

NORTHRIM BANCORP INC

Form 10-Q

November 08, 2010

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549  
FORM 10-Q**

(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2010**

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 000-33501  
NORTHRIM BANCORP, INC.**

(Exact name of registrant as specified in its charter)

**Alaska**

(State or other jurisdiction of incorporation or organization)

**92-0175752**

(I.R.S. Employer Identification Number)

**3111 C Street**

**Anchorage, Alaska**

(Address of principal executive offices)

**99503**

(Zip Code)

**(907) 562-0062**

**(Registrant's telephone number, including area code)**

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(do not check if a smaller reporting company)

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

The number of shares of the issuer's Common Stock outstanding at November 5, 2010 was 6,409,779.

**TABLE OF CONTENTS**

**PART I FINANCIAL INFORMATION**

Item 1. Financial Statements

Consolidated Balance Sheets (unaudited):

September 30, 2010, December 31, 2009 and September 30, 2009 4

Consolidated Statements of Income (unaudited):

Three and nine months ended September 30, 2010 and 2009 5

Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income (unaudited):

Nine months ended September 30, 2010 and 2009 6

Consolidated Statements of Cash Flows (unaudited):

Nine months ended September 30, 2010 and 2009 7

Notes to the Consolidated Financial Statements 8

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 18

Item 3. Quantitative and Qualitative Disclosures About Market Risk 35

Item 4. Controls and Procedures 35

**PART II OTHER INFORMATION**

Item 1. Legal Proceedings 36

Item 1A. Risk Factors 36

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds 36

Item 3. Defaults Upon Senior Securities 36

Item 4. Reserved 36

Item 5. Other Information 36

Item 6. Exhibits 36

**SIGNATURES** 37

EX-31.1

EX-31.2

EX-32.1

EX-32.2

**Table of Contents**

**PART I. FINANCIAL INFORMATION**

These consolidated financial statements should be read in conjunction with the financial statements, accompanying notes and other relevant information included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

**ITEM 1. FINANCIAL STATEMENTS**

- 3 -

---

**Table of Contents****CONSOLIDATED FINANCIAL STATEMENTS****NORTHRIM BANCORP, INC.**

## Consolidated Balance Sheets

September 30, 2010, December 31, 2009 and September 30, 2009

|  | September<br>30,<br>2010<br><i>(Unaudited)</i> | December<br>31,<br>2009 | September<br>30,<br>2009<br><i>(Unaudited)</i> |
|--|--|-------------------------|--|
|  | <i>(In Thousands, Except Share Data)</i>       |                         |  |
| <b>ASSETS</b>                                  |  |                         |  |
| Cash and due from banks                        | \$ 22,367                                      | \$ 19,395               | \$ 24,979                                      |
| Overnight investments                          | 60,939   | 47,326                  | 51,120   |
| Investment securities available for sale       | 206,342  | 178,159                 | 142,373  |
| Investment securities held to maturity         | 6,692  | 7,285                   | 9,896  |
| Investment in Federal Home Loan Bank stock     | 2,003  | 2,003                   | 2,003  |
| Total investment securities                    | 215,037  | 187,447                 | 154,272  |
| Loans held for sale                            | 20,082   |                         |  |
| Loans  | 635,475  | 655,039                 | 674,191  |
| Allowance for loan losses                      | (14,711)                                       | (13,108)                | (13,452)                                       |
| Net loans                                      | 640,846  | 641,931                 | 660,739  |
| Purchased receivables, net                     | 8,654  | 7,261                   | 8,202  |
| Accrued interest receivable                    | 3,234  | 3,986                   | 3,472  |
| Premises and equipment, net                    | 28,769   | 28,523                  | 28,889   |
| Goodwill and intangible assets                 | 8,767  | 8,996                   | 9,072  |
| Other real estate owned                        | 11,019   | 17,355                  | 10,118   |
| Other assets                                   | 38,302   | 40,809                  | 34,829   |
| Total assets                                   | \$ 1,037,934                                   | \$ 1,003,029            | \$ 985,692                                     |
| <b>LIABILITIES</b>                             |  |                         |  |
| Deposits:                                      |  |                         |  |
| Demand   | \$ 281,972                                     | \$ 276,532              | \$ 267,291                                     |
| Interest-bearing demand                        | 126,056  | 134,899                 | 115,337  |
| Savings  | 77,971   | 66,647                  | 62,761   |
| Alaska CDs                                     | 111,526  | 104,840                 | 108,057  |
| Money market                                   | 132,349  | 125,339                 | 123,239  |
| Certificates of deposit less than \$100,000    | 56,984   | 64,652                  | 62,603   |
| Certificates of deposit greater than \$100,000 | 91,870   | 80,199                  | 97,820   |
| Total deposits                                 | 878,728  | 853,108                 | 837,108  |
| Securities sold under repurchase agreements    | 9,996  | 6,733                   | 5,090  |
| Other borrowings                               | 5,506  | 5,587                   | 5,649  |
| Junior subordinated debentures                 | 18,558   | 18,558                  | 18,558   |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|                   |         |         |         |
|-------------------|---------|---------|---------|
| Other liabilities | 8,290   | 8,023   | 9,356   |
| Total liabilities | 921,078 | 892,009 | 875,761 |

SHAREHOLDERS EQUITY

Preferred Stock, \$1 par value, 2,500,000 shares authorized,  
none issued or outstanding

Common stock, \$1 par value, 10,000,000 shares authorized,  
6,409,799 6,371,455, and 6,359,650 shares issued and  
outstanding at September 30, 2010, December 31, 2009, and  
September 30, 2009, respectively

|  |        |        |        |
|--|--------|--------|--------|
| Common stock                           | 6,410  | 6,371  | 6,360  |
| Additional paid-in capital             | 52,660 | 52,139 | 51,994 |
| Retained earnings                      | 56,268 | 51,121 | 49,819 |
| Accumulated other comprehensive income | 1,476  | 1,341  | 1,727  |

|  |         |         |         |
|--|---------|---------|---------|
| Total Northrim BanCorp shareholders equity | 116,814 | 110,972 | 109,900 |
|--|---------|---------|---------|

|                         |    |    |    |
|-------------------------|----|----|----|
| Noncontrolling interest | 42 | 48 | 31 |
|-------------------------|----|----|----|

|                           |         |         |         |
|---------------------------|---------|---------|---------|
| Total shareholders equity | 116,856 | 111,020 | 109,931 |
|---------------------------|---------|---------|---------|

|   |              |              |            |
|---|--------------|--------------|------------|
| Total liabilities and shareholders equity | \$ 1,037,934 | \$ 1,003,029 | \$ 985,692 |
|---|--------------|--------------|------------|

See notes to the consolidated financial statements

- 4 -

**Table of Contents**

NORTHRIM BANCORP, INC.  
 Consolidated Statements of Income  
 For the Three and Nine Months Ended September 30, 2010 and 2009

|   | Three Months Ended<br>September 30,          |               | Nine Months Ended<br>September 30, |               |
|---|--|---------------|------------------------------------|---------------|
|   | 2010   | 2009          | 2010                               | 2009          |
|   | <i>(Unaudited)</i>                           |               | <i>(Unaudited)</i>                 |               |
|   | <i>(In Thousands, Except Per Share Data)</i> |               |                                    |               |
| Interest Income   |  |               |                                    |               |
| Interest and fees on loans  | \$ 11,249                                    | \$ 12,218     | \$ 33,883                          | \$ 36,672     |
| Interest on investment securities:  |  |               |                                    |               |
| Securities available for sale   | 895  | 1,057         | 3,394                              | 3,057         |
| Securities held to maturity   | 68   | 98            | 213                                | 295           |
| Interest on overnight investments   | 54   | 31            | 119                                | 64            |
| Interest on domestic certificate of deposit                                 |  |               |                                    | 58            |
| <b>Total Interest Income</b>  | <b>12,266</b>                                | <b>13,404</b> | <b>37,609</b>                      | <b>40,146</b> |
| Interest Expense  |  |               |                                    |               |
| Interest expense on deposits, borrowings and junior subordinated debentures | 1,370  | 1,662         | 4,306                              | 5,562         |
| <b>Net Interest Income</b>  | <b>10,896</b>                                | <b>11,742</b> | <b>33,303</b>                      | <b>34,584</b> |
| Provision for loan losses   | 417  | 1,374         | 3,167                              | 4,866         |
| <b>Net Interest Income After Provision for Loan Losses</b>                  | <b>10,479</b>                                | <b>10,368</b> | <b>30,136</b>                      | <b>29,718</b> |
| Other Operating Income  |  |               |                                    |               |
| OREO gain on sale and rental income   | 1,277  | 206           | 1,930                              | 446           |
| Service charges on deposit accounts   | 659  | 791           | 2,121                              | 2,269         |
| Equity in earnings from RML   | 570  | 385           | 679                                | 1,997         |
| Purchased receivable income   | 485  | 474           | 1,394                              | 1,706         |
| Employee benefit plan income  | 466  | 469           | 1,417                              | 1,282         |
| Electronic banking income   | 449  | 463           | 1,284                              | 1,124         |
| Gain on sale of securities  | 58   | 24            | 471                                | 220           |
| Equity in earnings (loss) from Elliott Cove                                 | (4)  | (13)          | (1)                                | (106)         |
| Other income  | 517  | 566           | 1,650                              | 1,676         |
| <b>Total Other Operating Income</b>   | <b>4,477</b>                                 | <b>3,365</b>  | <b>10,945</b>                      | <b>10,614</b> |
| Other Operating Expense   |  |               |                                    |               |
| Salaries and other personnel expense  | 5,394  | 5,730         | 16,416                             | 16,889        |
| Occupancy   | 1,016  | 977           | 2,832                              | 2,789         |
| Insurance expense   | 502  | 502           | 1,482                              | 2,266         |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|  |              |               |               |               |
|--|--------------|---------------|---------------|---------------|
| Marketing expense  | 445          | 317           | 1,323         | 951           |
| Professional and outside services                            | 338          | 374           | 903           | 1,061         |
| OREO expense net, including impairment                       | 308          | 309           | 1,023         | 1,170         |
| Equipment expense  | 304          | 286           | 821           | 887           |
| Intangible asset amortization expense                        | 76           | 82            | 229           | 247           |
| Prepayment penalty on long term debt                         |              | 718           |               | 718           |
| Purchased receivable losses (gains)                          | (3)          |               | 404           | (16)          |
| Other operating expense                                      | 1,607        | 1,577         | 4,889         | 4,979         |
| <b>Total Other Operating Expense</b>                         | <b>9,987</b> | <b>10,872</b> | <b>30,322</b> | <b>31,941</b> |
| <br>   |              |               |               |               |
| Income Before Provision for Income Taxes                     | 4,969        | 2,861         | 10,759        | 8,391         |
| Provision for income taxes                                   | 1,629        | 810           | 3,243         | 2,318         |
| <br>   |              |               |               |               |
| Net Income   | 3,340        | 2,051         | 7,516         | 6,073         |
| Less: Net income attributable to the noncontrolling interest | 162          | 102           | 298           | 292           |
| <br>   |              |               |               |               |
| Net Income Attributable to Northrim BanCorp                  | \$ 3,178     | \$ 1,949      | \$ 7,218      | \$ 5,781      |
| <br>   |              |               |               |               |
| Earnings Per Share, Basic                                    | \$ 0.50      | \$ 0.31       | \$ 1.13       | \$ 0.91       |
| Earnings Per Share, Diluted                                  | \$ 0.49      | \$ 0.30       | \$ 1.11       | \$ 0.90       |
| <br>   |              |               |               |               |
| Weighted Average Shares Outstanding, Basic                   | 6,401,069    | 6,348,519     | 6,391,252     | 6,388,757     |
| <br>   |              |               |               |               |
| Weighted Average Shares Outstanding, Diluted                 | 6,479,813    | 6,422,262     | 6,473,915     | 6,406,117     |

See notes to the consolidated financial statements

- 5 -



**Table of Contents**

NORTHRIM BANCORP, INC.  
 Consolidated Statements of Changes in  
 Shareholders' Equity and Comprehensive Income  
 For the Nine Months Ended September 30, 2010 and 2009

|   | Common Stock<br>Number<br>of Shares | Par<br>Value | Additional<br>Paid-in<br>Capital | Retained<br>Earnings<br><i>(Unaudited)</i><br><i>(In Thousands)</i> | Accumulated<br>Other<br>Comprehensive<br>Income | Noncontrolling<br>Interest | Total     |
|---|-------------------------------------|--------------|----------------------------------|---|---|----------------------------|-----------|
| Nine months ending<br>September 30, 2009:<br>Balance as of<br>January 1, 2009   | 6,331                               | \$6,331      | \$51,458                         | \$45,958  | \$ 901  | \$ 36                      | \$104,684 |
| Cash dividend<br>declared   |                                     |              |                                  | (1,920)   |   |                            | (1,920)   |
| Stock option expense  |                                     |              | 445                              |   |   |                            | 445       |
| Exercise of stock<br>options  | 29                                  | 29           | 33                               |   |   |                            | 62        |
| Excess tax benefits<br>from share-based<br>payment arrangements   |                                     |              | 58                               |   |   |                            | 58        |
| Distributions to<br>noncontrolling interest   |                                     |              |                                  |   |   | (297)                      | (297)     |
| Comprehensive<br>income:<br>Change in unrealized<br>holding gain (loss) on<br>available for sale<br>investment securities,<br>net of related income<br>tax effect |                                     |              |                                  |   | 826   |                            | 826       |
| Net income<br>attributable to the<br>noncontrolling interest  |                                     |              |                                  |   |   | 292                        | 292       |
| Net income<br>attributable to<br>Northrim BanCorp   |                                     |              |                                  | 5,781   |   |                            | 5,781     |
| Total Comprehensive<br>Income   |                                     |              |                                  |   |   |                            | 6,899     |
| Balance as of<br>September 30, 2009   | 6,360                               | \$6,360      | \$51,994                         | \$49,819  | \$1,727   | \$ 31                      | \$109,931 |

|   |       |         |          |          |         |       |           |
|---|-------|---------|----------|----------|---------|-------|-----------|
| Nine months ending<br>September 30, 2010:<br>Balance as of<br>January 1, 2010   | 6,371 | \$6,371 | \$52,139 | \$51,121 | \$1,341 | \$ 48 | \$111,020 |
| Cash dividend<br>declared   |       |         |          | (2,071)  |         |       | (2,071)   |
| Stock option expense  |       |         | 387      |          |         |       | 387       |
| Exercise of stock<br>options  | 39    | 39      | (43)     |          |         |       | (4)       |
| Excess tax benefits<br>from share-based<br>payment arrangements   |       |         | 177      |          |         |       | 177       |
| Distributions to<br>noncontrolling interest   |       |         |          |          |         | (304) | (304)     |
| Comprehensive<br>income:<br>Change in unrealized<br>holding gain (loss) on<br>available for sale<br>investment securities,<br>net of related income<br>tax effect |       |         |          |          |         | 135   | 135       |
| Net income<br>attributable to the<br>noncontrolling interest  |       |         |          |          |         | 298   | 298       |
| Net income<br>attributable to<br>Northrim BanCorp   |       |         |          | 7,218    |         |       | 7,218     |
| Total Comprehensive<br>Income   |       |         |          |          |         |       | 7,651     |
| Balance as of<br>September 30, 2010   | 6,410 | \$6,410 | \$52,660 | \$56,268 | \$1,476 | \$ 42 | \$116,856 |

