%	103.14%	131.07%

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING STATEMENTS

Certain matters discussed or incorporated by reference in this Annual Report on Form 10-K including, but not limited to, matters described in "Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations," are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, Section 27A of the Securities Act of 1933, as amended, and subject to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may contain words related to future projections including, but not limited to, words such as "believe," "expect," "anticipate," "intend," "may," "will," "should," "could," "would," and variations of those words and similar words that are subject to risks, uncertainties and other factors that could cause actual results to differ significantly from those projected. Factors that could cause or contribute to such differences include, but are not limited to, the following: (1) the duration of financial and economic volatility and actions taken by the United States Congress and governmental agencies, including the United States Department of the Treasury, to deal with challenges to the U.S. financial system; (2) the risks presented by a continued economic recession, which could adversely affect credit quality, collateral values including real estate collateral, investment values, liquidity and loan originations and loan portfolio delinquency rates; (3) variances in the actual versus projected growth in assets and return on assets; (4) potential increasing loan losses; (5) potential increasing levels of expenses associated with resolving nonperforming assets as well as regulatory changes; (6) changes in the interest rate environment including interest rates charged on loans, earned on securities investments and paid on deposits and other borrowed funds; (7) competition effects; (8) potential declines in fee and other noninterest income earned associated with economic factors as well as regulatory changes; (9) general economic conditions nationally, regionally, and in the operating market areas of 1st Capital Bank could be less favorable than expected or could have a more direct and pronounced effect on 1st Capital Bank than expected and adversely affect the Bank's ability to continue internal growth and maintain earning assets in accordance with the Bank's business plan; (10) changes in the regulatory environment including government intervention in the U.S. financial system; (11) changes in business conditions and inflation; (12) changes in securities markets, public debt markets, and other capital markets; (13) potential data processing and other operational systems failures or fraud; (14) potential continued decline in real estate values in 1st Capital Bank's operating market areas; (15) the effects of uncontrollable events such as terrorism, the threat of terrorism or the impact of the military conflicts in Afghanistan and Iraq and the conduct of the war on terrorism by the United States and its allies, worsening financial and economic conditions, natural disasters, and disruption of power supplies and communications; (16) changes in accounting standards, tax laws or regulations and interpretations of such standards, laws or regulations; (17) the reputation of the financial services industry could experience further deterioration, which could adversely affect 1st Capital Bank's ability to access markets for funding and to acquire and retain customers; and (18) the efficiencies that 1st Capital Bank may expect to receive from any investments in personnel and infrastructure may not be realized, as well as other factors. The factors set forth under "Item 1A-Risk Factors" in this report and other cautionary statements and information set forth in this report should be carefully considered and understood as being applicable to all related forward-looking statements contained in this report, when evaluating the business prospects of 1st Capital Bank.

Forward-looking statements are not guarantees of performance. By their nature, they involve risks, uncertainties and assumptions. The future results and shareholder values may differ significantly from those expressed in these forward-looking statements. You are cautioned not to put undue reliance on any forward-looking statement. Any such statement speaks only as of the date of this report, and in the case of any documents that may be incorporated by reference, as of the date of those documents. We do not undertake any obligation to update or release any revisions to any forward-looking statements, to report any new information, future event or other circumstances after the date of this report or to reflect the occurrence of unanticipated events, except as required by law. However, your attention is directed to any further disclosures made on related subjects in our subsequent reports filed with the Federal Deposit Insurance Corporation on Forms 10-K, 10-Q and 8-K.

Critical Accounting Policies

General

The Bank's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within our statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. The Bank uses historical loss data, peer group experience, and the economic environment and other qualitative factors in determining the probable incurred losses in the Bank's loan portfolio. Actual losses could differ

significantly from the historical factors that the Bank uses. Other estimates that the Bank uses are related to the valuation of stock-based compensation and the need for a valuation allowance on the Bank's deferred income tax assets. In addition, GAAP itself may change from one previously acceptable method to another method. Although the economics of the Bank's transactions would be the same, the timing of events that would impact the Bank's transactions could change.

Allowance for Loan Losses

The allowance for loan losses is an estimate of the credit loss risk in the Bank's loan portfolio. The allowance is based on two basic principles of accounting: (1) the requirement that losses be accrued when it is probable that a loss has occurred at the balance sheet date and such loss can be reasonably estimated (general reserves); and (2) the requirement that losses be accrued on impaired loans based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance (specific reserves).

The allowance for loan losses is determined based upon estimates that can and do change when the actual risk, loss events, or changes in other factors, occur. The analysis of the allowance uses an historical loss view as one of the indicators of future losses and as a result could differ from the loss incurred in the future. However, since the Bank's analysis of risk and loss potential is updated regularly, the errors that might otherwise occur are partially mitigated. If the allowance for loan losses falls below that deemed adequate (by reason of loan growth, actual losses, the effect of changes in risk ratings, changes in other external factors or some combination of these factors), the Bank will replenish the allowance for loan losses. For further information regarding the Bank's allowance for loan losses, see "Allowance for Loan Losses Activity" discussion later in this "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

Stock-Based Compensation

All companies are required to recognize compensation expense in an amount equal to the fair value of share-based payments such as stock options and restricted stock granted to employees and directors. As a result, the Bank is required to estimate the fair value of stock options for each award granted on the grant date (grant date fair value) using an option pricing model. Grant date fair value of restricted stock awards is determined by the market price of the Bank's common stock on the date of the grant. The Bank is required to record compensation expense for all outstanding awards over the requisite service period of the awards. Critical assumptions that affect the estimated fair value of each option include expected stock price volatility, dividend yields, option life and the risk-free interest rate.

Income Taxes

The Bank accounts for uncertainty in income taxes by recording only tax positions that met the more likely than not recognition threshold, that the tax position would be sustained in a tax examination.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

The Bank applies the asset and liability method to account for income taxes. Deferred tax assets and liabilities are calculated by applying applicable tax laws to the differences between the financial statement basis and the tax basis of assets and liabilities. The effect on deferred taxes of changes in tax laws and rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided to reduce deferred tax assets to a level which, more likely than not, will be realized. "More likely than not" is defined as greater than a 50% chance. 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. All available evidence, both positive and negative, is considered to determine whether, based on the weight of the evidence, a valuation allowance is needed.

Overview

Net income for the year ended December 31, 2012 was $1,806,000 and basic and fully diluted earnings per share were $0.56 and $0.54, respectively. For the year ended December 31, 2012, the Bank realized a return on average equity of 5.50% and return on average assets of 0.60%. Net income for the year ended December 31, 2011 was $3,138,000 and basic and fully diluted income per share was $0.97. For the year ended December 31, 2011, the Bank realized a return on average equity of 10.31% and return on average assets of 1.35%. Net income for the year ended December 31, 2010 was $1,006,000 and the basic income per share was $0.31. For the year ended December 31, 2010, the Bank realized return on average equity of 3.61% and a return on average assets of 0.50%.

Table One below provides a summary of the components of net income (loss) for the years ended December 31, 2012, 2011 and 2010.

Table One: Components of Net Income

For the year ended December 31,	2012	2011	2010
Net interest income	$ 11,777,000	$ 10,171,000	$ 7,927,000
Provision for loan losses	(994,000)	(665,000)	(642,000)
Noninterest income	909,000	144,000	116,000
Noninterest expense	(8,720,000)	(7,407,000)	(6,247,000)
Income tax (provision) benefit	(1,166,000)	895,000	(148,000)
Net income	$ 1,806,000	$ 3,138,000	$ 1,006,000
Average total assets	$ 299,207,000	$ 232,602,000	$ 199,507,000
Net income as a percentage of average total assets	0.60%	1.35%	0.50%

Net interest income increased in 2012, compared to both 2011 and 2010, as the Bank grew in size and continued to focus on strengthening the Net Interest Margin. The provision for loan losses likewise grew, largely in conjunction with the Bank's growing loan portfolio. Noninterest income increased significantly in 2012 compared to prior years due to dividend income and to death benefits arising from the Bank's purchase of bank owned life insurance at the end of the third quarter of that year. Noninterest expenses and the provision for taxes also grew as the size and profitability of the Bank grew, and as the Bank set aside additional tax reserves. Conversely, a tax benefit was recorded in 2011 as the Bank reversed the valuation allowance recorded against its deferred tax assets.

At December 31, 2012 and 2011, total assets of the Bank were $329,349,000 and $288,315,000, respectively. At December 31, 2012 and 2011, loans, net of deferred fees and costs, totaled $243,253,000 and $200,582,000, respectively. Deposits at year-end 2012 and 2011 were $294,654,000 and $255,583,000, respectively. The Bank's continued growth in deposits, consisting primarily of noninterest-bearing deposit growth of $5,037,000 and interest bearing demand and money market deposit growth of $21,402,000, and a decrease in Due from the Federal Reserve of $39,020,000, supported loan growth of $42,671,000 and an increase of $28,077,000 in investment securities. The Bank ended 2012 and 2011 with a Tier 1 capital ratio of 13.87% and 15.82%, respectively, and a total risk-based capital ratio of 15.12% and 17.07%, respectively.

Net Interest Income and Net Interest Margin

Net interest income represents the excess of interest and fees earned on interest earning assets (loans, investment securities, Due from Federal Reserve Bank and overnight deposits and interest bearing deposits in other financial institutions) over the interest paid on deposits and borrowed funds. The Bank's net interest income before the provision for loan losses was $11,777,000 for the year ended December 31, 2012 compared to $10,171,000 for the year

ended December 31, 2011 and $7,927,000 for the year ended December 31, 2010. Net interest margin is net interest income expressed as a percentage of average earning assets. The Bank's net interest margin was 4.10% for the year ended December 31, 2012 compared to 4.54% for the year ended December 31, 2011 and 4.10% for the year ended December 31, 2010. The decrease in net interest margin in 2012 compared to 2011 was primarily the result of decreasing yields on the loan portfolio. This effect was compounded by strong growth in the deposit portfolio during that time resulting in an increase in liquidity being directed to lower yielding investments and other assets that in turn temporarily reduced the overall yield on earning assets. In comparison, the increase in the net interest margin in 2011 compared to 2010 was primarily the result of increasing yields on the loan portfolio in addition to growth in the portfolio as the Bank worked to maintain the yield on its loan portfolio during that period of decreasing interest rates.

Overall, margin compression is a general trend facing the banking industry, as funding costs have already been reduced to historically low levels while asset yields continue to decrease as a result of the Federal Reserve's aggressive monetary policies (including quantitative easing), the strong price competition for high quality loans and the replacement of maturing and amortizing higher yielding securities by lower yielding securities reflecting current market interest rates.

Interest income for the year ended December 31, 2012 of $12,601,000 was comprised primarily of $12,008,000 of loan interest and fee income, net of amortized deferred loan costs, $413,000 of interest income from investment securities, $74,000 of interest income on interest-bearing deposits in other financial institutions and $106,000 of interest income from Due from Federal Reserve Bank and overnight deposits. Average loan balances for 2012 were $220,552,000, while average investment securities balances were $18,376,000, average interest-bearing deposits in other financial institutions were $7,725,000, and average Due from Federal Reserve Bank and overnight deposits were $40,835,000. Interest income increased $1,450,000 for the year ended December 31, 2012 compared to the year ended December 31, 2011, primarily due to growth in the loan portfolio, which added $1,754,000 to interest income. This increase was partially offset by a decrease in the yield of the loan portfolio as existing loans renewed at or repriced to lower interest rates. Similarly, increases in the average balance of investment securities were materially offset by decreases in yields as the securities in the portfolio continued to amortize.

Interest expense was $824,000 for the year ended December 31, 2012. The average balances of interest bearing liabilities for 2012 were $164,347,000, while average noninterest-bearing deposits were $101,701,000 (38.2% of total average deposits) and there were no borrowings. Interest expense decreased $156,000 for the year ended December 31, 2012 compared to the year ended December 31, 2011. The Bank was able to reduce interest costs even as the portfolio of deposits grew by focusing growth on lower-cost core deposit accounts and by reducing the rates paid on the deposit portfolio.

Interest income for the year ended December 31, 2011 of $11,151,000 was comprised primarily of $10,671,000 of loan interest and fee income, net of amortized deferred loan costs, $395,000 of interest income from investment securities, $41,000 of interest income on interest-bearing deposits in other financial institutions and $44,000 of interest income from Due from Federal Reserve Bank and overnight deposits. Average loan balances for 2011 were $189,421,000, while average investment securities balances were $13,232,000, average interest-bearing deposits in other financial institutions were $2,794,000, and average Due from Federal Reserve Bank and overnight deposits were $18,665,000. Interest income increased $1,973,000 for the year ended December 31, 2011 compared to the year ended December 31, 2010, primarily due to growth in the loan portfolio and was also benefited by an increase in rates earned on those loans.

Interest expense was $980,000 for the year ended December 31, 2011. The average balances of interest bearing liabilities for 2010 were $137,757,000, while average noninterest-bearing deposits were $63,445,000 (31.5% of total average deposits) and there were no borrowings. Interest expense decreased $271,000 for the year ended December 31, 2011 compared to the year ended December 31, 2010, primarily due to decreases in the rates paid to depositors. These decreases were partially offset by increases in interest expense due to the growth of deposits.

Interest income for the year ended December 31, 2010 of $9,178,000 was comprised primarily of $8,582,000 of loan interest and fee income, net of amortized costs, $458,000 of interest income from investment securities, $83,000 of interest income on interest-bearing deposits in other financial institutions and $55,000 of interest income from Due from Federal Reserve Bank and overnight deposits. Average loan balances for 2010 were $153,235,000, while average investment securities balances were $13,446,000, average interest-bearing deposits in other financial institutions were $5,494,000, and average Due from Federal Reserve Bank and overnight deposits were $21,068,000. Interest income increased $1,964,000 for the year ended December 31, 2010 compared to the year ended December 31, 2009.

Interest expense was $1,251,000 for the year ended December 31, 2010. The average balances of interest bearing liabilities for 2010 were $123,676,000, while average noninterest-bearing deposits were $46,740,000 (27.4% of total average deposits) and there were no borrowings. Interest expense decreased $467,000 for the year ended December 31, 2010 compared to the year ended December 31, 2009.

Table Two below is provided to enable the reader to understand the components of the Bank's interest income and expenses. Table Two provides an analysis of net interest margin on earning assets setting forth average assets, liabilities and shareholders' equity; interest income and interest expense and average rates earned and paid; and the net interest margin on earning assets. Average balances are based on daily average balances.

Table Two: Analysis of Net Interest Margin on Earning Assets

For the year ended December 31,	2012			2011			2010		
	Avg Balance	Interest	Avg Yield /Cost	Avg Balance	Interest	Avg Yield /Cost	Avg Balance	Interest	Avg Yield /Cost
Assets:									
Earning assets									
Loans (1)	$ 220,552,000	$ 12,008,000	5.44%	$ 189,421,000	$ 10,671,000	5.63%	$ 153,235,000	$ 8,582,000	5.60%
Available-for-sale investment securities	18,376,000	413,000	2.25%	13,232,000	395,000	2.99%	13,446,000	458,000	3.41%
Interest bearing deposits in other financial institutions	7,725,000	74,000	0.96%	2,794,000	41,000	1.47%	5,494,000	83,000	1.51%
Due from Federal Reserve Bank	40,835,000	106,000	0.26%	18,665,000	44,000	0.24%	21,068,000	55,000	0.26%
Total earning assets	287,488,000	12,601,000	4.38%	224,112,000	11,151,000	4.98%	193,243,000	9,178,000	4.75%
Cash & due from banks	8,611,000			7,742,000			5,683,000		
Other assets	6,754,000			3,732,000			2,933,000		
Allowance for loan losses	(3,646,000)			(2,984,000)			(2,352,000)		
	$ 299,207,000			$ 232,602,000			$199,507,000		
Liabilities & Shareholders' Equity:									
Interest bearing liabilities:									
Interest bearing checking accounts	$ 12,792,000	$ 27,000	0.21%	$ 8,573,000	$ 28,000	0.33%	$ 6,619,000	$ 25,000	0.38%
Money market	62,953,000	344,000	0.55%	50,002,000	379,000	0.76%	45,074,000	430,000	0.95%
Savings	51,902,000	282,000	0.54%	32,724,000	251,000	0.77%	27,050,000	361,000	1.33%
Time deposits	36,700,000	171,000	0.47%	46,457,000	322,000	0.69%	44,933,000	435,000	0.97%
Total interest bearing liabilities	164,347,000	824,000	0.50%	137,757,000	980,000	0.71%	123,676,000	1,251,000	1.01%
Demand deposits	101,701,000			63,445,000			46,740,000		
Other liabilities	323,000			958,000			1,204,000		
Total liabilities	266,371,000			202,160,000			171,620,000		
Shareholders' equity	32,836,000			30,442,000			27,887,000		
	$ 299,207,000			$ 232,602,000			$ 199,507,000		
Net interest income & margin (2)		$ 11,777,000	4.10%		$ 10,171,000	4.54%		$ 7,927,000	4.10%

(1) Amortization of loan origination costs, net of loan fees, of $368,000, $348,000 and $337,000 for the years ended December 31, 2012, 2011 and 2010, respectively, have been netted against the interest income.

(2) Net interest margin is computed by dividing net interest income by total average earning assets for the periods reported.

Table Three below is provided to enable the reader to understand the change in the components of the Bank's interest income and expenses that were documented in Table Two. Table Three provides a detail of the changes in earnings between the compared years, highlighting the impact of changes in volume and rate on net interest earnings.

Table Three: Analysis of Volume and Rate Changes on Net Interest Income and Expenses

Year ended December 31, 2012 compared to the year ended December 31, 2011

Increase (decrease) due to change in:	Volume	Rate (1)	Net Change
Earning assets:			
Loans (1)	$ 1,754,000	$ (417,000)	$ 1,337,000
Available-for-sale investment securities	154,000	(136,000)	18,000
Interest bearing deposits in other financial institutions	72,000	(39,000)	33,000
Due from Federal Reserve Bank	52,000	10,000	62,000
Total	2,032,000	(582,000)	1,450,000
Interest bearing liabilities:			
Interest bearing checking accounts	14,000	(15,000)	(1,000)
Money market	98,000	(133,000)	(35,000)
Savings	147,000	(116,000)	31,000
Time deposits	(68,000)	(83,000)	(151,000)
Total	191,000	(347,000)	(156,000)
Interest differential	$ 1,841,000	$ (235,000)	$ 1,606,000

Year ended December 31, 2011 compared to the year ended December 31, 2010

Increase (decrease) due to change in:	Volume	Rate (1)	Net Change
Earning assets:			
Loans (1)	$ 2,027,000	$ 62,000	$ 2,089,000
Available-for-sale investment securities	(7,000)	(56,000)	(63,000)
Interest bearing deposits in other financial institutions	(41,000)	(1,000)	(42,000)
Due from Federal Reserve Bank	(6,000)	(5,000)	(11,000)
Total	1,973,000	-	1,973,000
Interest bearing liabilities:			
Interest bearing checking accounts	7,000	(4,000)	3,000
Money market	47,000	(98,000)	(51,000)
Savings	76,000	(186,000)	(110,000)
Time deposits	15,000	(128,000)	(113,000)
Total	145,000	(416,000)	(271,000)
Interest differential	$ 1,828,000	$ 416,000	$ 2,244,000

(1) Changes in interest income and expense caused by changes in mix have been attributed to changes in rates.

Provision for Loan Losses

The Bank provided $994,000, $665,000 and $642,000 for loan losses for years ended December 31, 2012, 2011 and 2010, respectively. There were no charge-offs or recoveries for the years ended December 31, 2012. Loan charge-offs were $68,000 and there were no recoveries for the year ended December 31, 2011. There were no charge-offs or recoveries for the years ended December 31, 2010. For further information please see "Allowance for Loan Losses Activity."

Service Charges, Fees and Other Income

Table Four below provides a summary of the components of noninterest income for the years ended December 31, 2012, 2011 and 2010.

Table Four: Components of Noninterest Income

For the year ended December 31,	2012	2011	2010
Service charges on deposit accounts	$ 85,000	$ 75,000	$ 66,000
Bank owned life insurance benefits	699,000	-	-
Bank owned life insurance dividend income	37,000	-	-
Other	88,000	69,000	50,000
Total	$ 909,000	$ 144,000	$ 116,000

Noninterest income of $909,000 for the year ended December 31, 2012 increased $765,000 or 531.3% compared to the year ended December 31, 2011, primarily due to the Bank owned life insurance benefits received a result of the key man life insurance purchased on its President and Chief Executive Officer, Fred Rowden, who unexpectedly passed away in November 2012.

Noninterest income of $144,000 for the year ended December 31, 2011 consisted largely of fees from service charges on deposit accounts, as well as wire fees and mortgage loan referral fees which were reflected in Other income. Noninterest income for the year ended December 31, 2011 increased $28,000 or 24.1% compared to the year ended December 31, 2010, primarily due to an increase in the number of deposit accounts held by the Bank.

Salaries and Benefits

Salaries and benefits expenses were $5,159,000, or 59% of total noninterest expenses, for the year ended December 31, 2012. At the end of 2012, there were 57 full-time equivalent staff . Salaries and benefits expenses for the year ended December 31, 2012 increased $887,000, or 21% compared to the year ended December 31, 2011, primarily due to an increase in the number of staff by 6, or 12%, as the Bank grew in size and expensed a full year of compensation for staff added at the end of the prior year.

Salaries and benefits expenses were $4,272,000, or 58% of total noninterest expenses, for the year ended December 31, 2011. At the end of 2011, there were 51 full-time equivalent staff . Salaries and benefits expenses for the year ended December 31, 2011 increased $982,000, or 30% compared to the year ended December 31, 2010, primarily due to an increase in the number of staff by 9, or 21%, as the Bank grew in size. Five of these staff additions are veteran banking professionals who joined the Bank in the fourth quarter of 2012 and who represent an investment that the Bank is making to enhance future balance sheet growth.

Occupancy, Furniture and Equipment

Occupancy, furniture and equipment expenses were $1,053,000 for the year ended December 31, 2012. Occupancy, furniture and equipment expenses for the year ended December 31, 2012 increased $107,000 or 11% compared to the year ended December 31, 2011, primarily due to the new Monterey branch office.

Occupancy, furniture and equipment expenses were $946,000 for the year ended December 31, 2011. Occupancy, furniture and equipment expenses for the year ended December 31, 2010 increased $60,000 or 6.8% compared to the year ended December 31, 2009, primarily due to the growth of the Bank.

Other Expenses

Table Five below provides a summary of the components of other noninterest expense for the years ended December 31, 2012, 2011 and 2010.

Table Five: Components of Other Noninterest Expense

For the year ended December 31,	2012	2011	2010
Professional fees	$ 426,000	$ 300,000	$ 311,000
Advertising and promotion	426,000	293,000	287,000
Outsourced data services	401,000	371,000	355,000
Regulatory dues and assessments	242,000	327,000	351,000
Customer Expenses	171,000	162,000	130,000
Directors' compensation expense	123,000	92,000	75,000
Licensing and software expenses	122,000	117,000	106,000
Stationery and supplies	110,000	103,000	88,000
Education and seminars	88,000	99,000	83,000
Telephone and postage	88,000	73,000	60,000
Operational Expenses	56,000	83,000	47,000
Loan Expenses	50,000	72,000	26,000
Provision for unfunded loan commitments	-	(60,000)	39,000
Other operating expenses	205,000	157,000	113,000
Total	$ 2,508,000	$ 2,189,000	$ 2,071,000

For the year ended December 31, 2012, compared to 2011, the majority of the components of noninterest expense, as detailed in Table 5, have increased an average of $23,000, for an average growth of 15% in noninterest costs. This growth is consistent with the trend in loan and deposit growth of 21% and 15%, respectively. Marketing expenses increased 45%, or $133,000, as the Bank hosted marketing events and worked with local organizations to increase awareness of the Bank's services, and professional fees increased 42%, or $126,000, as audit and legal costs increased with the growth of the Bank. These increases were offset by a decrease of $85,000 or 26% in Regulatory dues and assessments as assessment rates were further lowered for well-rated institutions, and by a $27,000, or 33%, decrease in Operational expenses and a $22,000, or 31%, decrease in Loan expenses.

For the year ended December 31, 2011, compared to 2010, the majority of the components of noninterest expense, as detailed in Table 5, have increased between $11,000 and $35,000, for an average growth of 6% in noninterest costs. The largest increase, $46,000 for Loan expenses for the year ended December 2011 compared to year ended December 2010, is primarily due to the investment in a number of additional collateral appraisals as a corroboration of the Bank's credit quality analyses. These increases were offset by a decrease of $24,000 or 7% in Regulatory dues and assessments as new, lower assessment rates were implemented for well rated institutions and by a $99,000 decrease in Reserve for unfunded loan commitments.

Total noninterest expenses were $8,720,000, $7,407,000 and $6,247,000 for the years ended December 31, 2012, 2011 and 2010, respectively.

Provision for Taxes

A provision for tax expenses of $1,166,000 was required for the twelve months ended December 31, 2012, compared to a net income tax benefit of $895,000 recorded for the same period in 2011. The provision for income tax expense in 2012 increased as the Bank recorded taxes resulting from its third year of profitable operations. In addition, the Bank established a $294,000 reserve for deductions claimed under the State of California Enterprise Zone program in light of recent positions taken by the Franchise Tax Board. For the year ended December 31, 2012, the Bank's effective tax rate was 39.2%. The effective tax rate was less than the statutory rate applicable to the Bank of approximately 41.2% due to the impact of non-taxable income such as earnings and benefits on bank owned life insurance.

A net income tax benefit of $895,000 was recorded for the twelve months ended December 31, 2011 compared to a provision for tax expense of $148,000 recorded in 2010. Recognition of this tax benefit resulted from the reversal of the valuation allowance previously recognized against the Bank's net deferred tax assets as the strength of actual and forecasted earnings eliminated the need for this valuation allowance. The Bank's net deferred tax assets include the anticipated tax benefit of the previous years' operating losses. As use of that loss carry-forward was disallowed by the State of California in 2010 and 2011, the full amount of that benefit has been carried forward to 2012.

Balance Sheet Analysis

The Bank's total assets were $329,349,000 at December 31, 2012, an increase of $41,034,000 or 14.2% from $288,315,000 at December 31, 2011. The average balance of total assets for the year ended December 31, 2012 was $299,207,000, an increase of $66,605,000 or 28.6% from $232,602,000 for the year ended December 31, 2011. The majority of that growth was in loans, and was funded by an increase in deposits and a decrease in Due from Federal Reserve. As of December 31, 2012, the ratio of net loans to deposits increased to 81.1% compared to 77.2% as of December 31, 2011. Also, as noted above, core deposits (which include non-maturity demand and savings deposit accounts) as a percentage of total deposits increased to 89% from 83% at the end of the prior year.

The Bank's total assets were $288,315,000 at December 31, 2011, an increase of $61,481,000 or 27.1% from $226,834,000 at December 31, 2010. The average balance of total assets for the year ended December 31, 2011 was $232,602,000, an increase of $33,095,000 or 16.6% from $199,507,000 for the year ended December 31, 2010.

Cash and cash-equivalents

Funds held at the Federal Reserve Bank of San Francisco decreased from $60,062,000 at December 31, 2011 to $21,042,000 at December 31, 2012. This reduction resulted from the Bank's decision to invest excess on-balance sheet liquidity into time deposits with other financial institutions and securities in order to augment interest income. Therefore, time deposits with other financial institutions increased from $3,835,000 at December 31, 2011 to $9,321,000 at December 31, 2012 and securities increased from $13,685,000 at December 31, 2011 to $41,762,000 at December 31, 2012.

Investment Securities

The Bank classifies its investment securities as trading, available-for-sale or held-to-maturity at the time of purchase. At December 31, 2012 and 2011 all of the Bank's investments were classified as available-for-sale and there were no sales of investment securities or transfers between categories. Securities available-for-sale may be sold to implement asset/liability management strategies and in response to changes in interest rates, prepayment rates and similar factors. Table Six below summarizes the fair values of the Bank's available-for-sale investment securities held on December 31 for the years cited.

Table Six: Investment Securities Composition

As of December 31,

Available-for-sale (at fair value)	2012	2011	2010
Government and government sponsored agency guaranteed residential mortgage-backed securities	$33,680,000	$11,798,000	$13,372,000
Government and government sponsored agency guaranteed commercial mortgage-backed securities	8,082,000	1,887,000	868,000
Total investment securities	$41,762,000	$13,685,000	$14,600,000

A majority of the Bank's security portfolio at December 31, 2012 was comprised of AA+ rated mortgage backed securities (fixed and floating) and floating rate tranches of collateralized mortgage obligations issued by U.S. Government Agencies. The interest rates on the collateralized mortgage obligations float at a margin over 1 month LIBOR, subject to lifetime caps, rendering these securities highly interest rate sensitive. Net unrealized gains on available-for-sale investment securities totaling $686,000 and $553,000 were recorded, net of $285,000 and $229,000 in deferred tax liabilities, as accumulated other comprehensive income within shareholders' equity at December 31, 2012 and 2011.