See notes to the consolidated financial statements

- 6 -

**Table of Contents**

NORTHRIM BANCORP, INC.  
Consolidated Statement of Cash Flows  
For the Nine Months Ended September 30, 2010 and 2009

|   | Nine Months Ended<br>September 30,<br>2010                      2009<br><i>(Unaudited)</i><br><i>(In Thousands)</i> |               |
|---|---|---------------|
| Operating Activities:   |   |               |
| Net income  | \$ 7,516  | \$ 6,073      |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |   |               |
| Security (gains), net   | (471)   | (220)         |
| Depreciation and amortization of premises and equipment                           | 1,165   | 1,234         |
| Amortization of software  | 130   | 121           |
| Intangible asset amortization   | 229   | 247           |
| Amortization of investment security premium, net of discount accretion            | 306   | 214           |
| Deferred tax liability (benefit)  | 2,054   | (1,221)       |
| Stock-based compensation  | 387   | 445           |
| Excess tax benefits from share-based payment arrangements                         | (177)   | (58)          |
| Deferral of loan fees and costs, net  | 153   | (6)           |
| Provision for loan losses   | 3,167   | 4,866         |
| Purchased receivable loss (recovery)  | 404   | (16)          |
| Purchases of loans held for sale  | (43,593)  | (75,096)      |
| Proceeds from the sale of loans held for sale                                     | 23,530  | 75,160        |
| Gain on sale of loans held for sale   | (19)  | (64)          |
| Gain on sale of other real estate owned   | (1,443)   | (424)         |
| Impairment on other real estate owned   | 250   | 516           |
| Earnings in excess of proceeds from RML   | (848)   | 522           |
| Equity in loss from Elliott Cove  | 1   | 106           |
| Decrease in accrued interest receivable   | 752   | 1,340         |
| (Increase) decrease in other assets   | 1,260   | (2,091)       |
| Decrease (increase) of deferred gain on sales of other real estate owned          | 328   | (90)          |
| Decrease (increase) of other liabilities  | 418   | (372)         |
| <b>Net Cash (Used) Provided by Operating Activities</b>                           | <b>(4,501)</b>  | <b>11,186</b> |
| Investing Activities:   |   |               |
| Investment in securities:   |   |               |
| Purchases of investment securities-available-for-sale                             | (169,199)   | (87,722)      |
| Purchases of investment securities-held-to-maturity                               | (517)   | (1,217)       |
| Proceeds from sales/maturities of securities-available-for-sale                   | 141,416   | 87,769        |
| Proceeds from calls/maturities of securities-held-to-maturity                     | 1,105   | 750           |
| Proceeds from maturities of domestic certificates of deposit                      |   | 14,500        |
| Purchases of domestic certificates of deposit                                     |   | (5,000)       |
| Investment in (repayment from) purchased receivables                              | (1,797)   | 10,889        |
| Loan paydowns, net of new advances  | 15,857  | 29,269        |
| Proceeds from sale of other real estate owned                                     | 9,225   | 7,466         |
| Investment in other real estate owned   | (34)  | (1,470)       |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|   |           |           |
|---|-----------|-----------|
| Loan to Elliott Cove, net of repayments                   | 60        | (106)     |
| Purchases of premises and equipment                       | (1,411)   | (390)     |
| Purchases of software                                     | (145)     | (60)      |
| Net Cash (Used) Provided by Investing Activities          | (5,540)   | 54,678    |
| Financing Activities:                                     |           |           |
| (Decrease) increase in deposits                           | 25,620    | (6,144)   |
| Increase in securities sold under repurchase agreements   | 3,263     | 3,460     |
| Decrease in borrowings                                    | (81)      | (22,827)  |
| Distributions to noncontrolling interest                  | (304)     | (297)     |
| Proceeds from issuance of common stock                    | (4)       | 62        |
| Excess tax benefits from share-based payment arrangements | 177       | 58        |
| Cash dividends paid                                       | (2,045)   | (1,907)   |
| Net Cash (Used) Provided by Financing Activities          | 26,626    | (27,595)  |
| Net Increase in Cash and Cash Equivalents                 | 16,585    | 38,269    |
| Cash and Cash Equivalents at Beginning of Period          | 66,721    | 37,830    |
| Cash and Cash Equivalents at End of Period                | \$ 83,306 | \$ 76,099 |
| Supplemental Information:                                 |           |           |
| Income taxes paid   | \$ 1,263  | \$ 4,720  |
| Interest paid   | \$ 4,310  | \$ 6,017  |
| Transfer of loans to other real estate owned              | \$ 1,990  | \$ 3,518  |
| Loans made to facilitate sales of other real estate owned | \$ 5,967  | \$ 2,404  |
| Cash dividends declared but not paid                      | \$ 26     | \$ 18     |

See notes to the consolidated financial statements

- 7 -

**Table of Contents**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

September 30, 2010 and 2009

**1. Basis of Presentation**

The accompanying unaudited financial statements have been prepared by Northrim BanCorp, Inc. (the Company) in accordance with accounting principles generally accepted in the United States of America (GAAP) and with instructions to Form 10-Q under the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain reclassifications have been made to prior year amounts to maintain consistency with the current year with no impact on net income or total shareholders' equity. The Company determined that it operates as a single operating segment. Operating results for the interim period ended September 30, 2010, are not necessarily indicative of the results anticipated for the year ending December 31, 2010. These financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

**2. Significant Accounting Policies and Recent Accounting Pronouncements**

The Company's significant accounting policies are discussed in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

In July 2010, the FASB issued ASU 2010-20, an update to ASC 310-30, *Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality*. This update is intended to provide financial statement users with greater transparency about an entity's allowance for credit losses and the credit quality of its financing receivables. The update requires expanded disclosures that will facilitate financial statement users' evaluation of the nature of credit risk inherent in the entity's portfolio of financing receivables, how that risk is analyzed and assessed in arriving at the allowance for credit losses and the changes and reasons for those changes in the allowance for credit losses. ASU 2010-20 is effective for the Company's financial statements for annual and interim periods ending after December 15, 2010 and must be adopted prospectively. The Company does not expect that adoption will impact its financial position, results of operations, and earnings per share.

**3. Investment Securities**

The carrying values and approximate fair values of investment securities at September 30, 2010 and September 30, 2009, respectively, are presented below. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. There were eight securities with unrealized losses as of September 30, 2010 and no securities with unrealized losses as of September 30, 2009, respectively, that had been in a loss position for less than twelve months. There were no securities with unrealized losses as of September 30, 2010 and 2009 that had been in a loss position for more than twelve months. Because the Company does not intend to sell, nor is it required to sell these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

**Table of Contents**

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains<br><i>(In Thousands)</i> | Gross<br>Unrealized<br>Losses | Fair Value |
|---|-------------------|---|-------------------------------|------------|
| 2010:   |                   |   |                               |            |
| Securities available for sale                 |                   |   |                               |            |
| U.S. Treasury & government sponsored entities | \$ 151,614        | \$ 805  | \$ 7                          | \$ 152,411 |
| Municipal Securities                          | 6,169             | 300   |                               | 6,469      |
| U.S. Agency Mortgage-backed Securities        | 76                | 3   |                               | 79         |
| Corporate bonds                               | 45,980            | 1,440   | 37                            | 47,383     |
| Total securities available for sale           | \$ 203,839        | \$ 2,548  | \$ 44                         | \$ 206,342 |
| Securities held to maturity                   |                   |   |                               |            |
| Municipal securities                          | \$ 6,692          | \$ 304  | \$                            | \$ 6,996   |
| Total securities held to maturity             | \$ 6,692          | \$ 304  | \$                            | \$ 6,996   |
| Federal Home Loan Bank stock                  | \$ 2,003          | \$  | \$                            | \$ 2,003   |
| 2009:   |                   |   |                               |            |
| Securities available for sale                 |                   |   |                               |            |
| U.S. Treasury & government sponsored entities | \$ 107,537        | \$ 1,174  | \$                            | \$ 108,711 |
| Municipal Securities                          | 5,041             | 193   |                               | 5,234      |
| U.S. Agency Mortgage-backed Securities        | 91                |   |                               | 91         |
| Corporate bonds                               | 26,770            | 1,567   |                               | 28,337     |
| Total securities available for sale           | \$ 139,439        | \$ 2,934  | \$                            | \$ 142,373 |
| Securities Held to Maturity                   |                   |   |                               |            |
| Municipal Securities                          | \$ 9,896          | \$ 311  | \$                            | \$ 10,207  |
| Total securities held to maturity             | \$ 9,896          | \$ 311  | \$                            | \$ 10,207  |
| Federal Home Loan Bank Stock                  | \$ 2,003          | \$  | \$                            | \$ 2,003   |

The amortized cost and fair values of debt securities at September 30, 2010, are distributed by contractual maturity as shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The proceeds and resulting gains and losses, computed using specific identification, from sales of investment securities for the nine months ending September 30, 2010 and September 30, 2009, respectively, are as follows:

| September 30, | Proceeds | Gross<br>Gains<br><i>(In Thousands)</i> | Gross<br>Losses |
|---------------|----------|---|-----------------|
|---------------|----------|---|-----------------|

2010:

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|                               |           |        |    |
|-------------------------------|-----------|--------|----|
| Available for sale securities | \$ 20,261 | \$ 471 | \$ |
| Held to maturity securities   | \$        | \$     | \$ |
| 2009:                         |           |        |    |
| Available for sale securities | \$ 7,550  | \$ 220 | \$ |
| Held to maturity securities   | \$        | \$     | \$ |

A summary of interest income for the nine months ending September 30, 2010 and 2009 on available for sale investment securities is as follows:

- 9 -

---

**Table of Contents**

|   |                       |         |
|---|-----------------------|---------|
| September 30,                                 | 2010                  | 2009    |
|   | <i>(In Thousands)</i> |         |
| US Treasury and government sponsored entities | \$2,096               | \$1,860 |
| U.S. Agency Mortgage-backed Securities        | 3                     | 5       |
| Other   | 1,080                 | 1,011   |
| Total taxable interest income                 | \$3,179               | \$2,876 |
| Municipal Securities                          | 215                   | 181     |
| Total tax-exempt interest income              | 215                   | 181     |
| Total   | \$3,394               | \$3,057 |

For the periods ending September 30, 2010, December 31, 2009 and September 30, 2009, we held Federal Home Loan Bank of Seattle ( FHLB ) stock with a book value approximately equal to its market value in the amounts of \$2.0 million for each period. The Company evaluated its investment in FHLB stock for other-than-temporary impairment as of September 30, 2010, consistent with its accounting policy. Based on the Company's evaluation of the underlying investment, including the long-term nature of the investment, the liquidity position of the FHLB of Seattle, the actions being taken by the FHLB of Seattle to address its regulatory capital situation, and the Company's intent and ability to hold the investment for a period of time sufficient to recover the par value, the Company did not recognize an other-than-temporary impairment loss. Even though the Company did not recognize an other-than-temporary impairment loss during the nine-month period ending September 30, 2010, continued deterioration in the FHLB of Seattle's financial position may result in future impairment losses.

The Company has never had any investment in the common or preferred stock of the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation, which are commonly known as Fannie Mae and Freddie Mac, respectively. Additionally, we held no securities of any single issuer (other than government sponsored entities) that exceeded 10% of our shareholders' equity at September 30, 2010, December 31, 2009 or September 30, 2009.