See Table Fourteen below for a list of the available-for-sale investment securities by maturity and corresponding weighted average yields.

Loans

The Bank concentrates its lending activities in the following principal areas: (1) commercial; (2) commercial real estate; (3) consumer loans; and (4) real estate construction (both commercial and residential). The Bank's total net loans were $238,939,000 at December 31, 2012, an increase of $41,677,000 or 21.1% from $197,262,000 at December 31, 2011. This increase reflects a return on the significant investment in staff and infrastructure the Bank made during the second half of 2011, including the investment in hiring a number of well known, experienced local bankers and moving the Monterey Branch to a larger and better located facility. Table Seven below summarizes the composition and concentration of the loan portfolio as of December 31.

Table Seven: Loan Portfolio Composition

As of December 31,

	2012	%	2011	%	2010	%	2009	%	2008	%
Commercial	$ 89,834,000	37%	$ 78,504,000	39%	$ 74,311,000	42%	$ 62,466,000	47%	$ 56,263,000	55%
Real estate:										
Construction	4,834,000	2%	4,126,000	2%	2,678,000	2%	-	-	3,726,000	4%
Other	147,320,000	61%	115,902,000	58%	97,581,000	55%	69,885,000	52%	41,648,000	40%
Consumer	748,000	N/M	1,580,000	1%	1,991,000	1%	1,979,000	1%	1,448,000	1%
Deferred Loan Costs, net	517,000	N/M	470,000	N/M	426,000	N/M	482,000	N/M	331,000	N/M
Total	243,253,000	100%	200,582,000	100%	176,987,000	100%	134,812 ,000	100%	103,416 ,000	100%
Allowance for loan losses	(4,314,000)		(3,320,000)		(2,723,000)		(2,081,000)		(1,552,000)	
Total net loans	$ 238,939,000		$ 197,262,000		$ 174,264,000		$ 132,731,000		$ 101,864,000	

As the Bank continued its growth in its fifth full year of operations, the Bank reported increases in all significant loans categories during 2012. The Bank carefully endeavors to balance the opportunities for real estate lending growth with growth in its commercial borrower base.

A significant portion of the Bank's loans are direct loans made to individuals and local businesses. The Bank relies substantially on local promotional activity and personal contacts by Bank officers, directors and employees to compete with other financial institutions. The Bank makes loans to borrowers whose applications include a sound purpose and a viable primary repayment source, generally supported by a secondary source of repayment.

Commercial loans consist of credit lines for operating needs, loans for equipment purchases, working capital, and various other business loan products. Construction loans are generally comprised of commitments to customers within the Bank's service area for construction of commercial properties, multi-family properties and custom and semi-custom single-family residences. Other real estate loans consist primarily of commercial real estate secured loans, single family residential real estate loans and home equity lines of credit secured by first trust deeds on commercial properties and residential properties, typically with maturities from 3 to 10 years and original loan to value ratios generally from 65% to 75%. Consumer loans include a range of traditional consumer loan products. In general, the Bank does not make long-term mortgage loans; however, the Bank can assist customers through correspondent banks, mortgage brokers, or other referrals in securing most forms of longer term single-family mortgage financing.

Average loans, net of deferred fees and costs, for the year ended December 31, 2012 were $220,552,000, an increase of $31,131,000 or 16.4% from $189,421,000 for the year ended December 31, 2011.

Loan Quality and Credit Risk Management

The Bank assesses and manages credit risk on an ongoing basis through a credit culture that emphasizes credit quality, extensive internal monitoring and established formal lending policies. Additionally, the Bank contracts with an outside loan review consultant to periodically review the existing loan portfolio. Management believes its ability to identify and assess risk and return characteristics of the Bank's loan portfolio is critical to achieving profitability and growth. Management continues its emphasis on credit quality in the loan approval process, active credit administration and regular monitoring. With this in mind, management has designed and implemented a comprehensive loan review and grading system that functions to continually assess the credit risk inherent in the loan portfolio.

Ultimately, underlying trends in economic and business cycles may influence credit quality. The Bank's

business is concentrated in its service area, which primarily encompasses Monterey County. The economy of the Bank's service area is dependent upon government, manufacturing, residential construction, tourism, retail sales, population growth and smaller service-oriented businesses.

The Bank has extensions of credit and commitments to extend credit that are secured by real estate. The ultimate repayment of these loans is generally dependent on personal or business cash flows or the sale or refinancing of the real estate. The Bank monitors the effects of current and expected market conditions and other factors on the collectability of real estate loans. The more significant factors management considers involve the following: lease rate and terms, absorption and sale rates; real estate values and rates of return; operating expenses; inflation; and sufficiency of repayment sources independent of the real estate including, in some instances, personal guarantees.

In extending credit and commitments to borrowers, the Bank generally requires collateral and/or guarantees as security. The repayment of such loans is expected to come from cash flow or from proceeds from the sale of selected assets of the borrowers. The Bank's requirement for collateral and/or guarantees is determined on a case-by-case basis in connection with management's evaluation of the creditworthiness of the borrower. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, income-producing properties, residences and other real property. The Bank secures the collateral by perfecting its security interest in business assets, obtaining deeds of trust, or outright possession among other means.

In management's judgment, a concentration exists in real estate loans which represented approximately 63% of the Bank's loan portfolio at December 31, 2012. A continued substantial decline in the economy in general, or a continued decline in real estate values in the Bank's primary market areas in particular, could have an adverse impact on the collectability of these loans and require an increase in the provision for loan losses which could adversely affect the Bank's results of operations, financial condition, future prospects, and stock price. Management believes that its lending policies and underwriting standards will help to mitigate the level of losses during the continuing economic downturn that is occurring; however, there is no assurance that losses will not occur under such circumstances. The Bank's loan policies and underwriting standards include, but are not limited to, the following: (1) maintaining a thorough understanding of the Bank's service area and originating a significant majority of its loans within that area, (2) maintaining a thorough understanding of borrowers' knowledge, capacity, and market position in their field of expertise, (3) basing real estate loan approvals not only on market demand for the project, but also on the borrowers' capacity to support the project financially in the event it does not perform to expectations (whether sale or income performance), and (4) maintaining conforming and prudent loan to value and loan to cost ratios based on independent outside appraisals and ongoing inspection and analysis by the Bank's lending officers or contracted third-party professionals.

Commercial loans represent 37% of the loan portfolio. While the commercial loan portion of the portfolio is comprised of loans to a diversity of business and collateral types in no one industry, the portfolio does contain several large commercial loan relationships with a single borrower or group of affiliated borrowers. In addition, in management's judgment there is a geographic concentration in commercial loans centered in Monterey County. The effect of continuing weak or worsening economic conditions upon businesses borrowing from the Bank is presently uncertain.

Nonaccrual, Past Due and Restructured Loans

Management generally places loans on nonaccrual status when the future collectability of principal is in serious doubt or when a loan becomes 90 days past due, unless the loan is well secured and in the process of collection. Loans are charged off when, in the opinion of management, collection appears unlikely.

The Bank had five nonaccrual loans totaling $1,441,000, three of which also were considered to be troubled debt restructurings, and no loans that were 90 days or more past due and still accruing interest at December 31, 2012. There was one nonaccrual loan which loan also was considered a troubled debt restructuring totaling $240,000 and no loans that were 90 days or more past due and still accruing interest at December 31, 2011. The Bank had no nonaccrual loans, loans that were 90 days or more past due and still accruing interest or troubled debt restructurings at December 31, 2010. The 2012 troubled debt restructuring was for one relationship that included a commercial real estate loan and a commercial loan. The 2011 troubled debt restructuring was for a commercial loan. All of the restructurings consisted of terms which extended the loan's maturity and required monthly principal and interest payments. The Bank's recorded investment in the loans did not change and there were no other significant financial effects that resulted from the modifications because the loans were already evaluated individually for impairment prior to the modifications and the specific allowance for loan losses on the loan did not change as a result of the modifications. There was one financing

receivable (which is the same loan discussed above as having been modified in 2011) modified as a troubled debt restructuring within the previous 12 months for which there was a payment default during the year ended December 31, 2012. There were no financing receivables modified as troubled debt restructurings within the previous 12 months for which there was a payment default during the years ended December 31, 2011 or 2010.

The amount of impaired loans as of December 31, 2012, including the previously discussed nonaccrual loans, was $4,346,000. There were no loan concentrations in excess of 10% of total loans not otherwise disclosed as a category of loans as of December 31, 2012. Management is not aware of any potential problem loans, which were accruing and current at December 31, 2012, where serious doubt exists as to the ability of the borrower to comply with the present repayment terms. The amount of impaired loans as of December 31, 2011 consisted solely of the nonaccrual loan mentioned previously. Based on analysis as of December 31, 2012, management utilized the present value of expected cash flows using a discount rate equal to original interest rate on the loan to determine that a specific reserve of $417,000 was needed on these impaired loans.

Allowance for Loan Losses Activity

The Bank maintains an allowance for loan losses ("allowance") to cover probable incurred credit losses inherent in the loan portfolio, which is based upon management's estimated range of those losses. The allowance is established through a provision for loan losses and is increased by provisions charged against current earnings and recoveries and reduced by charge-offs. Actual losses for loans can vary significantly from this estimate. The methodology and assumptions used to determine the adequacy of the allowance are continually reviewed as to their appropriateness given the most recent losses realized and other factors that influence the estimation process. The model assumptions and resulting allowance level are adjusted accordingly as these factors change.

In addition, the Bank maintains a separate allowance for losses related to undisbursed loan commitments. Management estimates the amount of probable losses by applying a loss factor to the available portion of undisbursed lines of credit. This allowance of $100,000 as of December 31, 2012 and 2011, respectively, is included in accrued interest payable and other liabilities on the balance sheet.

The adequacy of the allowance and the level of the related provision for loan losses is determined based on management's judgment after consideration of numerous factors including but not limited to: (i) local and regional economic conditions, (ii) borrowers' financial condition, (iii) loan impairment and the related level of expected charge-offs, (iv) evaluation of industry trends, (v) industry and other concentrations, (vi) loans which are contractually current as to payment terms but demonstrate a higher degree of risk as identified by management, (vii) continuing evaluations of the performing loan portfolio, (viii) ongoing review and evaluation of problem loans identified as having loss potential, (ix) quarterly review by the Board of Directors, and (x) assessments by banking agencies and other third parties. Management and the Board of Directors evaluate the allowance and determine its appropriate level considering objective and subjective measures, such as knowledge of the borrowers' business, valuation of collateral, the determination of impaired loans and exposure to potential losses.

The Bank establishes general and specific reserves in accordance with applicable accounting and regulatory guidance. The allowance is calculated and analyzed by categories of the loan portfolio based on loan type and loan rating; however, the entire allowance is available to cover actual loan losses. While management uses available information to recognize possible losses on loans, future additions to the allowance may be necessary, based on changes in economic conditions and other matters. In addition, banking agencies, as an integral part of their examination process, periodically review the adequacy of the Bank's allowance. Such agencies may require the Bank to provide additions to the allowance based on their judgment of information available to them at the time of their examination. It is the policy of management to maintain the allowance for loan losses at a level adequate for known and inherent risks in the portfolio. The Bank's methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan losses that management believes is appropriate at each reporting date. Based on information currently available to analyze inherent credit risk, including economic factors, overall credit quality, historical data, to the extent that is available, and the actual experience of industry peers, management believes that the provision for loan losses and the allowance for loan losses are adequate. Adjustments may be made based on differences from estimated loan growth, the types of loans constituting this growth, changes in risk ratings within the portfolio, and general economic conditions; however, no prediction of the ultimate level of loans charged off in future periods can be made with any certainty.

The majority of the growth in the allowance during the year ended 2012 was due to changes in the concentration of various loan categories and to overall growth in the loan portfolio, with a lesser amount stemming from increased reserves for a relatively small number of loans downgraded to a criticized (i.e. Special Mention) or classified (i.e. Substandard) credit rating. Specifically, loans categorized as Special Mention or Substandard increased from approximately $5,400,000 at December 31, 2011 (2.69% of loans) to approximately $9,300,000 at December 31, 2012 (3.82% of loans), and the specific reserves for impaired loans increased from $25,000 at December 31, 2011 to $417,000 at December 31, 2012.

There were no material changes in the qualitative factors used as of 2012 compared to those assumptions in 2011. While there are some signs of improvement in economic conditions, certain qualitative factors remain higher than the level prior to the economic downturn. High unemployment, a fragile recovery in the housing sector, commodity volatility and a stressed commercial real estate sector are all factors that may continue to negatively influence the majority of our loan portfolio. Table Eight below summarizes the allowance by loan category with the percent of loans in each category to total loans.

Table Eight: Allowance for Loan Losses by Loan Category

As of December 31,

	2012		2011		2010		2009		2008	
	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans
Commercial	$ 1,709,000	40%	$ 1,399,000	42%	$ 1,322,000	49%	$ 1,044,000	51%	$ 986,000	63%
Real estate:										
Construction	43,000	1%	37,000	1%	23,000	1%	-	-	26,000	2%
Other	2,549,000	59%	1,757,000	53%	1,339,000	49%	1,007,000	48%	514,000	33%
Consumer	13,000	N/M	27,000	1%	30,000	1%	30,000	1%	26,000	2%
Total allocated	$ 4,314,000	100%	$ 3,220,000	97%	$ 2,714,000	100%	$ 2,081,000	100%	$ 1,552,000	100%
Unallocated	-	-	100,000	3%	9,000	N/M	-	-	-	-
Total	$ 4,314,000	100%	$ 3,320,000	100%	$ 2,723,000	100%	$ 2,081,000	100%	$ 1,552,000	100%

Table Nine below summarizes the activity in the allowance for loan losses for the years ended December 31, cited below.