**4. Lending Activities**

At September 30, 2010, 28% of the portfolio was scheduled to mature over the next 12 months, and 28% was scheduled to mature between October 1, 2011, and September 30, 2015. The following table sets forth the Company's loan portfolio composition by loan type for the dates indicated:

|                                      | September 30, 2010    |          | December 31, 2009 |          | September 30, 2009 |          |
|--------------------------------------|-----------------------|----------|-------------------|----------|--------------------|----------|
|                                      | Dollar                | Percent  | Dollar            | Percent  | Dollar             | Percent  |
|                                      | Amount                | of Total | Amount            | of Total | Amount             | of Total |
|                                      | <i>(In Thousands)</i> |          |                   |          |                    |          |
| Commercial                           | \$237,667             | 37%      | \$248,195         | 38%      | \$249,171          | 37%      |
| Construction/development             | 50,979                | 8%       | 62,573            | 10%      | 82,160             | 12%      |
| Commercial real estate               | 305,808               | 48%      | 301,816           | 46%      | 298,828            | 44%      |
| Home equity lines and other consumer | 43,882                | 7%       | 45,168            | 7%       | 46,047             | 7%       |
| Loans in process                     | 90                    | 0%       | 85                | 0%       | 691                | 0%       |
| Unearned loan fees, net              | (2,951)               | 0%       | (2,798)           | 0%       | (2,706)            | 0%       |
| Sub total                            | 635,475               | 100%     | 655,039           | 100%     | 674,191            | 100%     |



|                     |           |           |           |
|---------------------|-----------|-----------|-----------|
| Loans held for sale | 20,082    |           |           |
| Total loans         | \$655,557 | \$655,039 | \$674,191 |

- 10 -

---

**Table of Contents**

*Loans held for sale:* The Company has purchased residential loans from our mortgage affiliate, RML Holding Company ( RML ), from time to time since 1998. The Company then sells these loans in the secondary market. During 2009, the Company renewed its agreement with RML in anticipation of higher than normal refinance activity in the Anchorage market. The Company purchased \$43.6 million and sold \$23.5 million in loans in the nine-month period ending September 30, 2010. The Company purchased and sold \$75.1 million in loans in the nine-month period ending September 30, 2009.

**5. Allowance for Loan Losses, Nonperforming Assets and Loans Measured for Impairment**

The Company recorded a provision for loan losses in the amount of \$417,000 and \$3.2 million for the three and nine-month periods ending September 30, 2010 based upon its analysis of its loan portfolio.

The following table details activity in the Allowance for the periods indicated:

|                                      | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--------------------------------------|-------------------------------------|----------|------------------------------------|----------|
|                                      | 2010                                | 2009     | 2010                               | 2009     |
|                                      | <i>(In Thousands)</i>               |          |                                    |          |
| Balance at beginning of period       | \$14,427                            | \$13,187 | \$13,108                           | \$12,900 |
| Charge-offs:                         |                                     |          |                                    |          |
| Commercial                           | 519                                 | 987      | 2,153                              | 2,135    |
| Construction/development             |                                     | 231      | 79                                 | 1,301    |
| Commercial real estate               | 222                                 | 159      | 342                                | 1,217    |
| Home equity lines and other consumer | 52                                  | 145      | 305                                | 286      |
| Total charge-offs                    | 793                                 | 1,522    | 2,879                              | 4,939    |
| Recoveries:                          |                                     |          |                                    |          |
| Commercial                           | 638                                 | 398      | 1,256                              | 565      |
| Construction/development             |                                     |          | 4                                  |          |
| Commercial real estate               |                                     | 1        | 11                                 | 10       |
| Home equity lines and other consumer | 23                                  | 14       | 45                                 | 50       |
| Total recoveries                     | 660                                 | 413      | 1,315                              | 625      |
| Net, (recoveries) charge-offs        | 133                                 | 1,109    | 1,564                              | 4,314    |
| Provision for loan losses            | 417                                 | 1,374    | 3,167                              | 4,866    |
| Balance at end of period             | \$14,711                            | \$13,452 | \$14,711                           | \$13,452 |

At September 30, 2010, the Allowance was \$14.7 million as compared to \$13.5 million, at September 30, 2009. The increase in the Allowance at September 30, 2010 as compared to September 30, 2009 was the result of a \$3.2 million provision and \$1.6 million in net charge-offs. The Company's ratio of nonperforming loans compared to portfolio loans at September 30, 2010 was 2.19% as compared to 4.28% as of September 30, 2009. The Company's ratio of Allowance compared to portfolio loans at September 30, 2010 was 2.31% as compared to 2.00% as of September 30, 2009. While the Company's ratio of nonperforming loans compared to portfolio loans has decreased as of September 30, 2010, the Company believes that a higher reserve is appropriate to address the impact of the current economic environment on our loan portfolio.

**Table of Contents**

Nonperforming assets consist of nonaccrual loans, accruing loans of 90 days or more past due, restructured loans, and other real estate owned ( OREO ). The following table sets forth information with respect to nonperforming assets:

|   | September<br>30, 2010 | December 31,<br>2009<br><i>(In Thousands)</i> | September 30,<br>2009 |
|---|-----------------------|---|-----------------------|
| Nonaccrual loans                        | \$ 13,688             | \$ 12,738                                     | \$ 22,432             |
| Accruing loans past due 90 days or more | 200                   | 1,000   | 2,625                 |
| Restructured loans                      |                       | 3,754   | 3,800                 |
| <b>Total nonperforming loans</b>        | <b>13,888</b>         | <b>17,492</b>                                 | <b>28,857</b>         |
| Other real estate owned                 | 11,019                | 17,355  | 10,118                |
| Repossessed assets                      | 105                   |   |                       |
| <b>Total nonperforming assets</b>       | <b>\$ 25,012</b>      | <b>\$ 34,847</b>                              | <b>\$ 38,975</b>      |
| Allowance for loan losses               | \$ 14,711             | \$ 13,108                                     | \$ 13,452             |
| <br>                                    |                       |   |                       |
| Nonperforming loans to gross loans      | 2.19%                 | 2.67%   | 4.28%                 |
| Nonperforming assets to total assets    | 2.41%                 | 3.47%   | 3.95%                 |
| Allowance to gross loans                | 2.31%                 | 2.00%   | 2.00%                 |
| Allowance to nonperforming loans        | 105.93%               | 74.94%  | 46.62%                |

**6. Goodwill and Other Intangibles**

The Company performs goodwill impairment testing in accordance with the policy described in Note 1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2009. There was no indication of impairment as of September 30, 2010. The Company continues to monitor the Company's goodwill for potential impairment on an ongoing basis. No assurance can be given that there will not be an impairment charge to earnings during 2010 for goodwill impairment, if, for example, our stock price declines and continues to trade at a significant discount to its book value, although there are many factors that we analyze in determining the impairment of goodwill.

**7. Variable Interest Entities**

The Company has analyzed all of its affiliate relationships in accordance with GAAP and determined that Elliott Cove is a variable interest entity ( VIE ). However, the Company does not have a controlling interest in Elliott Cove. The Company owns a 48% equity interest in Elliott Cove, an investment advisory services company, through its wholly owned subsidiary, Northrim Investment Services Company ( NISC ). The Company determined that Elliott Cove is a VIE based on the fact that the Company provides Elliott Cove with a line of credit for which the majority owner of Elliott Cove provides additional subordinated financial support in the form of a 50% guarantee. This line of credit has a committed amount of \$750,000 and an outstanding balance of \$617,000 as of September 30, 2010. Furthermore, Elliott Cove does not have access to any other financial support through other institutions, nor is it likely that they would be able to obtain additional lines of credit based on their operational losses to date and their resulting lack of equity. As such, it appears that Elliott Cove cannot finance its activities without additional subordinated financial support and is therefore considered a VIE under GAAP. However, the Company has determined that it does not have a controlling interest in Elliott Cove based on the following facts and circumstances:

- a. Neither the Company nor any members of the Company's management have control over the budgeting or operational processes of Elliott Cove.
- b.

While the President, CEO and Chairman of the Company is a member of Elliott Cove's board, he does not exert influence on decisions beyond Northrim Investment Services Company's ownership percentage in Elliott Cove.

- c. The Company has no veto rights with respect to decisions affecting the operations of Elliott Cove

- 12 -

---

**Table of Contents**

The Company has the obligation to absorb losses of Elliott Cove up to its ownership percentage of 47.6%. There are no caps or guarantees on returns, and there are no protections to limit any investor's share of losses. Additionally, the Company provides Elliott Cove with a \$750,000 line of credit. This line includes a 50% personal guarantee by the majority owner of Elliott Cove. Therefore, the Company does have the obligation to absorb losses and the right to receive benefits that could be significant to Elliott Cove and which, as a result of its exposure to 50% of any losses incurred on the line of credit that the Company has extended to Elliott Cove, may be greater than the Company's 47.6% ownership therein.

However, GAAP requires that the Company have both the power to control the activities of Elliott Cove that most significantly impact its economic performance, and the obligation to absorb losses or the right to receive benefits from Elliott Cove that could potentially be significant to Elliott Cove. The Company has determined that the facts and circumstances of its relationship with Elliott Cove including its overall involvement in the operations, decision-making capabilities and proportionate share in earnings and losses does not satisfy the criteria for a controlling interest because it does not have the power to direct the activities of Elliott Cove according to GAAP.

The Company also provides a line of credit to our mortgage affiliate, RML. While the Company also provides a line of credit to RML, which is also guaranteed by the other owners of RML, RML has other available lines of credit with unrelated financial institutions which have been in place for many years. Additionally, RML has a history of profitability and has sufficient capital to support its operations. RML had \$17.9 million in equity, \$87.8 million in assets and net income of \$9.1 million as of and for the year ended December 31, 2009 (see Note 9 in the Company's Form 10-K for the year ended December 31, 2009). As such, the total equity investment in the entity, which is provided by the Company and the other owners, is adequate to finance the activities of RML. Therefore, the Company has concluded that RML is not a VIE.

**8. Deposit Activities**

Total deposits at September 30, 2010, December 31, 2009 and September 30, 2009 were \$878.7 million, \$853.1 million and \$837.1 million, respectively. The only deposit category with stated maturity dates is certificates of deposit. At September 30, 2010, the Company had \$148.9 million in certificates of deposit as compared to certificates of deposit of \$144.9 million and \$160.4 million, for the periods ending December 31, 2009 and September 30, 2009, respectively. At September 30, 2010, \$105.9 million, or 71%, of the Company's certificates of deposits are scheduled to mature over the next 12 months as compared to \$100.1 million, or 69%, of total certificates of deposit at December 31, 2009, and \$125.7 million, or 78%, of total certificates of deposit at September 30, 2009.

**9. Stock Incentive Plan**

The Company set aside 330,750 shares of authorized stock for the 2004 Stock Incentive Plan ( 2004 Plan ) under which it may grant stock options and restricted stock units. During the second quarter ended June 30, 2010, the Company's shareholders approved the 2010 Stock Option Plan ( 2010 Plan ) under which it may grant 325,000 shares of stock in the form of stock options and restricted stock units. The Company's policy is to issue new shares to cover awards. The total number of stock options and restricted stock units outstanding under the 2004 Plan and previous stock incentive plans at September 30, 2010 was 359,684. There are 23,232 shares available for future awards under the 2004 Plan. All 325,000 shares in the 2010 Plan are also available for future awards. Under both the 2004 and 2010 Plans, certain key employees have been granted the option to purchase set amounts of common stock at the market price on the day the option was granted. Optionees, at their own discretion, may cover the cost of exercise through the exchange, at the fair market value, of already owned shares of the Company's stock. Options are granted for a 10-year period and vest on a pro rata basis over the initial three years from grant. In addition to stock options, the Company has granted restricted stock units to certain key employees under the 2004 Plan. These restricted stock grants cliff vest at the end of a three-year time period.

**Table of Contents**

The Company recognized expenses of \$94,000 and \$85,000 on the fair value of restricted stock units and \$35,000 and \$61,000 on the fair value of stock options for a total of \$129,000 and \$146,000 in stock-based compensation expense for the three-month periods ending September 30, 2010 and 2009, respectively. For the nine-month periods ending September 30, 2010 and 2009, the Company recognized expense of \$283,000 and \$263,000, respectively, on the fair value of restricted stock units and \$104,000 and \$182,000, respectively, on the fair value of stock options for a total of \$387,000 and \$445,000, respectively, in stock-based compensation expense.

Proceeds from the exercise of stock options for the three months ended September 30, 2010 and 2009 were \$292,000 and \$262,000, respectively. The Company withheld shares valued at \$297,000 and \$204,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options or the vesting of restricted stock units for the three-month period ending September 30, 2010 and 2009, respectively. The Company recognized tax deductions of \$75,000 and \$51,000 related to the exercise of these stock options during the quarter ended September 30, 2010 and 2009, respectively.

Proceeds from the exercise of stock options for the nine months ended September 30, 2010 and 2009 were \$789,000 and \$334,000, respectively. The Company withheld shares valued at \$794,000 and \$276,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options or the vesting of restricted stock units for the nine-month periods ending September 30, 2010 and 2009, respectively. The Company recognized tax deductions of \$177,000 and \$58,000, respectively, related to the exercise of stock options during the nine months ended September 30, 2010 and 2009, respectively. The Company recognized tax deductions of \$41,000 related to the vesting of restricted stock units during the nine months ended September 30, 2009. There were no restricted stock units that vested during the nine months ended September 30, 2010.

**10. Fair Value of Assets and Liabilities**

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

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

Level 2: Valuation is based upon quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company's estimation of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following methods and assumptions were used to estimate fair value disclosures. All financial instruments are held for other than trading purposes.

*Cash, Due from Banks and Overnight Investments*: Due to the short term nature of these instruments, the carrying amounts reported in the balance sheet represent their fair values.

*Investment Securities*: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. Investments in Federal Home Loan Bank stock are recorded at cost, which also represents fair value.

**Table of Contents**

*Loans Held for Sale:* Due to the short term nature of these instruments, the carrying amounts reported in the balance sheet represent their fair values.

*Loans:* Fair value adjustments for loans are mainly related to credit risk, interest rate risk, required equity return, and liquidity risk. Credit risk is primarily addressed in the financial statements through the Allowance (see Note 5). Loans are valued using a discounted cash flow methodology and are pooled based on type of interest rate (fixed or adjustable) and maturity. A discount rate was developed based on the relative risk of the cash flows, taking into account the maturity of the loans and liquidity risk. Impaired loans are carried at fair value. Specific valuation allowances are included in the Allowance. The carrying amount of accrued interest receivable approximates its fair value.

*Purchased Receivables:* Fair values for purchased receivables are based on their carrying amounts due to their short duration and repricing frequency.

*Deposit Liabilities:* The fair values of demand and savings deposits are equal to the carrying amount at the reporting date. The carrying amount for variable-rate time deposits approximates their fair value. Fair values for fixed-rate time deposits are estimated using a discounted cash flow calculation that applies currently offered interest rates to a schedule of aggregate expected monthly maturities of time deposits. The carrying amount of accrued interest payable approximates its fair value.

*Securities sold under repurchase agreements:* Fair values for securities sold under repurchase agreements are based on their carrying amounts due to their short duration and repricing frequency.

*Borrowings:* Due to the short term nature of these instruments, the carrying amount of short-term borrowings reported in the balance sheet approximate the fair value. Fair values for fixed-rate long-term borrowings are estimated using a discounted cash flow calculation that applies currently offered interest rates to a schedule of aggregate expected monthly payments.

*Junior Subordinated Debentures:* Fair value adjustments for junior subordinated debentures are based on the current discounted cash flows to maturity. Management utilized a market approach to determine the appropriate discount rate for junior subordinated debentures.

*Assets subject to nonrecurring adjustment to fair value:* The Company is also required to measure certain assets such as equity method investments, goodwill, intangible assets or OREO at fair value on a nonrecurring basis in accordance with GAAP. Any nonrecurring adjustments to fair value usually result from the write down of individual assets. The Company uses either in-house evaluations or external appraisals to estimate the fair value of OREO and impaired loans as of each reporting date. In-house appraisals are considered Level 3 inputs and external appraisals are considered Level 2 inputs.. The Company's determination of which method to use is based upon several factors. The Company takes into account compliance with legal and regulatory guidelines, the amount of the loan, the size of the assets, the location and type of property to be valued and how critical the timing of completion of the analysis is to the assessment of value. Those factors are balanced with the level of internal expertise, internal experience and market information available, versus external expertise available such as qualified appraisers, brokers, auctioneers and equipment specialists.

The Company uses external sources to estimate fair value for projects that are not fully constructed as of the date of valuation. These projects are generally valued as if complete, with an appropriate allowance for cost of completion, including contingencies developed from external sources such as vendors, engineers and contractors. The Company believes that recording other real estate owned that is not fully constructed based on as if complete values is more appropriate than recording other real estate owned that is not fully constructed using as is values. We concluded that as if complete values are appropriate for these types of projects based on the guidance for capitalization of project costs and subsequent measurement of the value of real estate contained in ASC 970-340. ASC 970-340-35-1 specifically states that estimates and cost allocations must be reviewed at the end of each reporting period and reallocated based on revised estimates. The Company adjusts the carry value of other real estate owned in

**Table of Contents**

accordance with this guidance for increases in estimated cost to complete that exceed the fair value of the real estate at the end of each reporting period.

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

*Limitations:* Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Estimated fair values as of September 30, 2010 and December 31, 2009 are as follows:

|   | September 30, 2010    |               | December 31, 2009  |               |
|---|-----------------------|---------------|--------------------|---------------|
|   | Carrying<br>Amount    | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
|   | <i>(In Thousands)</i> |               |                    |               |
| <b>Financial assets:</b>                    |                       |               |                    |               |
| Cash and cash equivalents                   | \$ 83,306             | \$ 83,306     | \$ 66,721          | \$ 66,721     |
| Investment securities                       | 212,534               | 215,341       | 187,447            | 187,678       |
| Loans held for sale                         | 20,082                | 20,082        |                    |               |
| Net loans                                   | 640,846               | 596,689       | 641,931            | 616,476       |
| Purchased receivables                       | 8,654                 | 8,654         | 7,261              | 7,261         |
| Accrued interest receivable                 | 3,234                 | 3,234         | 3,986              | 3,986         |
| <b>Financial liabilities:</b>               |                       |               |                    |               |
| Deposits                                    | \$878,728             | \$877,152     | \$853,108          | \$ 841,629    |
| Accrued interest payable                    | 390                   | 390           | 394                | 394           |
| Securities sold under repurchase            | 9,996                 | 9,996         | 6,733              | 6,733         |
| Other Borrowings                            | 5,506                 | 4,810         | 5,587              | 4,941         |
| Junior subordinated debentures              | 18,558                | 9,066         | 18,558             | 10,111        |
| <b>Unrecognized financial instruments:</b>  |                       |               |                    |               |
| Commitments to extend credit <sup>(1)</sup> | \$188,300             | \$ 1,883      | \$166,704          | \$ 1,667      |
| Standby letters of credit <sup>(1)</sup>    | 18,231                | 182           | 16,913             | 169           |

<sup>(1)</sup> Carrying amounts reflect the notional amount of credit exposure under these financial instruments.



**Table of Contents**

The following table sets forth the balances as of September 30, 2010 and 2009 of assets and liabilities measured at fair value on a recurring basis:

|  | Total      | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1)<br><i>(In Thousands)</i> | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--|------------|--|---|--|
| 2010:                                  |            |  |   |  |
| Available for sale securities          |            |  |   |  |
| U.S. Treasury & government sponsored   | \$ 152,411 |  | \$ 152,411  |  |
| Municipal Securities                   | 6,469      |  | 6,469   |  |
| U.S. Agency Mortgage-backed Securities | 79         |  | 79  |  |
| Corporate bonds                        | 47,383     |  | 47,383  |  |
| Total                                  | \$ 206,342 |  | \$ 206,342  |  |
| 2009:                                  |            |  |   |  |
| Available for sale securities          |            |  |   |  |
| U.S. Treasury & government sponsored   | \$ 108,711 |  | \$ 108,711  |  |
| Municipal Securities                   | 5,234      |  | 5,234   |  |
| U.S. Agency Mortgage-backed Securities | 91         |  | 91  |  |
| Corporate bonds                        | 28,337     |  | 28,337  |  |
| Total                                  | \$ 142,373 |  | \$ 142,373  |  |

As of and for the nine months ending September 30, 2010 and 2009, no impairment or valuation adjustment was recognized for assets recognized at fair value on a nonrecurring basis, except for certain assets as shown in the following table:

|  | Total    | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1)<br><i>(In Thousands)</i> | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>(gains)<br>losses |
|--|----------|--|---|--|----------------------------|
| 2010:                                      |          |  |   |  |                            |
| Loans measured for impairment <sup>1</sup> | \$ 5,163 |  | \$ 3,928  | \$ 1,235   | \$(793)                    |
| Other real estate owned <sup>2</sup>       | 640      |  |   | 640  | 250                        |
| Total                                      | \$ 5,803 |  | \$ 3,928  | \$ 1,875   | \$(543)                    |

|  |           |          |           |         |
|--|-----------|----------|-----------|---------|
| 2009:                                      |           |          |           |         |
| Loans measured for impairment <sup>1</sup> | \$ 17,753 | \$ 6,143 | \$ 11,610 | \$(416) |
| Other real estate owned <sup>2</sup>       | 6,171     |          | 6,171     | 516     |
| Total                                      | \$23,924  | \$ 6,143 | \$ 17,781 | \$ 100  |

<sup>1</sup> Relates to certain impaired collateral dependant loans. The impairment was measured based on the fair value of collateral, in accordance with GAAP.

<sup>2</sup> Relates to certain impaired other real estate owned. This impairment arose from an adjustment to the Company's estimate of the fair market value of these properties based on changes in estimated costs to complete the projects and changes in market conditions.

For loans measured for impairment, the Company classifies fair value measurements using observable inputs, such as external appraisals, as level 2 valuations in the fair value hierarchy, and unobservable inputs, such as in-house evaluations, as level 3 valuations in the fair value hierarchy.

- 17 -

---

**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This discussion should be read in conjunction with the unaudited financial statements of Northrim BanCorp, Inc. (the Company) and the notes thereto presented elsewhere in this report and with the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

**Note Regarding Forward Looking-Statements**

This quarterly report on Form 10-Q includes forward-looking statements, which are not historical facts. These forward-looking statements describe management's expectations about future events and developments such as future operating results, growth in loans and deposits, continued success of the Company's style of banking, and the strength of the local economy. All statements other than statements of historical fact, including statements regarding industry prospects and future results of operations or financial position, made in this report are forward-looking. We use words such as anticipate, believe, expect, intend and similar expressions in part to help identify forward-looking statements. Forward-looking statements reflect management's current plans and expectations and are inherently uncertain. Our actual results may differ significantly from management's expectations, and those variations may be both material and adverse. Forward-looking statements are subject to various risks and uncertainties that may cause our actual results to differ materially and adversely from our expectations as indicated in the forward-looking statements. These risks and uncertainties include: the general condition of, and changes in, the Alaska economy; factors that impact our net interest margin; and our ability to maintain asset quality. Further, actual results may be affected by competition on price and other factors with other financial institutions; customer acceptance of new products and services; the regulatory environment in which we operate; and general trends in the local, regional and national banking industry and economy. Many of these risks, as well as other risks that may have a material adverse impact on our operations and business, are identified in Item 1A Risk Factors of this report, and in our other filings with the SEC. However, you should be aware that these factors are not an exhaustive list, and you should not assume these are the only factors that may cause our actual results to differ from our expectations. In addition, you should note that we do not intend to update any of the forward-looking statements or the uncertainties that may adversely impact those statements, other than as required by law.

**Critical Accounting Policies**

The preparation of the consolidated financial statements requires us to make a number of estimates and assumptions that affect the reported amounts and disclosures in the consolidated financial statements. On an ongoing basis, we evaluate our estimates and assumptions based upon historical experience and various other factors and circumstances. We believe that our estimates and assumptions are reasonable; however, actual results may differ significantly from these estimates and assumptions which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and on our results of operations for the reporting periods.

The accounting policies that involve significant estimates and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities, are considered critical accounting policies. The Company's critical accounting policies include those that address the accounting for the Allowance, the valuation of goodwill and other intangible assets, and the valuation of other real estate owned. These critical accounting policies are further described in Management's Discussion and Analysis and in Note 1, Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements in the Company's Form 10-K as of December 31, 2009. Management has applied its critical accounting policies and estimation methods consistently in all periods presented in these financial statements.

See Note 2 of the Notes to the Consolidated Financial Statements in this Form 10-Q for a summary of the pronouncements that became effective in 2010 and discussion of the impact of their adoption on the Company's consolidated financial statements.

**Table of Contents**

**Economic Conditions**

According to the Department of Labor, Alaska's seasonally adjusted unemployment rate for August was 7.7%, unchanged from July. The comparable national jobless rate for August was 9.6%, up slightly from 9.5% in July. One year ago, the national unemployment rate was 9.7% compared to 8.2% for Alaska. August was the 22nd consecutive month that Alaska's unemployment rate was lower than the nation's. The average monthly payroll job count in Alaska has increased 1% (from 322,550 to 325,875) through August of 2010 when compared to the first eight months of 2009..

According to the Bureau of Economic Analysis personal income in Alaska rose 3.5% between the second quarter of 2009 and 2010. This is compared to 2.2% growth over the same period in the US. Personal income in Alaska has grown for six consecutive quarters between the first quarter of 2009 and the second quarter of 2010.

The retail sector is currently benefitting from the seasonal boost in consumption generated from the Permanent Fund Dividend, which paid \$1,281 to every Alaska resident early in October.

**Highlights and Summary of Performance – Third Quarter of 2010**

- § Northrim continued to maintain strong capital ratios with Tier 1 Capital/risk adjusted assets of 14.46% as compared to 14.77% in the immediate prior quarter and 13.96% a year ago. Because the Company elected not to participate in the Capital Purchase Program sponsored by the U. S. Treasury in 2008, these ratios do not reflect any government investment in Northrim.
- § Northrim's tangible common equity to tangible assets at quarter end was 10.50%, up from 10.32% a year earlier and consistent with the previous quarter which was 10.53%. Tangible common equity to tangible assets is a non-GAAP ratio that represents total equity less goodwill and intangible assets divided by total assets less goodwill and intangible assets. The GAAP measure of equity to assets is total equity divided by total assets. Total equity to total assets was 11.26% at September 30, 2010 as compared to 11.15% at September 30, 2009.
- § Nonperforming assets declined in the quarter to \$25.0 million or 2.41% of total assets, compared to \$39 million or 3.95% at September 30, 2009.
- § Book value was \$18.22 per share and tangible book value was \$16.86 per share, up from \$17.28 and \$15.85 respectively a year earlier. Tangible book value is shareholder's equity, less intangible assets, divided by common stock outstanding.
- § The allowance for loan losses continued to increase, now totaling 2.31% of total portfolio loans at September 30, 2010, compared to 2.00% at September 30, 2009. The allowance for loan losses to nonperforming loans also increased to 105.93% from 46.62% a year ago.
- § Other operating income, which includes revenues from service charges, electronic banking, and financial services affiliates, contributed 29% of total third quarter revenues and 25% of year-to-date revenues.
- § The cash dividend paid on September 17, 2010, rose 20% to \$0.12 per diluted share from \$0.10 per diluted share paid in the prior quarter.

The Company reported net income and diluted earnings per share of \$3.2 million and \$0.49, respectively, for the quarter ending September 30, 2010 compared to net income and diluted earnings per share of \$1.9 million and \$0.30, respectively, for the quarter ending September 30, 2009. The increase in net income from the prior year was primarily attributable to an increase in other operating income and decreases in other operating expense and the provision for loan losses. These changes were partially offset by a decrease in net interest income and an increase in the provision for income taxes.