Table Nine: Allowance for Loan Losses

As of December 31,

	2012	2011	2010	2009	2008
Total Loans Outstanding	$243,253,000	$200,582,000	$176,987,000	$ 134,812,000	$103,416,000
Average loans outstanding	$220,552,000	$189,421,000	$153,235,000	$ 121,997,000	$ 76,547,000
Allowance for loan losses at beginning of period	$ 3,320,000	$ 2,723,000	$ 2,081,000	$ 1,552,000	$ 594,000
Loans charged off	-	(68,000)	-	-	(4,000)
Recoveries of loans previously charged off	-	-	-	-	-
Net loans charged off	-	(68,000)	-	-	(4,000)
Additions to allowance charged to operating expenses	994,000	665,000	642,000	529,000	962,000
Allowance for loan losses at end of period	$ 4,314,000	$ 3,320,000	$ 2,723,000	$ 2,081,000	$ 1,552,000
Ratio of net charge-offs to average loans outstanding	N/A	0.04%	N/A	N/A	(0.01%)
Provision for loan losses to average loans outstanding	0.45%	0.35%	0.42%	0.43%	1.26%
Allowance for loan losses to loans, net of deferred fees and costs, at end of period	1.77%	1.66%	1.54%	1.54%	1.51%

Other Real Estate

At December 31, 2012 and 2011, the Bank did not have any other real estate properties acquired through foreclosure or purchase.

Premises and equipment

Premises and equipment, net, increased from $615,000 at December 31, 2011 to $1,282,000 at December 31, 2012. The majority of this increase was due to investments in furniture and leasehold improvements as the Bank relocated and expanded its Monterey branch to serve its growing customer base in that market. The deposit total for the Monterey Branch has approximately doubled over the past two years.

Bank Owned Life Insurance

Bank owned life insurance totaled $3,555,000 at December 31, 2012. At the end of the third quarter of 2012, the Bank purchased single premium bank owned life insurance policies covering eleven Bank employees for $4,500,000. The total cash surrender value of those policies decreased to $3,555,000 at December 31, 2012 as a result of the principal repayment associated with the death of the Bank's former President and Chief Executive Officer, Fred Rowden.

Accrued interest receivable and other assets

Accrued interest receivable and other assets increased from $3,946,000 at December 31, 2011 to $4,897,000 at December 31, 2012. The majority of this increase was due to a receivable recorded for a portion of the above discussed BOLI repayment. The remainder of the increase was largely due to the Bank's investment in the capital stock of the Federal Home Loan Bank of San Francisco ("FHLB") increasing from $918,000 at December 31, 2011 to $1,027,000 at December 31, 2012 due to the standard asset-based investment requirement applicable to FHLB members.

Deposits

At December 31, 2012, total deposits increased $39,071,000 or 15.2% to $294,654,000 from the December 31, 2011 balance of $255,583,000. The Bank's deposit growth plan for 2012 continued to focus on growing core deposit relationships as a primary source of liquidity and of franchise value. During 2012, the Bank's investment in staff and infrastructure helped it to increase deposit balances in all of its core deposit categories, including an increase in noninterest-bearing demand deposits of $5,037,000 or 4.3%, interest-bearing demand deposits of $5,294,000 or 43.4%, and savings accounts of $23,806,000 or 61.7%. By year end 2012, the percentage of checking and savings accounts to total deposits increased to 89.4% compared to 83.4% one year ago. Time deposit accounts continued to be a focus for reducing deposit costs as the Bank decreased the portfolio by $11,174,000 or (26.3%). Interest expense on time deposits over $100,000 was $127,000 and on time deposits less than $100,000 was $44,000 for the year ended December 31, 2012. See Table Twelve "Certificates of Deposit Maturities" for the maturity distribution of the time deposit portfolio.

At December 31, 2011, total deposits increased $58,306,000 or 29.6% to $255,583,000 from the December 31, 2010 balance of $197,277,000. During 2011, the Bank also increased all of its core deposit categories, including an increase in noninterest-bearing demand deposits of $46,712,000 or 65.2%, interest-bearing demand deposits of $9,761,000 or 21.0%, and savings accounts of $11,751,000 or 43.8%. Time deposit accounts decreased by $9,918,000 or 18.9% as the Bank continued to focus on minimizing deposit costs. Interest expense on time deposits over $100,000 was $248,000 and on time deposits less than $100,000 was $74,000 for the year ended December 31, 2011.

The Bank's deposits are not received from a single depositor or group of affiliated depositors, the loss of any one of which would have a material adverse effect on the business of the Bank. Other than the overall impact of agriculture on the local economy, a material portion of the Bank's deposits are not concentrated within a single industry or group of related industries.

Borrowed Funds

As of December 31, 2012 and 2011, the Bank did not have any borrowed funds. As of December 31, 2012, the Bank has a total of $20,000,000 in unsecured Federal funds lines of credit through various correspondent banks and borrowing lines of credit secured by pledged loans of $47,028,000 through the Federal Home Loan Bank of San Francisco and of $43,903,000 through the Federal Reserve Bank of San Francisco. The lines of credit have been tested

and used for overnight borrowings, but not otherwise utilized since the inception of the Bank.

Capital Resources

The current and projected capital position of the Bank and the impact of capital plans and long-term strategies are reviewed regularly by management. The Bank's capital position represents the level of capital available to support continuing operations and expansion.

The Bank is subject to certain regulatory capital requirements promulgated by the FDIC. Failure to meet these minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by banking agencies that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, banks 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. The Bank's capital amounts and classification are also subject to qualitative judgments by the FDIC about components, risk weightings and other factors.

At December 31, 2012, shareholders' equity was $34,001,000. At December 31, 2011, shareholders' equity was $31,813,000. The change in capital between 2012 and 2011 is primarily attributable to the retention of $1,806,000 in net income, in addition to a $229,000 increase resulting from equity compensation. Nominal and tangible book values were $10.27 per share at December 31, 2012, versus $9.81 per share at December 31, 2011. Table Ten below lists the Bank's actual capital ratios at December 31, 2012 and 2011, as well as the minimum capital ratios required by banking agencies for capital adequacy.

Table Ten: Capital Ratios

As of December 31,

Capital to Risk-Adjusted Assets	2012	2011	2010	Minimum Regulatory Capital Requirements	Minimum To be Well Capitalized Under Prompt Corrective Action Provisions
Leverage ratio	10.67%	12.61%	13.89%	4.00%	5.00%
Tier 1 Risk-Based Capital	13.87%	15.85%	16.09%	4.00%	6.00%
Total Risk-Based Capital	15.12%	17.10%	17.34%	8.00%	10.00%

The $41,034,000 increase in total assets by the Bank during 2012 to a record $329,349,000 resulted in a better leveraging of the Bank's capital, decreasing the various capital ratios. Capital ratios are reviewed on a regular basis to ensure that capital exceeds the prescribed regulatory minimums and is adequate to meet future needs. The Bank's ratios are in excess of the regulatory definition of "well capitalized See also "Item 1 – Business - Supervision and Regulation – Capital Adequacy Guidelines" for discussion of capital regulations under the subheading *"Risk-Based Capital"* and the discussion of a proposal to change capital regulations under the subheading *"Basel III Capital Proposal."*

Management currently believes that the Bank's capital is adequate to support current operations and anticipated growth; however, future capital requirements of the Bank are uncertain and may be affected by economic and other factors. See "Risk Factors" in "Item 1A - Risk Factors" for a discussion of the availability and effects of raising additional capital.

Market Risk Management

Market risk is the risk of loss from adverse changes in market prices and rates. The Bank's market risk arises primarily from interest rate risk inherent in its loan and deposit functions. The goal for managing the assets and liabilities of the Bank is to maximize shareholder value and earnings while maintaining a high quality balance sheet without exposing the Bank to undue interest rate risk. The Board of Directors has overall responsibility for interest rate risk management policies. The Bank has an Asset Liability and Investment Committee that establishes and monitors guidelines to control the sensitivity of earnings to changes in interest rates.

Asset/Liability Management

Activities involved in asset/liability and investment management include, but are not limited to, lending, accepting and placing deposits and investing in securities. Interest rate risk is the primary market risk associated with asset/liability management. Sensitivity of earnings to interest rate changes arises when yields on assets change in a different time period or in a different amount from that of interest costs on liabilities. To mitigate interest rate risk, the structure of the balance sheet is managed with the goal that movements of interest rates on assets and liabilities are correlated and contribute to earnings even in periods of volatile interest rates. The Bank's asset/liability management policy sets limits on the acceptable amount of variance in net interest margin and market value of equity under changing interest environments. The Bank uses simulation models to forecast earnings, net interest margin and market value of equity.

Simulation of earnings is the primary tool used to measure the sensitivity of earnings to interest rate changes. Using computer-modeling techniques, the Bank is able to estimate the potential impact of changing interest rates on earnings. A balance sheet forecast is prepared quarterly using inputs of actual loans, securities and interest bearing liabilities (i.e. deposits/borrowings) positions as the beginning base. The forecast balance sheet is processed against seven interest rate scenarios. The scenarios include a 100, 200 and 300 basis point rising rate forecast, a flat rate forecast and a 100, 200 and 300 basis point falling rate forecast which take place within a one year time frame. Net interest income is measured during the year assuming a gradual change in rates over the twelve-month horizon. The simulation modeling indicated below attempts to estimate changes in the Bank's net interest income utilizing a forecast balance sheet projected from year-end balances.

Table Eleven below summarizes the effect on net interest income (NII) of a ±100, 200 and 300 basis point change in interest rates as measured against a constant rate (no change) scenario.

Table Eleven: Interest Rate Risk Simulation of Net Interest as of December 31, 2012

	$ Change in NII from Current 12 Month Horizon
Variation from a constant rate scenario	
+300bp	$ 1,158,000
+200bp	844,000
+100bp	439,000
-100bp	(200,000)
-200bp	(748,000)
-300bp	(1,323,000)

The simulations of earnings do not incorporate any management actions, which might moderate the negative consequences of interest rate deviations. Therefore, they do not reflect likely actual results, but serve as reasonable estimates of interest rate risk.

An increase in earnings in a rising rate environment and a decrease in earnings in a declining rate environment may be equated to an asset sensitive position. An asset sensitive position in a rising interest rate environment will cause a bank's interest rate margin to expand. This results as floating or variable rate loans reprice more rapidly than fixed rate certificates of deposit that reprice as they mature over time. Conversely, a declining interest rate environment will cause the opposite effect. A decrease in earnings in a rising rate environment and an increase in earnings in a declining rate environment may be equated to a liability sensitive position. Variable rate loans that are earning at their floor rates can reprice more slowly than fixed rate certificates of deposits, causing liability sensivity. A liability sensitive position in a rising interest rate environment will cause a bank's interest rate margin to contract, while a declining interest rate environment will have the opposite effect. As reflected in Table Eleven, at December 31, 2012, the interest rate risk simulation indicates an asset sensitive position.

Inflation

The impact of inflation on a financial institution differs significantly from that exerted on manufacturing, or other commercial concerns, primarily because its assets and liabilities are largely monetary. In general, inflation primarily affects the Bank through its effect on market rates of interest, which primarily affects the Bank's ability to attract loan customers. Inflation affects the growth of total assets by increasing the level of loan demand, and potentially adversely affects capital adequacy because loan growth in inflationary periods can increase at rates higher than the rate that capital grows through retention of earnings which may be generated in the future. In addition to its effects on interest rates, inflation increases overall operating expenses. Inflation has not had a material effect upon the results of operations of the Bank for the years ended December 31, 2012, 2011 and 2010.

Liquidity

Liquidity management refers to the Bank's ability to provide funds on an ongoing basis to meet fluctuations in deposit levels as well as the credit needs and requirements of its clients. Both assets and liabilities contribute to the Bank's liquidity position. Federal funds lines, short-term investments such as interest-bearing deposits in other financial institutions and securities, and loan repayments contribute to liquidity, along with deposit increases, while loan funding and deposit withdrawals decrease liquidity.

The Bank assesses the likelihood of projected funding requirements by reviewing historical funding patterns, current and forecasted economic conditions and individual client funding needs. Commitments to fund loans at December 31, 2012 and 2011 were approximately $51,555,000 and $62,493,000, respectively. Outstanding standby letters of credit at December 31, 2012 and 2011 were $238,000 and $1,068,000, respectively. Such loan commitments relate primarily to revolving lines of credit and other commercial loans and to real estate construction loans. Since substantially all commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Bank's sources of liquidity consist of cash and due from correspondent banks, overnight funds sold to correspondent banks, Due from the Federal Reserve Bank, and unpledged or excess pledged marketable investments. At December 31, 2012, liquid assets totaled $63,348,000 or 19% of total assets. In addition to liquid assets, the Bank maintains short-term unsecured lines of credit in the amount of $20,000,000 with correspondent banks and secured lines of credit of $47,028,000 through the Federal Home Loan Bank of San Francisco and $43,903,000 through the Federal Reserve Bank of San Francisco. At December 31, 2012, the Bank had no amounts outstanding under these credit lines. The Bank also has informal agreements with various other banks to sell participations in loans, if necessary. The Bank serves primarily a business customer base and, as such, its deposit base is susceptible to economic fluctuations. Accordingly, management strives to maintain a balanced position of liquid assets to volatile and cyclical deposits.

Liquidity is also affected by portfolio maturities and the effect of interest rate fluctuations on the marketability of both assets and liabilities. The Bank can sell any of its unpledged or excess pledged securities held in the available-for-sale category to meet liquidity needs. Unpledged securities are also available to pledge as collateral for borrowings if the need should arise.

The maturity distribution of certificates of deposit at December 31, 2012, 2011 and 2010 is set forth in Table Twelve below. These deposits are generally more rate sensitive than other deposits and, therefore, are more likely to be withdrawn to obtain higher yields elsewhere if available.

Table Twelve: Certificates of Deposit Maturities

As of December 31,

	Less than $100,000	Over $100,000
2012		
Three months or less	$ 2,299,000	$ 6,833,000
Over three months through six months	2,097,000	9,847,000
Over six months through twelve months	2,083,000	4,665,000
Over twelve months	325,000	3,165,000
Total	$ 6,804,000	$ 24,510,000
2011		
Three months or less	$ 2,185,000	$ 11,400,000
Over three months through six months	2,583,000	11,723,000
Over six months through twelve months	2,218,000	9,443,000
Over twelve months	715,000	2,221,000
Total	$ 7,701,000	$ 34,787,000
2010		
Three months or less	$ 6,625,000	$ 23,531,000
Over three months through six months	1,836,000	8,133,000
Over six months through twelve months	1,679,000	7 ,5 74,000
Over twelve months	401,000	2,627,000
Total	$ 10,541,000	$ 41,865,000

Loan demand also affects the Bank's liquidity position. Table Thirteen below presents the contractual maturities of loans at December 31, 2012. Also provided with respect to such loans are the amounts due after one year, classified according to sensitivity to changes in interest rates:

Table Thirteen: Loan and Lease Maturities (Gross Loans)

As of December 31, 2012

	One year or less	One year through five years	Over five years	Total
Commercial	$ 51,281,000	$ 27,361,000	$ 11,192,000	$ 89,834,000
Real estate – construction	4,834,000	-	-	4,834,000
Real estate – other	17,398,000	27,389,000	102,533,000	147,320,000
Consumer	109,000	639,000	-	748,000
Total	$ 73,622,000	$ 55,389,000	$ 113,725,000	$ 242,736,000

Loans maturing after one year with:	
Interest rates that are fixed or floor rates in excess of variable rates	$ 137,718,100
Variable interest rates	31,395,900
Total	$ 169,114,000

The carrying amount, maturity distribution and weighted average yield of the Bank's available-for-sale investment securities at December 31, 2012, 2011 and 2010 is presented in Table Fourteen below.