Northrim's total assets grew 5% to \$1.04 billion at September 30, 2010 from \$986 million at September 30, 2009, with increases in portfolio investments, loans held for sale, overnight investments, and cash and due from banks more than offsetting continuing declines in portfolio loans. The loan portfolio decreased 6% in the third quarter to

\$635 million from \$674 million a year ago. This decrease

- 19 -

---

**Table of Contents**

was primarily due to continued decreases in Construction loans and a lower level of Commercial loans.

The loan portfolio remains diversified with commercial loans accounting for 37% of the portfolio and commercial real estate accounting for 48% of the portfolio at September 30, 2010. Construction and land development loans, which account for 8% of the loan portfolio at September 30, 2010 are down 38% to \$51 million from \$82.2 million a year ago, reflecting the maturing of projects funded in past years, the reduction in new projects started in the past two years, and continuing successful collection efforts.

**Credit Quality and Nonperforming Assets**

Nonperforming assets at September 30, 2010, declined by \$14 million year-over-year and \$3.4 million from the preceding quarter. The risk profile of the portfolio improved as a result of the following developments:

- § Loans measured for impairment decreased to \$22.2 million at September 30, 2010, compared to \$25.1 million at June 30, 2010, and \$52.6 million in the third quarter a year ago.
- § Nonperforming loans totaled \$13.9 million, or 2.19% of total portfolio loans at September 30, 2010, compared to \$28.9 million, or 4.28% of total portfolio loans a year ago.
- § The \$4.8 million condominium conversion project in Anchorage that moved into OREO during the fourth quarter of 2009 continues to generate rental income producing an average yield of approximately 2%. Of the 68 original units, 35 condos have been sold and 22 are rented, providing positive year-to-date cash flow for the project.
- § Sales of OREO continued during the third quarter, with 26 properties sold for an aggregate of \$3.3 million, generating a \$332,000 net gain over current carrying value in the third quarter of 2010. The Company also recognized \$830,000 in deferred gains on sales of OREO property that occurred in previous periods and now meet the accounting requirements for gain recognition. Of the current period gain, \$422,000 was related to a deferred gain for one commercial property that was sold in 2007, and the remainder of the gains recognized in the current quarter were from the sale of ten condominiums and two lots sold in late 2009 and throughout the first half of 2010. At September 30, 2010 the Company had \$194,000 in remaining deferred gains on sale of OREO property.
- § Year-to-date OREO sales generated \$9.2 million in gross proceeds, including \$613,000 in gain on sale of 62 properties. Year-to-date gain on the sale of OREO totaled \$1.4 million including the recognition of the \$830,000 in deferred gains discussed above.
- § Net charge-offs in the third quarter of 2010 totaled \$132,000, or 0.02% of average loans, reflecting the effects of \$661,000 in recoveries, compared to net charge-offs of \$1.1 million, or 0.16% of average loans during the third quarter of 2009. Year-to-date net charge-offs totaled \$1.6 million, or 0.32%, annualized, of average loans, down from \$4.3 million, 0.83%, annualized, of average loans in the first nine months of 2009.
- § The coverage ratio of the allowance to nonperforming loans increased to 105.93% at September 30, 2010, compared to 46.62% in the third quarter a year ago.

At September 30, 2010, management had identified potential problem loans of \$11.7 million as compared to potential problem loans of \$17.0 million at December 31, 2009 and \$6.5 million at September 30, 2009. Potential problem loans are loans which are currently performing and are not included in nonaccrual loans, accruing loans 90 days or more past due, impaired loans or troubled debt restructurings ( TDRs ) that have developed negative indications that the borrower may not be able to comply with present payment terms and which may later be included in nonaccrual, past due, impaired or TDRs. The \$5.3 million decrease in potential problem loans at September 30, 2010 from December 31, 2009 is primarily due to the transfer of one \$3.3 million residential land development loan and 2 commercial loans to nonaccrual status.

At September 30, 2010, December 31, 2009 and September 30, 2009 the Company held OREO of \$11.0 million, \$17.4 million and \$10.1 million, respectively. As of September 30, 2010, OREO consists of \$6.3 million in condominiums, \$3.2 million in residential lots in various stages of development, \$1.2 million

- 20 -

---

**Table of Contents**

in single family residences and \$399,000 in commercial property. During the third quarter of 2010, additions to OREO included two single family residences valued at \$907,000, one commercial building valued at \$99,000, and one condominium valued at \$49,000. During the third quarter of 2010, the Company received approximately \$3.3 million in proceeds for the sale of OREO, which included \$2.1 million from the sale of condominiums, \$1 million from the sale of residential lots and \$228,000 from the sale of a single family residence. Total net gains on the sale of OREO properties were \$1.2 million and \$1.4 million for the three and nine-month periods ending September 30, 2010.

The following summarizes OREO activity for the three and nine-month periods ending September 30, 2010 and 2009:

|   | Three Months Ended<br>September 30, |           | Nine Months Ended September<br>30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2010                                | 2009      | 2010                               | 2009      |
|   | <i>(In Thousands)</i>               |           |                                    |           |
| Balance, beginning of the period                  | \$ 12,973                           | \$ 11,576 | \$ 17,355                          | \$ 12,617 |
| Transfers from loans, net                         | 1,059                               | 627       | 1,990                              | 3,518     |
| Investment in other real estate owned             | 7                                   | 298       | 34                                 | 1,470     |
| Proceeds from the sale of other real estate owned | (3,337)                             | (2,634)   | (9,225)                            | (7,466)   |
| Gain on sale of other real estate owned, net      | 1,162                               | 201       | 1,443                              | 424       |
| Deferred gain on sale of other real estate owned  | (771)                               | 71        | (328)                              | 71        |
| Impairment on other real estate owned             | (74)                                | (21)      | (250)                              | (516)     |
| Balance at end of period                          | \$ 11,019                           | \$ 10,118 | \$ 11,019                          | \$ 10,118 |

**RESULTS OF OPERATIONS****Income Statement****Net Income**

Net income attributable to Northrim BanCorp for the three and nine-month periods ending September 30, 2010, increased \$1.3 million from \$1.9 million to \$3.2 million and \$1.4 million from \$5.8 million to \$7.2 million, respectively, as compared to the same periods in 2009. These increases were due to increased other operating income, decreased loan loss provisions and other operating expenses, net of decreased net interest income and increased provisions for income taxes. Other operating income increased \$1.1 million and \$331,000 for the three and nine-month periods ending September 30, 2010 primarily due to increased OREO sale and rental income. This increase was partially offset in the nine month period ending September 30, 2010 by decreased earnings from RML. The provision for loan losses decreased \$957,000 and \$1.7 million for the three and nine-month periods ending September 30, 2010 primarily due to decreases in the loan portfolio and lower net charge offs in 2010 as compared to 2009. Other operating expenses decreased \$885,000 for the quarter primarily due to a penalty for prepayment of long term FHLB advances that was incurred in the same period in 2009. Other operating expense decreased \$1.6 million for the nine months ended as of September 30, 2010 primarily due to the prepayment penalty from 2009 as well as decreases in FDIC insurance expense and salaries and other personnel expenses. These decreases were partially offset by increased purchased receivable losses. Net interest income decreased \$846,000 for the quarter and \$1.3 million for the nine months ended September 30, 2010, mainly due to a decrease in interest revenue from lower loan balances and from lower yields on long term investments.

**Net Interest Income / Net Interest Margin**

Net interest income for the three and nine-month periods ending September 30, 2010 decreased \$846,000 and \$1.3 million, respectively, as compared to the same periods in 2009 because of larger reductions in interest income, accompanied by a smaller decrease in the costs on the Company's interest-bearing liabilities. The Company's net



interest income as a percentage of average interest-earning assets on a tax equivalent basis decreased by 61 basis points and 31 basis points, respectively, to 4.77% and 5.05%, for the three and nine-month periods ending September 30, 2010 as compared to the same periods in 2009.

- 21 -

---

**Table of Contents**

Average loans, the largest category of interest-earning assets, decreased by \$29.7 million and \$49.6 million in the three and nine-month periods ending September 30, 2010 as compared to the same periods in 2009. Average commercial, construction, home equity lines and other consumer loans all decreased in both periods while commercial real estate loans increased during these same periods. Real estate loans held for sale increased in the three month period ending September 30, 2010 and decreased in the nine month period ending September 30, 2010. The overall decline in the loan portfolio resulted from a combination of refinance and loan payoff activity and a decrease in construction loan originations.

Average investments increased \$74.4 million and \$68.6 million in the three and nine-month periods ending September 30, 2010 as compared to the same periods in 2009. This increase arose as loan totals decreased in both periods and total deposits increased in the third quarter.

Average interest-bearing liabilities increased \$19.2 million during the third quarter of 2010 and decreased \$9.7 million for the nine-month period ending September 30, 2010 as compared to the same periods in 2009. The increase for the three-month period was the result of increased average interest-bearing deposit balances. The decrease for the nine-month periods arose from the payoff of the Company's long term borrowings from FHLB of \$9.9 million in the third quarter of 2009 as well as a shift in customer deposits from interest-bearing to noninterest-bearing demand deposits. Lastly, the Company had average public certificates of deposits from the Alaska Permanent Fund Corporation of \$43.9 million in the first nine months of 2009 and had no public deposits in 2010. The Alaska Permanent Fund Corporation may invest in certificates of deposit at Alaska banks in an aggregate amount with respect to each bank, not to exceed its capital and at specified rates and terms. The depository bank must collateralize the deposits either with pledged securities or a letter of credit.

The average cost of interest-bearing liabilities decreased 21 basis points and 26 basis points for the three and nine-month periods ending September 30, 2010 compared to the same periods in 2009 due mainly to declining market rates and the payoff of the Company's FHLB borrowings.

**Components of Net Interest Margin**

- 22 -

---

**Table of Contents**

The following table compares average balances and rates as well as net tax equivalent margin on earning assets for the three and nine months ending September 30, 2010 and 2009:

|   | Average Balances |            | Change      |       | Three Months Ended September 30, |           |          |        | Average Yields/Costs |         |        |  |  |
|---|------------------|------------|-------------|-------|----------------------------------|-----------|----------|--------|----------------------|---------|--------|--|--|
|   | 2010             | 2009       | \$          | %     | Interest income/<br>expense      |           | Change   |        | Tax Equivalent       |         | Change |  |  |
|   |                  |            |             |       | 2010                             | 2009      | \$       | %      | 2010                 | 2009    |        |  |  |
|   |                  |            |             |       | <i>(In Thousands)</i>            |           |          |        |                      |         |        |  |  |
| Commercial                                  | \$ 240,235       | \$ 252,224 | \$ (11,989) | -5%   | \$ 4,232                         | \$ 4,587  | \$ (355) | -8%    | 6.99%                | 7.22%   | -0.2%  |  |  |
| Construction/development                    | 51,756           | 83,199     | (31,443)    | -38%  | 1,042                            | 1,810     | (768)    | -42%   | 7.99%                | 8.63%   | -0.6%  |  |  |
| Commercial real estate                      | 296,403          | 293,236    | 3,167       | 1%    | 5,091                            | 5,043     | 48       | 1%     | 6.81%                | 6.82%   | -0.0%  |  |  |
| Home equity lines and                       |                  |            |             |       |                                  |           |          |        |                      |         |        |  |  |
| Other consumer                              | 45,256           | 46,655     | (1,399)     | -3%   | 743                              | 792       | (49)     | -6%    | 6.60%                | 6.73%   | -0.1%  |  |  |
| Real estate loans for sale                  | 12,532           | 411        | 12,121      | 2949% | 141                              | (14)      | 155      | -1107% | 4.45%                | -13.32% | 17.7%  |  |  |
| Other loans <sup>1</sup>                    | (1,058)          | (853)      | 205         | 24%   |                                  |           |          |        |                      |         |        |  |  |
| Total loans <sup>2, 3</sup>                 | 645,124          | 674,872    | (29,748)    | -4%   | 11,249                           | 12,218    | (969)    | -8%    | 6.93%                | 7.19%   | -0.2%  |  |  |
| Short-term investments                      | 84,371           | 49,609     | 34,762      | 70%   | 54                               | 31        | 23       | 74%    | 0.25%                | 0.24%   | 0.0%   |  |  |
| Long-term investments                       | 183,585          | 143,979    | 39,606      | 28%   | 963                              | 1,155     | (192)    | -17%   | 2.22%                | 3.23%   | -1.0%  |  |  |
| Total investments                           | 267,956          | 193,588    | 74,368      | 38%   | 1,017                            | 1,186     | (169)    | -14%   | 1.59%                | 2.45%   | -0.8%  |  |  |
| Interest-earning assets                     | 913,080          | 868,460    | 44,620      | 5%    | 12,266                           | 13,404    | (1,138)  | -8%    | 5.36%                | 6.13%   | -0.7%  |  |  |
| Non-earning assets                          | 105,788          | 104,378    | 1,410       | 1%    |                                  |           |          |        |                      |         |        |  |  |
| Total                                       | \$ 1,018,868     | \$ 972,838 | \$ 46,030   | 5%    |                                  |           |          |        |                      |         |        |  |  |
| Interest-bearing deposits                   | \$ 591,319       | \$ 568,755 | \$ 22,564   | 4%    | \$ 1,161                         | \$ 1,350  | \$ (189) | -14%   | 0.78%                | 0.94%   | -0.1%  |  |  |
| Other borrowings                            | 33,983           | 37,396     | (3,413)     | -9%   | 209                              | 312       | (103)    | -33%   | 2.41%                | 3.26%   | -0.8%  |  |  |
| Total interest-bearing                      |                  |            |             |       |                                  |           |          |        |                      |         |        |  |  |
| Liabilities                                 | 625,302          | 606,151    | 19,151      | 3%    | 1,370                            | 1,662     | (292)    | -18%   | 0.87%                | 1.08%   | -0.2%  |  |  |
| Demand deposits and                         |                  |            |             |       |                                  |           |          |        |                      |         |        |  |  |
| Other noninterest-bearing                   |                  |            |             |       |                                  |           |          |        |                      |         |        |  |  |
| Liabilities                                 | 277,753          | 256,992    | 20,761      | 8%    |                                  |           |          |        |                      |         |        |  |  |
| Equity                                      | 115,813          | 109,695    | 6,118       | 6%    |                                  |           |          |        |                      |         |        |  |  |
| Total                                       | \$ 1,018,868     | \$ 972,838 | \$ 46,030   | 5%    |                                  |           |          |        |                      |         |        |  |  |
| Net interest income                         |                  |            |             |       | \$ 10,896                        | \$ 11,742 | \$ (846) | -7%    |                      |         |        |  |  |
| Net tax equivalent margin on earning assets |                  |            |             |       |                                  |           |          |        | 4.77%                | 5.38%   | -0.6%  |  |  |

<sup>1</sup> Other loans is made up of deferred loan fees, net of loans in process.