Table Fourteen: Securities Maturities and Weighted Average Yields

As of December 31, 2012

	Carrying Amount	Weighted Average Yield
2012		
Available-for-sale securities not due at a single maturity date:		
Government and government sponsored agency guaranteed residential mortgage-backed securities	$ 33,680,000	1.37%
Government and government sponsored agency guaranteed commercial mortgage-backed securities	8,082,000	1.72%
	$ 41,762,000	1.27%
2011		
Available-for-sale securities not due at a single maturity date:		
Government and government sponsored agency guaranteed residential mortgage-backed securities	$ 11,798,000	3.62%
Government and government sponsored agency guaranteed commercial mortgage-backed securities	1,887,000	4.54%
	$ 13,685,000	3.14%
2010		
Available-for-sale securities not due at a single maturity date:		
Government and government sponsored agency guaranteed residential mortgage-backed securities	$ 13,732,000	3.84%
Government and government sponsored agency guaranteed commercial mortgage-backed securities	868,000	4.87%
	$ 14,600,000	3.90%

Off-Balance Sheet Arrangements

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of its customers and to reduce its exposure to fluctuations in interest rates. These financial instruments consist of commitments to extend credit and letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet.

As of December 31, 2012, commitments to extend credit and stand-by letters of credit were the only financial instruments with off-balance sheet risk. The Bank has not entered into any contracts for financial derivative instruments such as futures, swaps, options or similar instruments. Real estate commitments are generally secured by property with a loan-to-value ratio of 65% to 75%. In addition, the majority of the Bank's commitments have variable interest rates.

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 and letters of credit as it does for loans included on the balance sheet. Table Fifteen below lists financial instruments that represent off-balance sheet credit as of December 31, 2012, 2011 and 2010.

Table Fifteen: Commitments to extend credit

As of December 31,	2012	2011	2010
Commercial	$ 44,440,000	$ 54,853,000	$ 42,671,000
Real Estate- construction	791,000	633,000	3,497,000
Real Estate- other	6,255,000	6,642,000	6,745,000
Consumer	69,000	365,000	231,000
Total	$ 51,555,000	$ 62,493,000	$ 53,144,000
Letters of credit	$ 238,000	$ 1,068,000	$ 476,000

A detail of the Bank's contractual obligations as of December 31, 2012 is provided in Table Sixteen below.

Table Sixteen: Contractual Obligations

As of December 31,

	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Time deposits	$ 31,314,000	$ 27,824,000	$ 3,490,000	$ -	$ -
Capital lease obligations	-	-	-	-	-
Operating leases	2,587,000	418,000	706,000	599,000	864,000
Purchase obligations	-	-	-	-	-
Other long-term liabilities	-	-	-	-	-
reflected on the Bank's balance sheet under GAAP	-	-	-	-	-
Total	$ 33,901,000	$ 28,242,000	$ 4,196,000	$ 599,000	$ 864,000

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

Item 8. Financial Statements and Supplementary Data

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Schedules have been omitted since the required information is not present in amounts sufficient to require submission of the schedule or because the information required is included in the financial statements or notes thereto.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors
1st Capital Bank
Monterey, California

We have audited the accompanying balance sheets of 1st Capital Bank (the "Bank") as of December 31, 2012 and 2011, and the related statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years 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 audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Bank is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of 1st Capital Bank as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

\s\ CROWE HORWATH LLP

Sacramento, California
March xx, 2013

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors
1st Capital Bank
Monterey, California

We have audited the accompanying statements of income, comprehensive income, changes in shareholders' equity and cash flows of 1st Capital Bank (the "Bank") for the year ended December 31, 2010. 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.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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 financial statements referred to above present fairly, in all material respects, the results of 1st Capital Bank's operations and its cash flows for year ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

/s/ PERRY-SMITH LLP

Sacramento, California
March 23, 2011

BALANCE SHEETS

December 31,	2012	2011
Assets		
Cash and due from banks	$ 8,551,000	$ 8,910,000
Due from Federal Reserve Bank	21,042,000	60,062,000
Total cash and cash-equivalents	29,593,000	68,972,000
Interest-earning deposits in other financial institutions	9,321,000	3,835,000
Available-for-sale investment securities at estimated fair value	41,762,000	13,685,000
Loans:		
Commercial	89,834,000	78,504,000
Real estate-construction	4,834,000	4,126,000
Real estate-other	147,320,000	115,902,000
Consumer	748,000	1,580,000
Deferred loan costs, net	517,000	470,000
Total loans	243,253,000	200,582,000
Allowance for loan losses	(4,314,000)	(3,320,000)
Net loans	238,939,000	197,262,000
Premises and equipment, net	1,282,000	615,000
Bank owned life insurance	3,555,000	-
Accrued interest receivable and other assets	4,897,000	3,946,000
Total assets	$ 329,349,000	$ 288,315,000
Liabilities and Shareholders' Equity		
Deposits:		
Non interest-bearing demand	$ 123,403,000	$ 118,366,000
Interest - bearing checking accounts	17,482,000	12,188,000
Money market	60,091,000	43,983,000
Savings	62,364,000	38,558,000
Time	31,314,000	42,488,000
Total deposits	294,654,000	255,583,000
Accrued interest payable and other liabilities	694,000	919,000
Total liabilities	295,348,000	256,502,000
Commitments and contingencies		
Shareholders' Equity:		
Preferred stock – no par value; 10,000,000 shares authorized; no shares issued or outstanding at December 31, 2012 and 2011	-	-
Common stock - no par value; 20,000,000 shares authorized; 3,310,503 and 3,243,293 shares issued and outstanding at December 31, 2012 and December 31, 2011, respectively	33,518,000	33,213,000
Retained earnings (accumulated deficit)	82,000	(1,724,000)
Accumulated other comprehensive income, net of taxes	401,000	324,000
Total shareholders' equity	34,001,000	31,813,000
Total liabilities and shareholders' equity	$ 329,349,000	$ 288,315,000

See notes to Financial Statements

STATEMENTS OF INCOME

For the Year Ending December 31,	2012	2011	2010
Interest Income			
Loans, including fees	$ 12,008,000	$ 10,671,000	$ 8,582,000
Available-for-sale investment securities	413,000	395,000	458,000
Interest earning deposits in other financial institutions	74,000	41,000	83,000
Due from Federal Reserve Bank	106,000	44,000	55,000
Total interest income	12,601,000	11,151,000	9,178,000
Interest Expense			
Interest -bearing checking accounts	27,000	28,000	25,000
Money market	344,000	379,000	430,000
Savings	282,000	251,000	361,000
Time	171,000	322,000	435,000
Total interest expense	824,000	980,000	1,251,000
Net Interest Income before Provision for Loan Losses	11,777,000	10,171,000	7,927,000
Provision for Loan Losses	994,000	665,000	642,000
Net Interest Income after Provision for Loan Losses	10,783,000	9,506,000	7,285,000
Noninterest Income			
Service charges on deposits	85,000	75,000	66,000
BOLI benefits	699,000	-	-
Earnings on BOLI	37,000	-	-
Other income	88,000	69,000	50,000
Total noninterest income	909,000	144,000	116,000
Noninterest Expenses			
Salaries and employee benefits	5,159,000	4,272,000	3,290,000
Occupancy	725,000	575,000	574,000
Furniture and equipment	328,000	371,000	312,000
Other	2,508,000	2,189,000	2,071,000
Total noninterest expenses	8,720,000	7,407,000	6,247,000
Income Before Provision for Income Taxes	2,972,000	2,243,000	1,154,000
Provision for Income Taxes	1,166,000	(895,000)	148,000
Net Income	$ 1,806,000	$ 3,138,000	$ 1,006,000
Basic Earnings per Share	$ 0.56	$ 0.97	$ 0.31
Diluted Earnings per Share	$ 0.54	$ 0.97	$ 0.31
Weighted average number of shares outstanding			
Basic	3,224,782	3,220,853	3,220,853
Diluted	3,319,925	3,244,921	3,220,872

See Notes to Financial Statements

STATEMENTS OF COMPREHENSIVE INCOME

For the Year Ending December 31,	2012	2011	2010
Net Income	$ 1,806,000	$ 3,138,000	$ 1,006,000
Other comprehensive income:			
Change in unrealized gains on available-for-sale investment securities	133,000	105,000	-
Income tax effect	(56,000)	(44,000)	-
Total other comprehensive income	77,000	61,000	-
Total comprehensive income	$ 1,883,000	$ 3,199,000	$ 1,006,000

See Notes to Financial Statements

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	Common Stock		Retained Earnings/ Accumulated Deficit	Accumulated Other Comprehensive Income	Total
	Shares	Amount			
Balances, January 1, 2010	3,220,727	$32,880,000	$ (5,868,000)	$ 263,000	$27,275,000
Net income			1,006,000		1,006,000
Other comprehensive income					-
Share-based compensation expense		193,000			193,000
Balances, December 31, 2010	3,220,727	33,073,000	(4,862,000)	263,000	28,474,000
Net income			3,138,000		3,138,000
Other comprehensive income				61,000	61,000
Restricted stock granted	22,440				-
Share-based compensation expense		140,000			140,000
Balances, December 31, 2011	3,243,167	33,213,000	(1,724,000)	324,000	31,813,000
Net income			1,806,000		1,806,000
Other comprehensive income				77,000	77,000
Stock options exercised	7,836	76,000			76,000
Restricted stock granted	59,500				-
Share-based compensation expense		229,000			229,000
Balances, December 31, 2012	3,310,503	$33,518,000	$ 82,000	$ 401,000	$34,001,000

See Notes to Financial Statements

STATEMENTS OF CASH FLOWS

For the Year Ending December 31,	2012	2011	2010
Cash Flows from Operating Activities:			
Net income	$ 1,806,000	$ 3,138,000	$ 1,006,000
Reconciliation of net income to net cash provided by operating activities:			
Provision for loan losses	994,000	665,000	642,000
Depreciation	325,000	345,000	319,000
Share-based compensation expense	229,000	140,000	193,000
Amortization and accretion	138,000	91,000	83,000
(Increase) decrease in deferred loan costs, net	(47,000)	(44,000)	56,000
Deferred tax (benefit) provision	(36,000)	(183,000)	154,000
Change in valuation allowance on deferred tax assets	-	(1,861,000)	(154,000)
Bank-owned life insurance benefits	(699,000)	-	-
Earnings on bank-owned life insurance	(37,000)	-	-
(Increase) decrease in accrued interest receivable and other assets	(862,000)	373,000	140,000
(Decrease) increase in accrued interest payable and other liabilities	(225,000)	(208,000)	292,000
Net cash provided by operating activities:	1,586,000	2,456,000	2,731,000
Cash Flows from Investing Activities:			
(Increase) decrease in interest-bearing deposits in other financial institutions, net	(5,486,000)	(844,000)	3,092,000
Proceeds from maturities of and principal repayments on available-for-sale investment securities	3,920,000	2,971,000	4,279,000
Purchase of FHLB stock	(109,000)	(243,000)	(186,000)
Purchase of available-for-sale investment securities	(32,002,000)	(2,042,000)	(7,203,000)
Net increase in loans	(42,624,000)	(23,619,000)	(42,231,000)
Purchase of single premium bank-owned life insurance	(4,500,000)	-	-
Proceeds from death benefits on bank-owned life insurance	1,681,000	-	-
Purchases of equipment and leasehold improvements	(992,000)	(215,000)	(213,000)
Net cash used in investing activities	(80,112,000)	(23,992,000)	(42,462,000)
Cash Flows from Financing Activities:			
Net increase in demand and savings deposits	50,245,000	68,224,000	24,121,000
Net (decrease) increase in time deposit accounts	(11,174,000)	(9,918,000)	8,924,000
Cash received from stock options exercised	76,000	-	-
Net cash provided by financing activities	39,147,000	58,306,000	33,045,000
Net (decrease) increase in cash and equivalents	(39,379,000)	36,770,000	(6,686,000)
Cash and equivalents, beginning of period	68,972,000	32,202,000	38,888,000
Cash and equivalents, end of period	$ 29,593,000	$68,972,000	$ 32,202,000
Other Cash Flow Information:			
Interest paid	$ 863,000	$ 1,037,000	$ 1,303,000
Income taxes paid	$ 1,789,000	$ 888,000	$ 2,000

See Notes to Financial Statements

NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

1st Capital Bank (the "Bank") was approved as a state-chartered non-member bank on April 16, 2007 and is subject to regulation by the California Department of Financial Institutions (the "DFI") and the Federal Deposit Insurance Corporation (the "FDIC"). The Bank is headquartered in Monterey, California, has three branches, one in Monterey, one in King City and one in Salinas, and provides products and services to customers who are predominately small to middle-market businesses, professionals and not-for-profit organizations located in the Salinas Valley, Monterey Peninsula and surrounding areas.

On November 9, 2010, the FDIC issued a final rule implementing section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") that made permanent the $250,000 deposit insurance limit per depositor and provided unlimited insurance coverage for noninterest-bearing transaction accounts from December 31, 2010 through December 31, 2012. The unlimited insurance coverage was available to all depositors, including consumers, businesses, and government entities. This unlimited insurance coverage was separate from, and in addition to, the insurance coverage provided to a depositor's other deposit accounts held at an FDIC-insured institution. The unlimited insurance coverage for noninterest-bearing transaction accounts was not extended and terminated on December 31, 2012. The $250,000 maximum deposit insurance amount per depositor remains in effect.

The accounting and reporting policies of the Bank conform with accounting principles generally accepted in the United States of America ("GAAP") and prevailing practices within the banking industry.

Basis of presentation – Stock dividend

On February 28, 2012 the Board of Directors declared a 2% stock dividend, which was distributed on April 11, 2012, to shareholders of record as of March 28, 2012. The stock dividend was accounted for akin to a stock split because the Bank had an accumulated deficit at that time. All share and per-share information have been retroactively adjusted to reflect the stock dividend.

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 at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The allowance for loan losses and fair values of financial instruments are estimates that are particularly subject to change.

Cash and Cash-Equivalents

For the purpose of the statement of cash flows, cash and cash-equivalents consist of cash and due from banks, due from the Federal Reserve Bank and overnight deposits. Generally, Federal funds are sold for one day periods. Net cash flows are reported for customer loan and deposit transactions and interest-bearing deposits in other financial institutions.

Investment Securities

Investment securities are classified into the following categories:

- Available-for-sale securities, reported at fair value, with unrealized gains and losses excluded from earnings and reported, net of taxes, as accumulated other comprehensive income (loss) within shareholders' equity.

- Held-to-maturity securities, which management has the positive intent and ability to hold until maturity, reported at amortized cost, adjusted for the accretion of discounts and amortization of premiums.

Management determines the appropriate classification of its investments at the time of purchase and may only change the classification in certain limited circumstances. All transfers between categories are accounted for at fair value.

Gains and losses on the sale of investment securities are computed using the specific identification method. Interest earned on investment securities is reported in interest income, net of applicable adjustments for accretion of discounts and amortization of premiums.

Investment securities are periodically evaluated for impairment and more frequently when economic or market conditions warrant such an evaluation to determine whether a decline in their value is other than temporary. An investment security is impaired when its carrying value is greater than its fair value. Management utilizes criteria such as the magnitude and duration of the decline and the intent and ability of the Bank to retain its investment in the securities for a period of time sufficient to allow for an anticipated recovery in fair value, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, and management does not intend to sell the security or it is more likely than not that the Bank will not be required to sell the security before recovery, only the portion of the impairment loss representing credit exposure is recognized as a charge to earnings, with the balance recognized as a charge to other comprehensive income. If management intends to sell the security or it is more likely than not that the Bank will be required to sell the security before recovering its forecasted cost, the entire impairment loss is recognized as a charge to earnings.

Federal Home Loan Bank Stock

As a member of the Federal Home Loan Bank System, the Bank is required to maintain an investment in the capital stock of the Federal Home Loan Bank of San Francisco (FHLB). The investment in FHLB stock of $1,027,000 and $918,000 at December 31, 2012 and 2011, respectively, is carried at cost and included in accrued interest receivable and other assets in the accompanying balance sheets. The FHLB stock is periodically evaluated for impairment based on the ultimate recovery of its par value of $100 per share. The FHLB can suspend dividends and redemptions upon notification to its members. Both cash and stock dividends are reported as income.

Loans

Loans are stated at principal balances outstanding. Interest is accrued daily based upon outstanding loan balances. However, when, in the opinion of management, loans are considered to be impaired and the future collectability of interest and principal is in serious doubt, loans are placed on nonaccrual status and the accrual of interest income is suspended. In addition, loans are generally placed on non-accrual status when they are 90 days delinquent unless the loan is well-secured and in process of collection. 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 payments received on nonaccrual loans for which the ultimate collectability of principal is not in doubt, are applied first to earned but unpaid interest and then to principal. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Substantially all loan origination fees, commitment fees, direct loan origination costs and purchase premiums and discounts on loans are deferred and recognized as an adjustment of yield, to be amortized to interest income over the contractual term of the loan. The unamortized balance of deferred fees and costs is reported as a component of net loans.

Allowance for Loan Losses

The allowance for loan losses is an estimate of probable incurred credit losses in the Bank's loan portfolio that have been incurred as of the balance sheet date. The allowance is established through a provision for loan 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 individually identified impaired loans and general reserves for probable incurred losses related to loans that are collectively evaluated for impairment.

A loan 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 determined to be impaired are individually evaluated for impairment. When a loan 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 borrower's financial difficulties grants a concession to the borrower 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.

The determination of the general reserve for loans that are collectively evaluated for impairment is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Bank, its peers or a combination thereof since the Bank's inception in 2007. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations.

The Bank determines a separate allowance for each portfolio segment (loan type). These portfolio segments include commercial, real estate construction (including land and development loans), other commercial real estate, residential real estate, and consumer loans. The allowance for loan losses attributable to each portfolio segment, which includes both loans individually evaluated for impairment and loans that are collectively evaluated for impairment, are combined to determine the Bank's overall allowance, which is included on the balance sheet and available for all loss exposures.

The Bank assigns a risk rating to all 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 the Bank's 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 do not differ by portfolio segment, and 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.
>
> 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 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.

Commercial: Commercial loans generally possess a lower inherent risk of loss than some of the other portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Real estate – construction: Real estate - construction loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Real estate – other: Loans consist of a) Commercial real estate and b) Single family residential real estate and home equity lines of credit and the risks are identified as follows:

Commercial real estate: Commercial real estate loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Single family residential real estate and home equity lines of credit – The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Consumer – A consumer loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for the purchase of heavy equipment or industrial vehicles may also be included. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors and management 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 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 Credit Losses on Off-Balance-Sheet Credit Exposures

The Bank also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments of $100,000 at December 31, 2012 and 2011 is included in accrued interest payable and other liabilities on the balance sheets.

Foreclosed Assets

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed.

Bank Premises and Equipment

Bank premises and equipment are carried at cost. Depreciation is determined using the straight-line method over the estimated useful lives of the related assets. The useful lives of furniture, fixtures and equipment are estimated to be three to five years. Leasehold improvements are amortized over the lesser of the respective lease term (including renewal periods that are reasonably assured) or their useful lives, which are generally three to fifteen years.

Certain operating leases contain scheduled and specified rent increases or incentives in the form of tenant improvement allowances or credits. The scheduled rent increases are recognized on a straight-line basis over the lease term as an increase in the amount of rental expense recognized each period. Lease incentives are capitalized at the inception of the lease and amortized on a straight-line basis over the lease term as a reduction of rental expense. Amounts accrued in excess of amounts paid related to the scheduled rent increases and the unamortized deferred credits are included in accrued interest payable and other liabilities on the balance sheet.

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.

Income Taxes

Income tax expense is the total of the 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 tax consequences of temporary differences between the reported amount of assets and liabilities and their tax bases. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. A valuation allowance is recognized if, based on the weight of available evidence, management believes it is more likely than not that a portion or all of the deferred tax assets will not be realized. During the year ended December 31, 2011, management, based on the actual results of operations and the forecast of future earnings from operations determined that it was more likely than not that all of the deferred tax assets would be realized and therefore, the valuation allowance was reversed as a tax benefit.

The Bank considers all tax positions recognized in its financial statements for the likelihood of realization. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than fifty percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above, if any, is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the statement of operations.

Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options and restricted stock, result in the issuance of common stock which shares in the earnings of the Bank. The treasury stock method is applied to determine the dilutive effect of stock options and restricted stock in computing diluted earnings per share.

Share-Based Compensation

The Bank has one share-based compensation plan, the 1st Capital Bank 2007 Equity Incentive Plan (the "Plan"), which has been approved by its shareholders and permits the grant of stock options and restricted stock awards for up to 966,255 shares of the Bank's common stock of which 383,440 shares were available for future grants at December 31, 2012. The Plan is designed to attract and retain employees and directors. The amount, frequency, and terms of share-based awards may vary based on competitive practices, the Bank's operating results and government regulations. New shares are issued upon option exercise or lapse of restrictions. The Plan does not provide for the settlement of awards in cash. In addition, the Plan requires that the exercise price of options may not be less than the fair market value of the stock at the date the option is granted, and that the exercise price must be paid in full at the time the option is exercised.

Share-based compensation expense is recorded for all stock options and restricted stock that are ultimately expected to vest as the requisite service is rendered based on the grant date fair value of the awards. Management estimates the fair value of each option award as of the date of grant using a Black-Scholes-Merton option pricing formula. Expected volatilities are based on historical volatilities of the Bank's common stock over a preceding period commensurate with the expected term of the options. The Bank uses historical data to estimate option exercise and post-vesting termination behavior. (Employee and management options are tracked separately.) The expected term of options granted is based on this historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Expected dividend yield was not considered in the option pricing formula since the Bank has no current or future plans to pay dividends. The restricted stock awards are considered fixed awards as the number of shares and fair value is known at the date of grant. The fair value for restricted stock awards is determined by the market price of the Bank's common stock on the date of grant. In addition to these assumptions, management makes estimates regarding pre-vesting forfeitures that will impact total compensation expense recognized under the Plan.

Cash flows resulting from the tax benefits derived from tax deductions in excess of the compensation cost recognized for those awards (excess tax benefits) are classified as cash flows from financing activities in the statement of cash flows. The Bank had no excess tax benefits for the years ended December 31, 2012, 2011 and 2010.

Comprehensive Income

Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of other comprehensive income or loss that historically has not been recognized in the calculation of net income or loss. The only source of other comprehensive income or loss for the Bank is unrealized gains and losses on available-for-sale investment securities. Total comprehensive income and the components of other comprehensive income or loss are presented in the statement of comprehensive income. The cumulative balance of other comprehensive income is reported as a separate component of equity.

Adoption of New Financial Accounting Standards

Fair Value Measurements and Disclosures In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement ("Topic 820") – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" ("ASU 11-04"). This ASU amends Topic 820, "Fair Value Measurements and Disclosures," to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 11-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. The amendments in this guidance were effective for interim and annual reporting periods beginning after December 15, 2011. Adoption of this update did not have a material impact on the Bank's financial position, results of operations, or cash flows.

Presentation of Comprehensive Income In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income ("Topic 220") – Presentation of Comprehensive Income" ("ASU 11-05"). This ASU amends Topic 220, "Comprehensive Income," to require that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 11-05 requires entities to present, on the face of the financial statements , reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in shareholders' equity was eliminated. ASU 11-05 was effective for annual periods beginning after December 15, 2011. Adoption of this ASU did not have a material impact on the Bank's financial position, results of operations, or cash flows, except to add a new statement of comprehensive income.

2. AVAILABLE-FOR-SALE INVESTMENT SECURITIES

The amortized cost and estimated fair value of available-for-sale investment securities consisted of the following:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
December 31, 2012				
Government and government sponsored agency guaranteed residential mortgage-backed securities	$ 33,196,000	$ 492,000	$ (8,000)	$ 33,680,000
Government and government sponsored agency guaranteed commercial mortgage-backed securities	7,880,000	211,000	(9,000)	8,082,000
Total investment securities	$ 41,076,000	$ 703,000	$ (17,000)	$ 41,762,000
December 31, 2011				
Government and government sponsored agency guaranteed residential mortgage-backed securities	$ 11,394,000	$ 407,000	$ (3,000)	$ 11,798,000
Government agency guaranteed commercial mortgage-backed securities	1,738,000	149,000	-	1,887,000
Total investment securities	$ 13,132,000	$ 556,000	$ (3,000)	$ 13,685,000

Accumulated other comprehensive income within shareholders' equity included net unrealized gains on available-for-sale investment securities totaling $686,000 and $553,000, net of $285,000 and $229,000 in deferred tax liabilities as of December 31, 2012 and 2011, respectively. Net unrealized gains on available-for-sale investment securities totaling $133,000 and $105,000 were recorded, net of $56,000 and $44,000 in deferred taxes, as other comprehensive income within shareholders' equity during the years ended December 31, 2012 and 2011, respectively. There were no net unrealized gains or losses on available-for-sale investment securities recorded as other comprehensive income for the year ended December 31, 2010. There were no sales or transfers of available-for-sale investment securities during the years ended December 31, 2012, 2011 or 2010.

Contractual Maturities

Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties. The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2012 by contractual maturity are as follows with securities not due at a single maturity date shown separately:

In thousands	Amortized Cost	Estimated Fair Value
Available-for-sale securities:		
Investment securities not due at a single maturity date - mortgaged-backed securities	$ 41,076,000	$ 41,762,000
Total investment securities	$ 41,076,000	$ 41,762,000

Unrealized Losses

Investment securities with unrealized losses are summarized and classified according to the duration of the loss period as follows:

	Less Than 12 Months		12 Months or More		Total	
In thousands	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2012						
Available for sale securities:						
Government and government sponsored agency guaranteed mortgage-backed securities						
- Residential	$12,983,000	$ (8,000)	$ -	$ -	$12,983,000	$ (8,000)
- Commercial	4,420,000	(9,000)	-	-	4,420,000	(9,000)
Total investment securities	$17,403,000	$ (17,000)	$ -	$ -	$ 17,403,000	$(17,000)
December 31, 2011						
Available for sale securities:						
Government and government sponsored agency guaranteed mortgage-backed securities						
- Residential	$ 1,013,000	$ (3,000)	$ -	$ -	$ 1,013,000	$ (3,000)
- Commercial	-	-	-	-	-	-
Total investment securities	$ 1,013,000	$ (3,000)	$ -	$ -	$ 1,013,000	$ (3,000)

Unrealized losses on securities outstanding less than twelve months at December 31, 2012 and 2011 were caused primarily by interest rate changes. These securities are guaranteed by government-sponsored agencies and are of high credit quality. Since these securities are of high credit quality and the decline in value has existed for a short period of time, management believes that these securities may recover their losses in the foreseeable future and management has the intent and ability to hold the securities until the earlier of maturity or recovery of value. Accordingly, the Bank did not consider these investments other-than-temporarily impaired at December 31, 2012 or 2011.

Investment securities with amortized costs and estimated fair values totaling $15,557,000 and $16,226,000 at December 31, 2012 were pledged to secure public deposits and FHLB borrowing arrangements. Investment securities with amortized costs and estimated fair values totaling $13,025,000 and $13,572,000 at December 31, 2011 were pledged to secure public deposits and FHLB borrowing arrangements. The total reserve required for public deposits on hand as of December 31, 2012 and 2011 was $8,006,000 and $8,326,000 respectively.

2. LOANS AND ALLOWANCE FOR LOAN LOSSES

For the years ended December 31, 2012, 2011 and 2010, changes in the allowance for loan losses were as follows:

	2012	2011	2010
Balance, beginning of year	$ 3,320,000	$ 2,723,000	$ 2,081,000
Provision charged to expense	994,000	665,000	642,000
Loans charged off	-	(68,000)	-
Recoveries	-	-	-
Balance, end of year	$ 4,314,000	$ 3,320,000	$ 2,723,000

The following tables present loans and allowance for loan losses information by portfolio segment and class of financing receivable where required. For the purposes of these disclosures, the recorded investment in outstanding loans excludes accrued interest receivable and deferred loan origination fees and costs due to their insignificance.