- <sup>2</sup> Loan fees recognized during the period and included in the yield calculation totalled \$676,000 and \$677,000 in the third quarter of 2010 and 2009, respectively.
- <sup>3</sup> Average nonaccrual loans included in the computation of the average loans were \$14.5 million and \$18.2 million in the third quarter of 2010 and 2009, respectively.

- 23 -

---

**Table of Contents**

|   | Nine Months Ended September 30, |            |             |      |                             |           |            |      |  |       |        |
|---|---------------------------------|------------|-------------|------|-----------------------------|-----------|------------|------|--|-------|--------|
|   | Average Balances                |            | Change      |      | Interest income/<br>expense |           |            |      | Average Yields/Costs<br>Tax Equivalent |       |        |
|   | 2010                            | 2009       | \$          | %    | 2010                        | 2009      | \$         | %    | 2010                                   | 2009  | Change |
|   | <i>(In Thousands)</i>           |            |             |      |                             |           |            |      |  |       |        |
| Commercial  | \$ 242,971                      | \$ 269,926 | \$ (26,955) | -10% | \$ 12,908                   | \$ 14,152 | \$ (1,244) | -9%  | 7.10%                                  | 7.01% | 0.09%  |
| Construction/development  | 55,113                          | 87,644     | (32,531)    | -37% | 3,358                       | 5,185     | (1,827)    | -35% | 8.15%                                  | 7.91% | 0.24%  |
| Commercial real estate  | 295,133                         | 281,828    | 13,305      | 5%   | 15,135                      | 14,666    | 469        | 3%   | 6.86%                                  | 6.96% | -0.10% |
| Home equity lines and<br>other consumer                         | 47,038                          | 48,439     | (1,401)     | -3%  | 2,338                       | 2,460     | (122)      | -5%  | 6.64%                                  | 6.79% | -0.15% |
| Real estate loans for sale                                      | 4,311                           | 6,310      | (1,999)     | -32% | 144                         | 209       | (65)       | -31% | 4.46%                                  | 4.43% | 0.03%  |
| Other loans <sup>1</sup>  | (1,378)                         | (1,359)    | (19)        | 1%   |                             |           |            |      |  |       |        |
| Total loans <sup>2, 3</sup>                                     | 643,188                         | 692,788    | (49,600)    | -7%  | 33,883                      | 36,672    | (2,789)    | -8%  | 7.05%                                  | 7.08% | -0.03% |
| Short-term investments  | 62,923                          | 37,192     | 25,731      | 69%  | 119                         | 122       | (3)        | -2%  | 0.25%                                  | 0.43% | -0.18% |
| Long-term investments   | 181,378                         | 138,527    | 42,851      | 31%  | 3,607                       | 3,352     | 255        | 8%   | 2.77%                                  | 3.40% | -0.63% |
| Total investments   | 244,301                         | 175,719    | 68,582      | 39%  | 3,726                       | 3,474     | 252        | 7%   | 2.13%                                  | 2.78% | -0.65% |
| Interest-earning assets   | 887,489                         | 868,507    | 18,982      | 2%   | 37,609                      | 40,146    | (2,537)    | -6%  | 5.70%                                  | 6.21% | -0.51% |
| Nonearning assets   | 107,798                         | 107,566    | 232         | 0%   |                             |           |            |      |  |       |        |
| Total   | \$ 995,287                      | \$ 976,073 | \$ 19,214   | 2%   |                             |           |            |      |  |       |        |
| Interest-bearing deposits                                       | \$ 582,614                      | \$ 588,105 | \$ (5,491)  | -1%  | \$ 3,701                    | \$ 4,495  | \$ (794)   | -18% | 0.85%                                  | 1.02% | -0.17% |
| Borrowings  | 33,327                          | 37,556     | (4,229)     | -11% | 605                         | 1,067     | (462)      | -43% | 2.39%                                  | 3.75% | -1.36% |
| Total interest-bearing<br>liabilities                           | 615,941                         | 625,661    | (9,720)     | -2%  | 4,306                       | 5,562     | (1,256)    | -23% | 0.93%                                  | 1.19% | -0.26% |
| Demand deposits and<br>other noninterest-bearing<br>liabilities | 265,152                         | 242,255    | 22,897      | 9%   |                             |           |            |      |  |       |        |
| Equity  | 114,194                         | 108,157    | 6,037       | 6%   |                             |           |            |      |  |       |        |
| Total   | \$ 995,287                      | \$ 976,073 | \$ 19,214   | 2%   |                             |           |            |      |  |       |        |
| Net interest income   |                                 |            |             |      | \$ 33,303                   | \$ 34,584 | \$ (1,281) | -4%  |  |       |        |
| Net tax equivalent margin<br>on earning assets                  |                                 |            |             |      |                             |           |            |      | 5.05%                                  | 5.36% | -0.31% |

<sup>1</sup> Other loans is made up of deferred loan fees, net of loans in process.

<sup>2</sup> Loan fees recognized during the period and included in the yield calculation totalled \$2.0 million and \$2.7 million in the nine months ending September 30, 2010 and 2009, respectively.

<sup>3</sup> Average nonaccrual loans included in the computation of the average loans were \$13.7 million and \$19.0 million in the nine months ending September 30, 2010 and 2009, respectively.

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

The following tables set forth the changes in consolidated net interest income attributable to changes in volume and to changes in interest rates for the three and nine month periods ending September 30, 2010 as compared to the same periods in 2009. Changes attributable to the combined effect of volume and interest rate have been allocated proportionately to the changes due to volume and the changes due to interest rate.

|                           | Quarter ended September 30, 2010 vs.<br>2009 |            |            |
|---------------------------|--|------------|------------|
|                           | Increase (decrease) due to<br>Volume         | Rate       | Total      |
| Interest Income:          |  |            |            |
| Loans                     | \$ (793)                                     | \$ (176)   | \$ (969)   |
| Long-term investments     | 1,374  | (1,566)    | (192)      |
| Short-term investments    | 22   | 1          | 23         |
| Total interest income     | \$ 604                                       | \$ (1,740) | \$ (1,138) |
| Interest Expense:         |  |            |            |
| Deposits:                 |  |            |            |
| Interest-bearing deposits | \$ 57  | \$ (246)   | \$ (189)   |
| Borrowings                | (27)   | (76)       | (103)      |
| Total interest expense    | \$ 30  | \$ (322)   | \$ (292)   |

**Table of Contents**

|                           | Nine months ended September 30, 2010 vs.<br>2009 |            |            |
|---------------------------|--|------------|------------|
|                           | Increase (decrease) due to                       |            | Total      |
|                           | Volume   | Rate       |            |
| Interest Income:          |  |            |            |
| Loans                     | \$ (2,867)                                       | \$ 78      | \$ (2,789) |
| Long-term investments     | 636  | (381)      | 255        |
| Short-term investments    | (8)  | 5          | (3)        |
| Total interest income     | \$ (2,240)                                       | \$ (298)   | \$ (2,537) |
| Interest Expense:         |  |            |            |
| Deposits:                 |  |            |            |
| Interest-bearing deposits | \$ (42)  | \$ (752)   | \$ (794)   |
| Borrowings                | (110)  | (352)      | (462)      |
| Total interest expense    | \$ (152)   | \$ (1,104) | \$ (1,256) |

**Provision for Loan Losses**

As of and for the period ended September 30, 2010, the Company refined its method of estimating the Allowance for Loans Losses ( Allowance ). The Company elected this enhanced method of estimating the Allowance because we believe that it more accurately allocates expected losses by loan segment and class. The Company performed a retrospective review of the Allowance as of December 31, 2009, March 31, 2010 and June 30, 2010 and determined that this refinement does not have an effect on the Company's financial position, results of operations, or earnings per share for any period; rather, the refined method of estimating the Allowance changes how the total Allowance is allocated among the Company's loan types and the unallocated portion of the Allowance.

The following paragraphs describe the refinements in the Company's methodology for estimating the Allowance.

**Specific Allowance**

Prior to September 30, 2010, the Company determined the allocated portion of the Allowance by first calculating a specific allowance for impaired loans in accordance with the accounting guidance in ASC Topic 310-10-35. This analysis was based upon a specific analysis for each impaired loan, including appraisals on loans secured by real property, management's assessment of the current market, recent payment history and an evaluation of other sources of repayment. The specific allowance for impaired loans is included within each portfolio segment by type in the allowance allocation table. The calculation of the specific reserves did not change as a result of the change in the methodology for estimating the Allowance as of September 30, 2010.

**General Allowance**

Prior to September 30, 2010, the Company identified the following classes of loans not considered impaired for purposes of establishing the allocated portion of the general reserve of the Allowance. In management's judgment, these identifiable classes of loans carried higher levels of risk based upon our operating history and were the only class of loans subject to our formula based methodology:

Special mention loans: Loans in this category had deteriorated sufficiently that they would have difficulty in refinancing; similarly, purchasers of the business would not be eligible for bank financing unless they represent a significantly stronger credit risk. There was deterioration of financial condition or collateral value, still reasonably secured by collateral or net worth. Although the Company was presently protected from loss, potential weaknesses were apparent which, if not

corrected, could cause future problems.

Substandard loans: Loans in this category were those that were no longer adequately protected due to declining net worth, lack of earning capacity, or insufficient collateral. The possibility for

- 25 -

---



**Table of Contents**

loss of some portion of the loan principal could not be ruled out. Loans exhibited well-defined weaknesses that brought normal repayment into jeopardy.

Doubtful loans: Loans in this category exhibited the same weaknesses as those classified Substandard but the traits were more pronounced. Collection in full was improbable, however the extent of the loss may have been indeterminable due to pending factors which may yet occur that could salvage the loan, such as possible pledge of additional collateral, sale of assets, merger, acquisition or refinancing.

Loans made to retail and general wholesale businesses;

Loans collateralized by accounts receivable, inventory, furniture fixtures and equipment,

Loans for raw land, land development, and speculative construction loans with expected sellout of greater than one year,

Special mention loans, substandard loans and doubtful loans were classes of loans that are included in the Company's internal risk classifications. These classifications are based in large part upon regulatory definitions for classified loans. The other loan classes listed above are separately identifiable classes of loans which management believed were subject to higher levels of risk based on our operating history.

The loss factors that the Company applied to each class of loans within the various risk classifications were based primarily on industry standards, input from our regulators, and management's own judgment. Management's judgment was based on average historical losses incurred by the Company for various portfolio classes. The formula based reserve for these loans was included in the allocation table by loan type.

As of September 30, 2010 and going forward, the Company has identified the following segments and classes of loans not considered impaired for purposes of establishing the allocated portion of the general reserve of the Allowance. Under the enhanced methodology for estimating the Allowance, the Company first disaggregates the overall loan portfolio in the following segments: commercial, construction, real estate term and home equity lines and other consumer loans. Then the Company further disaggregates each segment into the following classes, which are also known as risk classifications: excellent, good, satisfactory, watch, special mention, substandard, doubtful and loss. After the portfolio has been disaggregated into these segments and classes, the Company calculates a general reserve for each segment and class based on the average three year loss history for each segment and class. This general reserve is then adjusted for qualitative factors, by segment and class. Qualitative factors are based on management's assessment of current trends that may cause losses inherent in the current loan portfolio to differ significantly from historical losses. Some factors that management considers in determining the qualitative adjustment to the general reserve include, national and local economic trends, business conditions, underwriting policies and standards, trends in local real estate markets, effects of various political activities, peer group data, and internal factors such as underwriting policies and expertise of the Company's employees.

**Unallocated Reserves**

Prior to September 30, 2010, the Company designated the remaining balance of the Allowance as unallocated. The unallocated portion of the Allowance was analyzed based on a review of three year average loan loss rates for loans which did not have a specific or general allocation as described above, combined with other qualitative factors. The Company validated the unallocated portion of the Allowance by back testing it in relation to the average historical loss rates for all loan classes that were not included in the calculation of the allocated portion of the Allowance as described above as adjusted by the qualitative factors listed above. The unallocated portion of the Allowance was analyzed in relation to a range of these adjusted average historical loss rates.

As of September 30, 2010, the Company implemented an expanded analysis of average historical losses segregated by both major loan segments and classes, as defined above, which includes our internal risk rating system. Starting with this Form 10-Q and going forward, the Company's unallocated portion of the Allowance will no longer be reviewed using average historical net loss rates, adjusted for qualitative factors discussed above, because the reserves calculated using these rates will be allocated by loan segment and class.



**Table of Contents**

Consequently, the refinement in the methodology of estimating the Allowance is likely to result in a much smaller unallocated portion of the Allowance.