The following table shows the allocation of the allowance for loan losses and outstanding loans at December 31, 2012 and the allowance for loan losses for the year ended December 31, 2012 by portfolio segment and by impairment methodology:

Allowance for Loan Losses For the Year Ended December 31, 2012

		Real Estate	Real Estate - Other				
	Commercial	Construction	Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses:							
Beginning balance	$ 1,399,000	$ 37,000	$ 1,592,000	$ 165,000	$ 27,000	$ 100,000	$ 3,320,000
Charge-offs	-	-	-	-	-	-	-
Recoveries	-	-	-	-	-	-	-
Provisions	310,000	6,000	723,000	69,000	(14,000)	(100,000)	994,000
Ending balance	$ 1,709,000	$ 43,000	$ 2,315,000	$ 234,000	$ 13,000	$ -	$ 4,314,000
Ending balance: individually evaluated for impairment	$ 417,000	$ -	$ -	$ -	$ -	$ -	$ 417,000
Ending balance: collectively evaluated for impairment	$ 1,292,000	$ 43,000	$ 2,315,000	$ 234,000	$ 13,000	$ -	$ 3,897,000
Ending balance: loans acquired with deteriorated credit quality	$ -	$	$ -	$ -	$ -	$ -	$ -
Outstanding Loans at December 31, 2012:							
Ending balance	$89,834,000	$ 4,834,000	$129,180,000	$ 18,140,000	$ 748,000		$242,736,000
Ending balance: individually evaluated for impairment	$ 2,066,000	$ -	$2,280,000	$ -	$ -		$ 4,346,000
Ending balance: collectively evaluated for impairment	$87,768,000	$ 4,834,000	$126,900,000	$ 18,140,000	$ 748,000		$238,390,000
Ending balance: loans acquired with deteriorated credit quality	$ -	$	$ -	$ -	$ -		$ -

The following table shows the allocation of the allowance for loan losses and outstanding loans at December 31, 2011 and the allowance for loan losses for the year ended December 31, 2011 by portfolio segment and by impairment methodology:

Allowance for Loan Losses For the Year Ended December 31, 2011

	Commercial	Real Estate - Construction	Real Estate - Other Commercial	Real Estate - Other Residential	Consumer	Unallocated	Total
Allowance for loan losses:							
Beginning balance	$ 1,322,000	$ 23,000	$ 1,200,000	$ 139,000	$ 30,000	$ 9,000	$2,723,000
Charge-offs	(68,000)	-	-	-	-	-	(68,000)
Recoveries	-	-	-	-	-	-	-
Provisions	145,000	14,000	392,000	26,000	(3,000)	91,000	665,000
Ending balance	$ 1,399,000	$ 37,000	$ 1,592,000	$165,000	$ 27,000	$100,000	$3,320,000
Ending balance: individually evaluated for impairment	$ 25,000	$ -	$ -	$ -	$ -	$ -	$ 25,000
Ending balance: collectively evaluated for impairment	$ 1,374,000	$ 37,000	$ 1,592,000	$165,000	$27,000	$100,000	$3,295,000
Ending balance: loans acquired with deteriorated credit quality	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Outstanding Loans at December 31, 2011:							
Ending balance	$ 78,504,000	$ 4,126,000	$102,753,000	$ 13,149,000	$1,580,000		$200,112,000
Ending balance: individually evaluated for impairment	$ 240,000	$ -	$ -	$ -	$ -		$240,000
Ending balance: collectively evaluated for impairment	$ 78,264,000	$ 4,126,000	$102,753,000	$13,149,000	$1,580,000		$199,872,000
Ending balance: loans acquired with deteriorated credit quality	$ -	$	$ -	$ -	$ -		$ -

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2012:

Credit Risk Profile by Internal Assigned Grade as of December 31, 2012

	Commercial	Real Estate - Construction	Real Estate - Other Commercial	Real Estate - Other Residential	Consumer	Total
Grade:						
Pass	$ 82,820,000	$ 4,834,000	$ 126,900,000	$18,140,000	$748,000	$233,442,000
Special Mention	4,216,000	-	-	-	-	4,216,000
Substandard	2,798,000	-	2,280,000	-	-	5,078,000
Doubtful	-	-	-	-	-	-
Total	$ 89,834,000	$ 4,834,000	$ 129,180,000	$18,140,000	$748,000	$242,736,000

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2011:

Credit Risk Profile by Internal Assigned Grade as of December 31, 2011

	Commercial	Real Estate- Construction	Real Estate - Other Commercial	Real Estate - Other Residential	Consumer	Total
Grade:						
Pass	$73,536,000	$4,126,000	$102,283,000	$13,149,000	$1,580,000	$194,674,000
Special Mention	4,623,000	-	-	-	-	4,623,000
Substandard	345,000	-	470,000	-	-	815,000
Doubtful	-	-	-	-	-	-
Total	$78,504,000	$4,126,000	$102,753,000	$13,149,000	$1,580,000	$ 200,112,000

The following table shows an aging analysis of the loan portfolio by the time past due at December 31, 2012:

Age Analysis of Past Due Outstanding Loans As of December 31, 2012

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Financing Receivables	Past Due Greater Than 90 Days and Still Accruing
Commercial	$ -	$ 500,000	$ -	$ 500,000	$ 89,334,000	$ 89,834,000	$ -
Real estate:							
Construction	-	-	-	-	4,834,000	4,834,000	-
Commercial	-	-	-	-	129,180,000	129,180,000	-
Residential	-	-	-	-	18,140,000	18,140,000	-
Consumer - other	-	-	-	-	748,000	748,000	-
Total	$ -	$ 500,000	$ -	$ 500,000	$ 242,236,000	$ 242,736,000	$ -

The following table shows an aging analysis of the loan portfolio by the time past due at December 31, 2011:

Age Analysis of Past Due Outstanding Loans As of December 31, 2011

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Past Due Greater Than 90 Days and Still Accruing
Commercial	$ -	$ -	$ -	$ -	$78,504,000	$78,504,000	$ -
Real estate:							
Construction	-	-	-	-	4,126,000	4,126,000	-
Commercial	-	-	-	-	102,753,000	102,753,000	-
Residential	-	-	-	-	13,149,000	13,149,000	-
Consumer - other	-	-	-	-	1,580,000	1,580,000	-
Total	$ -	$ -	$ -	$ -	$200,112,000	$200,112,000	$ -

The following table shows the recorded investment, unpaid principal balance and related allowance for loan losses for impaired loans as of December 31, 2012 and 2011:

	Recorded Investment	Unpaid Principal Balance	Related Allowance
Impaired Loans as of December 31, 2012			
With no related allowance recorded:			
Commercial real estate	$ 2,280,000	$ 2,080,000	$ -
Commercial	1,075,000	1,075,000	-
With a related allowance recorded:			
Commercial	991,000	991,000	417,000
Total	$ 4,346,000	$ 4,346,000	$ 417,000
Impaired Loans as of December 31, 2011			
With a related allowance recorded:			
Commercial	$ 240,000	$ 240,000	$ 25,000
Total	$ 240,000	$ 240,000	$ 25,000

The following table shows the average recorded investment and interest income recognized on impaired loans for the years ended December 31, 2012 and 2011:

Impaired Loans

Year Ended December 31,	2012		2011	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial real estate	$ 706,000	$ 38,000	$ -	$ -
With an allowance recorded:				
Commercial	382,000	16,000	250,000	-
Total	$ 1,793,000	$ 93,000	$ 250,000	$ -

The following table shows nonaccrual loans as of December 31, 2012 and 2011:

Loans on Nonaccrual Status

As of December 31,	2012	2011
Commercial	$ 981,000	$ 240,000
Real Estate - Construction	-	-
Real Estate - Other		
Commercial	460,000	-
Residential	-	-
Consumer	-	-
Total	$ 1,441,000	$ 240,000

Interest foregone on nonaccrual loans totaled $11,000 and $7,000 for the year ended December 31, 2012 and December 31, 2011, respectively. For the year ended December 31, 2010, the Bank had no impaired loans or loans placed on nonaccrual status.

The Bank modified loans totaling $ 507,000 and $250,000 as troubled debt restructurings during the years ended December 31, 2012 and 2011, respectively. There were no such restructurings during the year ended December 31, 2010. The current year restructuring was for one relationship that included a commercial real estate loan and a commercial loan. The prior year restructuring was for a commercial loan. All of the restructurings consisted of terms which extended the loan's maturity and required monthly principal and interest payments. The Bank's recorded investment in the loans did not change and totaled $460,000 and $240,000 at December 31, 2012 and 2011, respectively. There were no other significant financial effects that resulted from the modifications because the loans were already evaluated individually for impairment prior to the modifications and the specific allowance for loan losses on the loan did not change as a result of the modifications.

There was one financing receivable modified as a troubled debt restructuring within the previous 12 months for which there was a payment default during the year ended December 31, 2012. This is the same loan identified above as modified as a troubled debt restructuring in 2011. There were no financing receivables modified as troubled debt restructurings within the previous 12 months for which there was a payment default during the years ended December 31, 2011 or 2010.

Salaries and employee benefits totaling $528,000, $505,000 and $508,000 were deferred as loan origination costs for the years ended December 31, 2012, 2011 and 2010.

As of December 31, 2012, $43,903,000 and $47,028,000 of loans were pledged to the Federal Reserve Bank and the Federal Home Loan Bank, respectively, as security for borrowing lines. As of December 31, 2011, $44,778,000 and $50,094,000 of loans were pledged to the Federal Reserve Bank and the Federal Home Loan Bank, respectively, as security for borrowing lines.

4. BANK PREMISES AND EQUIPMENT

Bank premises and equipment consisted of the following at December 31:

	2012	2011
Furniture and equipment	$ 1,495,000	$ 1,324,000
Leasehold improvement	1,286,000	571,000
	2,781,000	1,895,000
Accumulated depreciation and amortization	(1,499,000)	(1,280,000)
Premises and equipment, net	$ 1,282,000	$ 615,000

Depreciation and amortization included in occupancy and furniture and equipment expense totaled $325,000, $345,000 and $319,000for the years ended December 31, 2012, 2011 and 2010, respectively.

5. TIME DEPOSITS

The composition of time deposits at December 31 are as follows:

	2012	2011
Time, $100,000 or more	$ 24,510,000	$ 34,787,000
Other time	6,804,000	7,701,000
Total	$ 31,314,000	$ 42,488,000

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

	2012	2011
Three months or less	$ 9,132,000	$ 13,585,000
Over three months through six months	11,944,000	14,306,000
Over six months through twelve months	6,748,000	11,661,000
Over twelve months through two years	3,490,000	2,936,000
Total	$ 31,314,000	$ 42,488,000

6. INCOME TAXES

The provision for income taxes for the years ended December 31, 2012, 2011 and 2010 consisted of the following:

	2012	2011	2010
Current:			
Federal	$ 811,000	$ 946,000	$ 4,000
State	391,000	203,000	144,000
Total	1,202,000	1,149,000	148,000
Deferred:			
Federal	(120,000)	(157,000)	336,000
State	84,000	(26,000)	(182,000)
Total	(36,000)	(183,000)	154,000
Changes in valuation allowance	-	(1,861,000)	(154,000)
Total	$ 1,166,000	$ (895,000)	$ 148,000

The effective federal tax rate for the years ended December 31, 2012, 2011 and 2010 differs from the statutory tax rate as follows:

	2012	2011	2010
Statutory Federal income tax rate	34.0%	34.0%	34.0%
State income taxes (net of Federal income tax benefit)	10.5%	5.2%	(2.2%)
Other	3.1%	3.7%	10.3%
Bank owned life insurance	(8.4%)	0.0%	0.0%
Valuation allowance	0.0%	(82.8%)	(29.3%)
Effective tax rate	39.2%	(39.9%)	12.8%

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant deferred tax assets (liabilities) at December 31 consisted of the following:

	2012	2011
Deferred tax assets:		
Allowance for loan losses	$ 1,903,000	$ 1,457,000
Pre-opening costs	298,000	330,000
Equity compensation expense	245,000	412,000
State taxes	-	76,000
Depreciation and amortization	51,000	22,000
Other	54,000	71,000
Total deferred tax assets	2,551,000	2,368,000
Deferred tax liabilities:		
Unrealized securities gains	(285,000)	(229,000)
Deferred loan costs	(344,000)	(324,000)
State taxes	(127,000)	-
Total deferred tax liabilities	(756,000)	(553,000)
Net deferred tax assets	$ 1,795,000	$ 1,815,000

A valuation allowance is provided to reduce deferred tax assets to a level which, more likely than not, will be realized. During the year ended December 31, 2011, management, based on the actual results of operations and the forecast of future earnings from operations determined that it was more likely than not that all of the deferred tax assets would be realized and therefore, the valuation allowance was reversed as a tax benefit.

At December 31, 2012, the Bank had a state net operating loss carry forward (NOL) of $682,000 and no federal NOL. At December 31, 2011, the Bank had a cumulative state NOL of $2,300,000, and no federal NOL.

The Bank files income tax returns in the United States and California jurisdictions. The statute of limitations is open for tax years ended December 31, 2008 and thereafter. There are currently no pending federal, state, or local income tax examinations by tax authorities.

The Bank has identified certain unrecognized tax benefits. A reconciliation of the beginning and ending amount of unrecognized tax benefits for the years ended December 31, 2012 and 2011is as follows:

	2012	2011
Unrecognized tax benefits:		
Beginning balance	$ -	$ -
Additions based on current year tax positions, net	94,000	-
Additions for tax positions of prior years	200,000	-
Reductions for tax positions of prior years	-	-
Settlements	-	-
Ending balance	$ 294,000	$ -

All of the unrecognized tax benefits, if recognized, would favorably affect the effective income tax rate in future periods. The Bank does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months.

7. SHORT-TERM BORROWING ARRANGEMENTS

The Bank has unsecured Federal funds lines of credit with three of its correspondent banks under which it can borrow up to $20,000,000. The Bank also has borrowing lines of $47,028,000 at the Federal Home Loan Bank and $45,403,000 at the Federal Reserve Discount Window which are secured and available for use. These borrowing lines are secured by loans, FHLB stock held by the Bank and available-for-sale investment securities. There were no borrowings outstanding under these arrangements at December 31, 2012 or 2011.

8. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Bank leases its Monterey, Salinas and King City branch offices, its administration facilities and its Monterey expansion under non-cancelable operating leases. The Monterey branch lease will expire in December of 2021, with two options to renew each for five years. The remaining leases expire October 2014, September 2017, and June 2016, respectively, and have various renewal options ranging from one to five year periods.

Future minimum lease payments are as follows:

Years ending December 31,	
2013	$ 418,000
2014	404,000
2015	302,000
2016	300,000
2017	299,000
Thereafter	864,000
Total	$ 2,587,000

Rental expense included in occupancy and equipment expense totaled $ 426,000, $280,000 and $277,000 for the years ended December 31, 2012, 2011 and 2010.

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 in order to meet the financing needs of its customers. At December 31, 2012, these financial instruments consisted of commitments to extend credit totaling $51,555,000 and standby letters of credit of $238,000. At December 31, 2011, these financial instruments consisted of commitments to extend credit totaling $62,493,000 and standby letters of credit of $1,068,000.

The Bank's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit is represented by the contractual amount of those instruments. The Bank uses the same credit

policies in making commitments as it does for loans included on the balance sheet. 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. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but may include accounts receivable, inventory, and deeds of trust on residential real estate and income-producing commercial properties.

Commercial loan commitments represent approximately 86% of total commitments and are generally unsecured or secured by collateral other than real estate and have variable interest rates. Real estate loan commitments represent approximately 2% of total commitments and are generally secured by property with a loan-to-value ratio not to exceed 75%. The majority of real estate commitments also have variable interest rates. Home equity and consumer lines of credit represent the remaining 11% and 1%, respectively, of total commitments and are generally secured by residential real estate and have both variable and fixed interest rates.

Standby letters of credit are conditional commitments issued by the Bank 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 these standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at December 31, 2012 and December 31, 2011. The Bank recognizes these fees as revenues over the term of the commitment or when the commitment is used.

Concentrations of Credit Risk

The Bank grants real estate mortgage, real estate construction and commercial loans to customers in Monterey and surrounding counties. Although the Bank intends to have a diversified loan portfolio, a substantial portion of its portfolio is secured by commercial and residential real estate at December 31, 2012.

In management's judgment, a concentration of loans exists in real estate related loans with approximately 63% of the Bank's loans being real estate related. A continued substantial decline in the performance of the economy in general or a continued decline in real estate values in the Bank's primary market area, in particular, could have an adverse impact on the collectability of these loans. Personal and business income represent the primary source of repayment for a majority of these loans.

Contingencies

The Bank may be subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect the financial position or results of operations of the Bank.

Correspondent Banking Agreements

The Bank maintains funds on deposit with other federally insured financial institutions under correspondent banking agreements. Under Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, those funds on deposit were covered by unlimited deposit insurance until December 31, 2012.

9. STOCK OPTION AND RESTRICTED STOCK AWARDS

The 2007 Equity Incentive Plan permits the grant of stock options and restricted stock awards to Directors, organizers and employees of the Bank. Options granted to Directors and organizers are considered Non-Qualified Stock Option Awards while options granted to employees are generally considered to be Incentive Stock Option Awards. All of the options granted under the Plan have 10-year contractual terms and have been issued with exercise prices equal to the fair market value of the underlying shares at the date of grant. The options granted to the organizers vested immediately, whereas the options granted to Directors and employees vest over a 3-year period from the date the options were granted.

Option activity under the Plan for the three-year period ended December 31, 2012 is presented below:

Options	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2010	465,148	$ 9.69		
Granted	21,930	8.44		
Exercised	-	-		
Forfeited	(31,450)	9.61		
Outstanding at December 31, 2010	455,628	9.64		
Granted	35,190	11.25		
Exercised	-	-		
Forfeited	(2,550)	7.35		
Outstanding at December 31, 2011	488,268	9.76		
Granted	15,150	11.71		
Exercised	(7,836)	9.73		
Forfeited	(2,543)	9.51		
Outstanding at December 31, 2012	493,039	$ 9.83	5.5	$ 496,000
Exercisable at December 31, 2012	450,517	$ 9.70	4.6	$ 483,000
Vested or expected to vest at December 31, 2012	490,841	$ 9.82	5.0	$ 496,000

As of December 31, 2012, the unrecognized compensation cost related to non-vested stock option awards totaled $135,000. That cost is expected to be amortized on a straight-line basis over a weighted average period of 1.20 years and will be adjusted for subsequent changes in estimated forfeitures.

The following stock option information is for the years ended December 31, 2012, 2011 and 2010:

	2012	2011	2010
Weighted average grant date fair value per share of options granted	$4.98	$4.22	$3.05
Significant fair value assumptions:			
Expected term in years	6 years	6 years	6 years
Average expected annual volatility	38.6%	37.7%	34.2%
Expected annual dividend yield	n/a	n/a	n/a
Average risk-free interest rate	0.83%	0.99%	2.39%
Total fair value of options granted	$75,000	$149,000	$67,000

There were 7,836 options exercised during the year ended December 31, 2012 with an aggregate intrinsic value totaling $8,000. No stock options were exercised during the years ended December 31, 2011 and 2010. A potential tax benefit of $335,000 for unexercised options has been recognized as a deferred tax asset as of December 31, 2012 of which $41,000, 21,000 and $38,000 was recognized as deferred tax benefits for the years ended December 31, 2012, 2011 and 2010, respectively, and $5,000 of a previously deferred benefit was realized in 2012. Share-based compensation cost for stock options recognized in operating results for the years ended December 31, 2012, 2011 and 2010 was $100,000, $50,000 and $193,000, respectively.

The activity related to nonvested restricted stock is presented below:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2011	-	$ -
Granted	22,400	8.82
Nonvested at December 31, 2011	22,400	8.82
Granted	59,500	11.19
Vested	(22,400)	8.82
Nonvested at December 31, 2012	59,500	$ 11.19

The fair value of restricted stock awards that vested during the year ended December 31, 2012 totaled $270,000. Unrecognized compensation cost related to nonvested restricted stock awards at December 31, 2012 was $636,000 and is expected to be recognized on a straight-line basis over a weighted average period of 4.8 years. Share-based compensation cost for restricted stock recognized in operating results for the years ended December 31, 2012 and 2011 were $129,000 and $90,000, respectively. Related tax benefits recognized for the years ended December 31, 2012 and 2011 were $53,000 and $33,000, respectively.

10. SHAREHOLDERS' EQUITY

Dividends

Upon declaration by the Board of Directors, all shareholders of record will be entitled to receive dividends. The California Financial Code restricts the total cash dividend payment of any state banking association in any calendar year to the lesser of (1) the bank's retained earnings or (2) the bank's net income for its last three fiscal years, less distributions made to shareholders during the same three-year period. At December 31, 2012, $82,000 was free of such restrictions. However, until expiration of the seven year de novo start-up period, the approval or non-objection of the FDIC may also be required for the Bank to pay cash dividends.

Earnings Per Share

The treasury stock method is applied to determine the dilutive effect of stock options and restricted stock in computing diluted earnings per share resulting in dilutive shares as follows for the years ended December 31, 2012, 2011 and 2010:

Weighted average number of shares outstanding:

Year ended December 31,	2012	2011	2010
Basic	3,224,782	3,220,853	3,220,853
Dilutive shares arising from equity compensation	95,143	4,068	19
Diluted	3,319,925	3,224,921	3,220,872
Anti-Dilutive shares arising from equity compensation	61,759	233,957	459,285

Anti-dilutive shares are shares of common stock issuable as restricted stock or under stock options for which the assumed proceeds per share from the exercise price, excess tax benefits and future compensation were greater than the average market prices and were not included in the computation of diluted earnings per share due to their anti-dilutive effect.

Regulatory Capital

The Bank is subject to certain regulatory capital requirements administered by the Federal Deposit Insurance Corporation (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 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 (Tier 1 capital to average assets) as set forth in the table below. The most recent notification from the FDIC categorized the Bank as well capitalized under these guidelines. There are no conditions or events since that notification that management believes have changed the Bank's category. Management believes that the Bank met all its capital adequacy requirements as of December 31, 2012 and 2011.

	Actual:		Minimum Capital Requirements :		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions:	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2012:						
Total Capital (to Risk Weighted Assets)	$ 36,646,000	15.12%	$ 19,384,000	8.00%	$ 24,231,000	10.00%
Tier 1 Capital (to Risk Weighted Assets)	33,600,000	13.87%	9,692,000	4.00%	14,538,000	6.00%
Tier 1 Capital (to Average Assets)	33,600,000	10.67%	12,591,000	4.00%	15,739,000	5.00%
As of December 31, 2011:						
Total Capital (to Risk Weighted Assets)	$ 33,985,000	17.10%	$ 15,897,000	8.00%	$ 19,871,000	10.00%
Tier 1 Capital (to Risk Weighted Assets)	31,490,000	15.85%	7,948,000	4.00%	11,923,000	6.00%
Tier 1 Capital (to Average Assets)	31,490,000	12.61%	9,992,000	4.00%	12,490,000	5.00%

11. 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 the years ended December 31, 2012 and 2011:

Beginning Balance	Additions	Repayments	Ending Balance
2012			
$ 7,757,000	$ 13,966,000	$ 13,132,000	$ 8,591,000
2011			
$ 7,796,000	$ 15,415,000	$ 15,454,000	$ 7,757,000
Undisbursed commitments to related parties, December 31, 2012			$ 1,599,000

12. 401(k) RETIREMENT PLAN

The Bank adopted a 401(k) Plan to enable employees (including the Bank's executive officers) to save for retirement through a tax-advantaged plan and to provide employees the opportunity to directly manage their retirement plan assets through a variety of investment options. The 401(k) Plan allows eligible employees (including the executive officers) to elect to contribute from 0% to 100% of their eligible compensation to the 401(k) Plan, up to the limit established by the Internal Revenue Service. Eligible compensation generally means all wages, salaries and fees for services from the Bank. It is the Bank's policy to match 50% of the employee's 401(k) contribution up to 6% of their salary or the maximum allowed contribution, with vesting over three years.

Expenses for 2012 and 2011 were $ 72,000 and $63,000, respectively and there was no matching offered in 2010.

13. OTHER EXPENSES

Other expenses for the years ended December 31, 2012, 2011 and 2010 consisted of the following:

	2012	2011	2010
Professional fees	$ 426,000	$ 300,000	$ 311,000
Advertising and promotion	426,000	293,000	287,000
Outsourced data services	401,000	371,000	355,000
Regulatory dues and assessments	242,000	327,000	351,000
Customer Expenses	171,000	162,000	130,000
Directors' compensation expense	123,000	92,000	75,000
Licensing and software expenses	122,000	117,000	106,000
Stationery and supplies	110,000	103,000	88,000
Education and seminars	88,000	99,000	83,000
Telephone and postage	88,000	73,000	60,000
Operational Expenses	56,000	83,000	47,000
Loan Expenses	50,000	72,000	26,000
Provision for unfunded loan commitments	-	(60,000)	39,000
Other operating expenses	205,000	157,000	113,000
	$ 2,508,000	$ 2,189,000	$ 2,071,000

14. FAIR VALUE MEASUREMENTS

Fair Value Hierarchy

The valuation techniques utilized by the Bank to determine fair value are based on the following hierarchy:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the Bank has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect the Bank's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Bank's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

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

	Carrying Value	Fair Value Measurements at December 31, 2012			
		Level 1	Level 2	Level 3	Total
Financial assets:					
Cash and due from banks	$ 8,551,000	$8,551,000			$ 8,551,000
Federal funds sold	21,042,000	21,042,000			21,042,000
Interest-bearing deposits in other financial institutions	9,321,000	9,437,000			9,437,000
Available-for-sale investment securities	41,762,000	-	$41,762,000		41,762,000
Loans, net	238,939,000	-	-	$240,472,000	240,472,000
Federal Home Loan Bank common stock	1,027,000	-	-	-	N/A
Accrued interest receivable	812,000	-	76,000	736,000	812,000
Financial liabilities:					
Deposits	$294,654,000	$254,951,000	$35,893,000	$ -	$290,844,000
Accrued interest payable	68,000	5,000	63,000	-	68,000

December 31, 2011	Carrying Amount	Estimated Fair Value
Financial assets:		
Cash and due from banks	$ 8,910,000	$ 8,910,000
Federal funds sold	60,062,000	60,062,000
Interest-bearing deposits in other financial institutions	3,835,000	3,924,000
Available-for-sale investment securities	13,685,000	13,685,000
Loans, net	197,262,000	198,720,000
Federal Home Loan Bank common stock	918,000	918,000
Accrued interest receivable	687,000	687,000
Financial liabilities:		
Deposits	$ 255,583,000	$ 250,619,000
Accrued interest payable	107,000	107,000

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 due from banks, due from the Federal Reserve Bank and accrued interest receivable and payable, the carrying amount is estimated to be fair value resulting in a Level 1 classification. Fair values for interest-bearing deposits in other financial institutions and fixed-rate certificates of deposit are estimated using discounted cash flow analyses using interest rates offered by or to the Bank at each reporting date for

deposits and certificates with similar remaining maturities resulting in a Level 2 classification. For investment securities, fair values are based on quoted market prices for these securities, quoted market prices for similar securities and indications of value provided by brokers and are classified as Level 2. Variable-rate loans that reprice frequently and with no significant change in credit risk are classified as Level 3 and the fair values for fixed-rate loans 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 resulting in a Level 3 classification. The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification. The fair values of commitments are estimated using the fees currently charged to enter into similar agreements and are not significant and, therefore, not included in the above table.

The following tables present information about the Bank's assets measured at fair value on a recurring basis as December 31, 2012 or 2011. The Bank did not have any liabilities measured at fair value on a recurring basis at December 31, 2012 or 2011.

	Fair Value Measurements		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2012			
Government and government- sponsored agency guaranteed residential mortgage-backed securities	$ -	$ 33,680,000	$ -
Government agency guaranteed commercial mortgage-backed securities	-	8,082,000	-
Total available-for-sale investment securities	$ -	$ 41,762,000	$ -
December 31, 2011			
Government and government- sponsored agency guaranteed residential mortgage-backed securities	$ -	$ 11,798,000	$ -
Government agency guaranteed commercial mortgage-backed securities	-	1,887,000	-
Total available-for-sale investment securities	$ -	$ 13,685,000	$ -

The fair values of securities available-for-sale are valued based on quoted market prices for similar securities, if available. If quoted market prices are not available, fair value is determined using quoted prices for similar securities. There were no changes in valuation techniques used or sales, purchases, issuances or settlements for the year ended December 31, 2012 or 2011.

There were no assets or liabilities measured at fair value on a non-recurring basis at December 31, 2012 or 2011. Impaired loans were not carried at fair value at December 31, 2012 or 2011 because the fair value of the underlying collateral exceeded the Bank's recorded investment, or because they were measured for impairment using the present value of future cash flow with a discount rate equal to the note rate which was not a fair value input.

The Bank did not change the methodology used to determine fair value for any financial instruments during 2012. There were no transfers between Level 1, Level 2, or Level 3 fair value measurements during the twelve months ended December 31, 2012 or 2011.