As of September 30, 2010 and going forward, the Company assesses the overall adequacy of the Allowance, which affects the unallocated portion of the Allowance, based on several factors including the level of the Allowance as compared to total loans and nonperforming loans in light of current economic conditions. The unallocated portion of the Allowance provides for coverage of credit losses inherent in the loan portfolio but not captured in the credit loss factors that are utilized in the risk rating-based component, or in the specific impairment component of the Allowance, and acknowledges the inherent imprecision of all loss prediction models.

The unallocated portion of the Allowance in the enhanced method of estimating the Allowance is based upon management's evaluation of various factors that are not directly measured in the determination of the allocated portions of the Allowance. Such factors include uncertainties in identifying triggering events that directly correlate to subsequent loss rates, uncertainties in economic conditions, risk factors that have not yet manifested themselves in loss allocation factors, and historical loss experience data that may not precisely correspond to the current portfolio. In addition, the unallocated reserve may be further adjusted based upon the direction of various risk indicators. Examples of such factors include the risk as to current and prospective economic conditions, the level and trend of charge offs or recoveries, and the risk of heightened imprecision or inconsistency of appraisals used in estimating real estate values. Although this allocation process may not accurately predict credit losses by loan type or in aggregate, the total Allowance is available to absorb losses that may arise from any loan segment or class. Due to the subjectivity involved in the determination of the unallocated portion of the Allowance, the relationship of the unallocated component to the total Allowance may fluctuate from period to period.

**Retrospective Review of the Allowance using the Enhanced Methodology for Estimating the Allowance**

The Company performed a retrospective review of the Allowance at December 31, 2009, March 31, 2010 and June 30, 2010 using the enhanced methodology described above. The following table summarizes what the Allowance would have looked like at these period ending dates if the Company had used the enhanced methodology to calculate the Allowance:

|          | September 30, 2010 |       |                                       |         | June 30, 2010 |       |                                       |         | March 31, 2010 |         |                                       |         | December 31, 2009 |         |
|----------|--------------------|-------|---------------------------------------|---------|---------------|-------|---------------------------------------|---------|----------------|---------|---------------------------------------|---------|-------------------|---------|
|          | Total              | Loans | Formula-<br>Impaired based<br>Amounts | Other   | Total         | Loans | Formula-<br>Impaired based<br>Amounts | Other   | Total          | Loans   | Formula-<br>Impaired based<br>Amounts | Other   | Total             | Loans   |
| able to: | \$ 5,808           | \$280 | \$ 5,528                              |         | \$ 6,164      | \$167 | \$ 5,997                              |         | \$ 5,530       | \$1,190 | \$4,340                               |         | \$ 4,964          | \$ 850  |
|          | 1,602              | 542   | 1,060                                 |         | 1,619         | 531   | 1,088                                 |         | 1,708          | 633     | 1,075                                 |         | 2,156             | 869     |
|          | 4,778              | 51    | 4,727                                 |         | 4,641         | 121   | 4,520                                 |         | 3,375          | 118     | 3,257                                 |         | 2,680             | 143     |
| and      | 506                |       | 506                                   |         | 625           | 1     | 624                                   |         | 520            | 1       | 519                                   |         | 501               | 1       |
|          | 2,017              |       |                                       | 2,017   | 1,378         |       |                                       | 1,378   | 2,913          |         |                                       | 2,913   | 2,807             |         |
|          | \$14,711           | \$873 | \$11,821                              | \$2,017 | \$14,427      | \$820 | \$12,229                              | \$1,378 | \$14,046       | \$1,942 | \$9,191                               | \$2,913 | \$13,108          | \$1,863 |

The following table shows the reported allocation of the Allowance based on the legacy methodology:

- 27 -

**Table of Contents**

| Allowance applicable to:                | Total           | December 31,<br>2009 |                |                | Total           | March 31, 2010 |                |                | Total           | June 30, 2010 |                |                |
|---|-----------------|----------------------|----------------|----------------|-----------------|----------------|----------------|----------------|-----------------|---------------|----------------|----------------|
|   |                 | Impaired             | Formula-based  | Other          |                 | Impaired       | Formula-based  | Other          |                 | Impaired      | Formula-based  | Other          |
| Commercial                              | \$ 3,962        | \$ 850               | \$ 3,112       |                | \$ 4,838        | \$ 1,190       | \$ 3,648       |                | \$ 4,834        | \$ 167        | \$ 4,667       |                |
| Construction                            | 1,365           | 869                  | 496            |                | 1,197           | 633            | 564            |                | 1,281           | 531           | 750            |                |
| Real estate term                        | 565             | 143                  | 422            |                | 714             | 118            | 596            |                | 1,692           | 121           | 1,571          |                |
| Home equity lines and<br>other consumer | 50              | 1                    | 49             |                | 72              | 1              | 71             |                | 75              | 1             | 74             |                |
| Unallocated                             | 7,166           |                      |                | 7,166          | 7,225           |                |                | 7,225          | 6,545           |               |                | 6,545          |
| <b>Total</b>                            | <b>\$13,108</b> | <b>\$1,863</b>       | <b>\$4,079</b> | <b>\$7,166</b> | <b>\$14,046</b> | <b>\$1,942</b> | <b>\$4,879</b> | <b>\$7,225</b> | <b>\$14,427</b> | <b>\$820</b>  | <b>\$7,062</b> | <b>\$6,545</b> |

The Company reviewed the Allowance for the year ending December 31, 2009 and the quarters ending March 31, 2010 and June 30, 2010 both in total and by loan category using both the legacy methodology applied through June 30, 2010 and the enhanced methodology that will be applied starting with the quarter ending September 30, 2010. The most significant change in the Allowance using the enhanced methodology for each of these periods is a larger allocation to the real estate sector of the Company's loan portfolio. Additionally, the formula based allocations for the commercial, construction and home equity lines and other consumer mortgages also increase under the revised methodology. The reason for these changes arises from the fact that the Company did not calculate a specific allocation by loan segment for loans risk rated as watch or better under the legacy methodology. Rather, these loans were grouped into the unallocated segment of the Allowance calculation. The calculation of the unallocated portion of the Allowance under the legacy methodology was based on three year average historical loss rates as adjusted for qualitative factors. The enhanced methodology results in a different allocation of the segments of the Allowance but does not indicate that the overall Allowance was misstated. This is due to the fact that both methodologies utilize three year average historical loss rates, as adjusted for qualitative factors, to analyze the overall Allowance. The enhanced methodology simply refines the calculation to allocate the Allowance to the individual loan categories.

The provision for loan losses was \$417,000 and \$1.4 million for the three-month periods ending September 30, 2010 and 2009, respectively. Net charge offs were \$132,000 and \$1.1 million, respectively, for the quarters ending September 30, 2010 and 2009. The provision for loan losses was \$3.2 million and \$4.9 million for the nine-month periods ending September 30, 2010 and 2009, respectively. Net charge offs were \$1.6 million and \$4.3 million, respectively, year to date as of September 30, 2010 and 2009. At September 30, 2010, the Allowance was \$14.7 million, or 2.31% of total loans as compared to \$13.5 million, or 2.00% of total loans a year ago. The Company believes that a higher reserve is appropriate at September 30, 2010 to address the impact of the current economic environment on our loan portfolio. See analysis of Allowance in the Balance Sheet Overview section.

**Other Operating Income**

Other operating income for the third quarter of 2010 increased \$1.1 million as compared to the third quarter of 2009. The increase is primarily due to a \$1.1 million increase in OREO sales and rental income. As discussed in the Credit Quality and Nonperforming Assets section above, the Company recognized \$332,000 in gains on the sale of OREO properties sold in the third quarter of 2010 and also recognized \$830,000 in gains that had been previously deferred related to sales of OREO property that occurred in previous periods and that now meet the requirements for gain recognition. These gains had been deferred because the Company provided loans to facilitate the sales of these properties. \$422,000 of the current period gain related to one commercial property that was sold in 2007, and the remainder of the gains recognized in the current quarter were from the sale of ten condominiums and two lots sold in late 2009 and throughout the first half of 2010. The Company recognized \$201,000 in gains on the sale of OREO in

the third quarter of 2009. Additionally, the Company earned rental income of \$116,000 on OREO properties in the third quarter of 2010 as compared to \$5,000 in 2009. This increase is due to the transfer of a large condominium development into OREO in December 2009.

Other operating income for the nine months ending September 30, 2010 increased \$331,000 as compared to the same period in 2009. This increase is primarily due to a \$1.5 million increase in OREO sales and rental income. Gains on the sale of OREO properties for the nine-month periods ending September 30, 2010 and 2009 are \$1.4 million, and \$424,000, respectively, including the gains recognized in 2010 that had

- 28 -

---

**Table of Contents**

been previously deferred that were discussed above. Rental income on OREO properties for the nine-month periods ending September 30, 2010 and 2009 were \$487,000 and \$22,000, respectively. This increase is also the result of the transfer of the large condominium development into OREO in December 2009. The increase in OREO sales and rental income for the nine months ended September 30, 2010 was offset by a decrease in earnings from RML of \$1.3 million as compared to the same period in 2009. This decrease resulted from decreased refinance activity in the first nine months of 2010 as compared to the same period in 2009. Additionally, purchased receivable income decreased by \$312,000 for the nine months ended September 30, 2010 due to decreased average balances. This decrease was partially offset by a \$251,000 increase in gains on the sale of available-for-sale securities.

**Other Operating Expense**

Other operating expense for the third quarter of 2010 decreased \$885,000 as compared to the third quarter of 2009. This decrease was primarily due to decreases of \$718,000 and \$336,000, respectively, in penalties related to the prepayment of long term FHLB borrowings and salaries and other personnel expense. Salaries and other personnel expense decreased due to a \$159,000 decrease in deferred compensation expense as the Company's liability under this plan decreased due to market losses on plan assets and a \$130,000 decrease in salary costs due to a decrease in the Company's workforce.

Other operating expense for the nine months ending September 30, 2010 decreased \$1.6 million from the same period in 2009. This decrease was primarily due to decreases of \$784,000 and \$718,000, respectively, in insurance expense and penalties related to the prepayment of long term FHLB borrowings. Insurance expense decreased due to a \$757,000 decrease in FDIC insurance premiums that was primarily the result of the one time special assessment that the Company incurred in the second quarter of 2009 as well as a decrease in the rate assessed on the Company in 2010. Additionally, there was a \$33,000 decrease in Keyman insurance expense resulting from increases in the cash surrender value of assets held under the Company's Keyman insurance policies. Additionally, salaries and other personnel expenses decreased \$473,000 in the first nine months of 2010 as compared to 2009 as a result of a \$346,000 decrease in salaries due to a decrease in the Company's workforce and a \$143,000 decrease in incentive compensation expense. These decreases were partially offset set by a \$420,000 increase in purchased receivable losses. The Company experienced losses on two customer accounts year-to-date as of September 30, 2010 and did not experience losses during the same period in 2009.

**Income Taxes**

The provision for income taxes increased by \$819,000 and \$925,000 in the three and nine-month periods ending September 30, 2010 as compared to the same periods in 2009, primarily due to increased pre-tax income. The tax rates for the three and nine-month periods ending September 30, 2010 were 33% and 30%, respectively, compared to 28% for the same periods in 2009. For the third quarter of 2010 as compared to the third quarter of 2009, decreased tax exempt interest income on investments and decreased tax exempt market gains on the Company's Keyman insurance relative to the level of taxable income for the period resulted in a 5% increase in the tax rate for the third quarter of 2010. For the nine-month period ending September 30, 2010 as compared to the same period in 2009, decreased tax exempt interest income on investments and tax exempt market gains on the Company's Keyman insurance policies for the period as compared to modest nondeductible market losses in the same period in 2009 resulted in a 2% increase in the tax rate for the period. This increase in the tax rate for the third quarter exceeds the increase for the nine-month period ending September 30, 2010 as compared to the same periods in 2009 because of the significant increase in pre-tax income in the third quarter.

**FINANCIAL CONDITION****Balance Sheet Overview**

**Table of Contents***Investment Securities*

Investment securities at September 30, 2010 increased \$27.6 million, or 15%, from December 31, 2009, and increased \$60.8 million, or 39%, from September 30, 2009. The increase in investments from December 31, 2009 to September 30, 2010 was primarily due to the investment of the proceeds from the increase in deposits from the same period. The increase in investments as of September 30, 2010 from September 30, 2009 arose as loan balances decreased and proceeds from increasing deposits balances were placed into investments.

*Loans and Lending Activities*

Our loan products include short and medium-term commercial loans, commercial credit lines, construction and real estate loans, and consumer loans. From our inception, we have emphasized commercial, land development and home construction, and commercial real estate lending. This type of lending has provided us with market opportunities and higher net interest margins than other types of lending. However, it also involves greater risks, including greater exposure to changes in local economic conditions, than certain other types of lending.

Loans are the highest yielding component of our earning assets. Loans comprised 71% and 72% of total average earning assets for the three and nine-month periods ending September 30, 2010, compared to 78% and 80% of total average earning assets for the three and nine-month periods ending September 30, 2009. The yield on loans averaged 6.93% and 7.05% for the three and nine-month periods ending September 30, 2010, compared to 7.19% and 7.08% during the same periods in 2009. See the Net Interest Income section for further discussion of average balances and yields for the three and nine-month periods ending September 30, 2010 and 2009.

The loan portfolio decreased by \$38.7 million, or 6%, to \$635.5 million at September 30, 2010 from \$674.2 million at September 30, 2009 due to continued maturities in the construction portfolio and a lower level of commercial loans. The following table details the changes in loan balances by loan type:

|   | September 30, 2010 |                        | December 31, 2009     |                        | September 30, 2009 |                        |
|---|--------------------|------------------------|-----------------------|------------------------|--------------------|------------------------|
|   | Dollar<br>Amount   | Percent<br>of<br>Total | Dollar<br>Amount      | Percent<br>of<br>Total | Dollar<br>Amount   | Percent<br>of<br>Total |
|   |                    |                        |                       |                        |                    |                        |
|   |                    |                        | <i>(In Thousands)</i> |                        |                    |                        |
| Commercial                              | \$ 237,667         | 37%                    | \$ 248,195            | 38%                    | \$ 249,171         | 37%                    |
| Construction/development                | 50,979             | 8%                     | 62,573                | 10%                    | 82,160             | 12%                    |
| Commercial real estate                  | 305,808            | 48%                    | 301,816               | 46%                    | 298,828            | 44%                    |
| Home equity lines and other<br>consumer | 43,882             | 7%                     | 45,168                | 7%                     | 46,047             | 7%                     |
| Loans in process                        | 90                 | 0%                     | 85                    | 0%                     | 691                | 0%                     |
| Unearned loan fees, net                 | (2,951)            | 0%                     | (2,798)               | 0%                     | (2,706)            | 0%                     |
| Sub total                               | 635,475            | 100%                   | 655,039               | 100%                   | 674,191            | 100%                   |
| Loans held for sale                     | 20,082             |                        |                       |                        |                    |                        |
| Total loans                             | \$ 655,557         |                        | \$ 655,039            |                        | \$ 674,191         |                        |

Due to its efforts to capitalize on market opportunities, the Company expects its loan portfolio to increase in the last quarter of 2010 mainly in the commercial and commercial real estate areas.

**Table of Contents***Analysis of Allowance for Loan Losses*

The Company maintains an Allowance to reflect estimated inherent losses from its loan portfolio as of the balance sheet date. The Allowance is decreased by loan charge-offs and increased by loan recoveries and provisions for loan losses. At September 30, 2010, the Allowance was \$14.7 million, or 2.31% of loans as compared to \$13.5 million, or 2.00% of loans a year ago. As of and for the period ended September 30, 2010 the Company refined its method of estimating the Allowance.

In determining its total Allowance, the Company first estimates a specific allowance for impaired loans. Management determines the fair value of the majority of these loans based on the underlying collateral values. This analysis is based upon a specific analysis for each impaired loan, including appraisals on loans secured by real property, management's assessment of the current market, recent payment history and an evaluation of other sources of repayment. In-house evaluations of fair value are used in the impairment analysis in some situations. Inputs to the in-house evaluation process include information about sales of comparable properties in the appropriate markets and changes in tax assessed values. With regard to our appraisal process, the Company obtains appraisals on real and personal property that secure its loans during the loan origination process in accordance with regulatory guidance and its loan policy. The Company obtains updated appraisals on loans secured by real or personal property based upon its assessment of changes in the current market or particular projects or properties, information from other current appraisals, and other sources of information. Appraisals may be adjusted downward by the Company based on our evaluation of the facts and circumstances on a case by case basis. Appraisals may be discounted when management believes that the absorption period used in the appraisal is unrealistic, when expected liquidation costs exceed those included in the appraisal, or when management's evaluation of deteriorating market conditions warrants an adjustment. Additionally, the Company may also adjust appraisals in the above circumstances between appraisal dates at its discretion. For collateral dependant loans, the Company uses the information provided in these updated appraisals along with its evaluation of all other information available on a particular property as it assesses the collateral coverage on its performing and nonperforming loans and the impact that may have on the adequacy of its Allowance. The specific allowance for impaired loans, as well as the overall Allowance, may increase or decrease based on the Company's assessment of updated appraisals as well as changes in the borrowers' financial condition.

When the Company determines that a loss has occurred on an impaired loan, a charge-off equal to the difference between carrying value and fair value is recorded. If a specific allowance is deemed necessary for a loan, and that loan is partially charged off, the loan remains classified as a nonperforming loan after the charge-off is recorded. Loans measured for impairment based on the underlying collateral value and all other loans measured for impairment are accounted for in the same way. The ratio of nonperforming loans for which there has been charge offs compared to total nonperforming loans as of September 30, 2010 was 14% compared to 18% at December 31, 2009 and 12% as of September 30, 2009.

The specific allowance on impaired loans at September 30, 2010, was \$874,000, or 4% of total loans that are specifically measured for impairment compared to \$1.9 million, or 12%, and \$2.2 million, or 4%, of total loans that were specifically measured for impairment at December 31, 2009 and September 30, 2009, respectively.

After the Company determines the specific allowance for impaired loans, the Company then estimates a general allocated allowance for all other loans that were not impaired as of the balance sheet date using a formula-based approach that includes average historical loss factors that are adjusted for qualitative factors. First, the Company disaggregates the unimpaired loan portfolio into segments and classes. As of September 30, 2010, the Company has identified the following loan segments: commercial loans, real estate term loans, construction loans, and consumer loans. Then, the Company disaggregates loan segments into classes. As of September 30, 2010, the Company has identified the internal risk codes as the only classes of loans. These classes include loans classified as excellent, good, satisfactory, watch, special mention, substandard, doubtful and loss.

A loan class is created in the Allowance calculation when that group of loans components constitute a significant concentration as a percentage of the Company's capital, when current market or economic conditions point to increased scrutiny, or when historical or recent experience suggests that additional



**Table of Contents**

attention is warranted in the analysis process. The Company has \$51 million in construction loans at September 30, 2010, and \$18.1 million of those loans have interest reserves as of September 30, 2010. Management does not consider construction loans with interest reserves to be a material class within the loan portfolio for purposes of the Allowance calculation.

The Company calculates an average historical loss rate for each segment and class of loans as of each reporting period. As of September 30, 2010, the Company has determined that a three year look-back period is appropriate given the current economic environment. Lastly, the Company determines a qualitative adjustment for each historical loss factor based on management's assessment of current internal and external factors that affect the overall expected losses inherent in each segment and class of the portfolio.

Finally, the Company assesses the overall adequacy of the Allowance based on several factors including the level of the Allowance as compared to total loans and nonperforming loans in light of current economic conditions. This portion of the Allowance is deemed unallocated because it is not allocated to any segment or class of the loan portfolio. This portion of the Allowance provides for coverage of credit losses inherent in the loan portfolio but not captured in the credit loss factors that are utilized in the risk rating-based component, or in the specific impairment component of the Allowance, and acknowledges the inherent imprecision of all loss prediction models.

The unallocated portion of the Allowance is based upon management's evaluation of various factors that are not directly measured in the determination of the allocated portions of the Allowance. Such factors include uncertainties in identifying triggering events that directly correlate to subsequent loss rates, uncertainties in economic conditions, risk factors that have not yet manifested themselves in loss allocation factors, and historical loss experience data that may not precisely correspond to the current portfolio. In addition, the unallocated reserve may be further adjusted based upon the direction of various risk indicators. Examples of such factors include the risk as to current and prospective economic conditions, the level and trend of charge offs or recoveries, and the risk of heightened imprecision or inconsistency of appraisals used in estimating real estate values. Although this allocation process may not accurately predict credit losses by loan type or in the aggregate, the total allowance for credit losses is available to absorb losses that may arise from any loan type or category. Due to the subjectivity involved in the determination of the unallocated portion of the Allowance, the relationship of the unallocated component to the total Allowance may fluctuate from period to period.

At September 30, 2010, the unallocated allowance as a percentage of the total Allowance was 14%. The Company performed a retrospective review of the Allowance using the new methodology for the periods ending December 31, 2009, March 31, 2010 and June 30, 2010 and determined that the unallocated allowance as a percentage of the total Allowance was 21%, 21% and 10%, respectively. The unallocated allowance as a percentage of the total Allowance using the legacy methodology was 45%, 55%, 51% and 45% for the periods ending September 30, 2009, December 31, 2009, March 31, 2010 and June 30, 2010.

*Deposits*

Deposits are the Company's primary source of funds. Total deposits increased \$25.6 million at September 30, 2010, from December 31, 2009, and increased \$41.6 million from September 30, 2009. The Company's deposits generally are expected to fluctuate according to the level of the Company's market share, economic conditions, and normal seasonal trends. The Company continues to market its High Performance Checking products and expects increases in the number of deposit accounts and the balances associated with them in 2010. There were no depositors with deposits representing 10% or more of total deposits at September 30, 2010, December 31, 2009, or September 30, 2009.

To provide customer assurances, the Company is participating in the FDIC's Transaction Account Guarantee Program (TAGP) that provides 100% guarantee of noninterest-bearing checking accounts, including NOW accounts paying less than 0.25%. The TAGP has recently been extended to January 1, 2013. Additionally, under recent changes from the FDIC, all interest-bearing deposit accounts are insured up to \$250,000. The increase in basic FDIC insurance coverage from \$100,000 to \$250,000

**Table of Contents**

was previously in effect through December 31, 2013, but in July 2010 the coverage limit was permanently increased.

*Borrowings*

At September 30, 2010, the Company's maximum borrowing line from the FHLB was \$112.7 million, approximately 11% of the Company's assets. FHLB advances are dependent on the availability of acceptable collateral such as marketable securities or real estate loans, although all FHLB advances are secured by a blanket pledge of the Company's assets. At September 30, 2010, December 31, 2009 and September 30, 2009, the Company had no outstanding balances on the borrowing line. The decrease in the outstanding balance of the line at September 30, 2010, December 31, 2009 and September 30, 2009 as compared to June 30, 2009 was the result of the early pay off of \$9.9 million in advances in September 2009. The advances had an average remaining life of over 8 years. A resulting \$718,000 prepayment penalty reduced earnings per diluted share for the third quarter of 2009 by \$0.07 and is expected to save as much as \$0.05 per diluted share in 2010 and additional amounts in future years.

The Company purchased its main office facility for \$12.9 million on July 1, 2008. In this transaction, the Company, through Northrim Building LLC, assumed an existing loan secured by the building in an amount of \$5.1 million. At September 30, 2010, December 31, 2009 and September 30, 2009, the outstanding balance on this loan was \$4.8 million, \$4.9 million and \$4.9 million, respectively. This loan has a maturity date of April 1, 2014 and a fixed interest rate of 5.95%.

In addition to the borrowings for the building, the Company had \$707,000 in other borrowings outstanding at September 30, 2010, as compared to \$690,000 and \$720,000, respectively, in other borrowings outstanding at December 31, 2009 and September 30, 2009. Other borrowings during each of these periods consisted of short-term borrowings from the Federal Reserve Bank for Treasury tax deposits.

At September 30, 2010, December 31, 2009 and September 30, 2009, the Company had no short-term (original maturity of one year or less) borrowings that exceeded 30% of shareholders' equity.

**Liquidity and Capital Resources**

The Company manages its liquidity through its Asset and Liability Committee. In addition to the \$83.3 million of cash and cash equivalents and \$185.6 million in unpledged available for sale securities held at September 30, 2010, the Company had additional funding sources which include fed fund borrowing lines and advances available at the Federal Home Loan Bank of Seattle and the Federal Reserve Bank of approximately \$93.5 million as of September 30, 2010.

At September 30, 2010, \$19.7 million in securities, or 9%, of the investment portfolio was pledged, as compared to \$17.7 million, or 9%, at December 31, 2009, and \$52.1 million, or 34%, at September 30, 2009. The changes in pledged securities are due to the fact that as of September 30, 2010 and December 31, 2009, the Company did not have any securities pledged to collateralize Alaska Permanent Fund certificates of deposit. At September 30, 2009, the Company had pledged \$36.6 million to collateralize Alaska Permanent Fund certificates of deposit.

As shown in the Consolidated Statements of Cash Flows, net cash used by operating activities was \$4.5 million for the nine months ended September 30, 2010. The use of cash by operating activities was primarily for purchases of \$43.6 million in loans held for sale, net of loans sold of \$23.5 million during the period for a net cash outflow of \$20.1 million. This outflow of cash was partially offset by positive net income, after excluding non-cash charges such as the provision for loan losses of \$3.2 million. Net cash of \$5.5 million was used in investing activities. This net outflow consisted primarily of \$27.2 million in net purchases of investment securities and was partially offset by \$15.9 million in loan paydowns, net of advances and \$9.2 million in proceeds from the sale of OREO properties. The \$26.6 million of cash provided by financing activities primarily consisted of the \$25.6 million increase in deposits during the nine-month period ended September 30, 2010.

**Table of Contents**

The Company issued 22,874 shares through the exercise of stock options in the third quarter of 2010 and did not repurchase any shares of its common stock under the Company's publicly announced repurchase program. At September 30, 2010, the Company had approximately 6.4 million shares of its common stock outstanding.

*Capital Requirements and Ratios*

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum regulatory capital requirements can result in certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material adverse effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and Northrim Bank (the "Bank") must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by regulators about the components of regulatory capital, risk weightings, and other factors. The regulatory agencies may establish higher minimum requirements if, for example, a bank or bank holding company has previously received special attention or has a high susceptibility to interest rate risk.

The requirements address both risk-based capital and leverage capital. At September 30, 2010, the Company and the Bank met all applicable regulatory capital adequacy requirements for a well-capitalized institution.

The FDIC has in place qualifications for banks to be classified as well-capitalized. As of September 15, 2010, the most recent notification from the FDIC categorized the Bank as well-capitalized. There have been no conditions or events known to us since the FDIC notification that have changed the Bank's classification.

The following table illustrates the actual capital ratios for the Company and the Bank as calculated under regulatory guidelines, compared to the regulatory minimum capital ratios and the regulatory minimum capital ratios needed to qualify as a well-capitalized institution as of September 30, 2010.

|                           | Adequately-<br>Capitalized | Well-<br>Capitalized | Actual<br>Ratio<br>BHC | Actual<br>Ratio<br>Bank |
|---------------------------|----------------------------|----------------------|------------------------|-------------------------|
| Tier 1 risk-based capital | 4.00%                      | 6.00%                | 14.46%                 | 13.47%                  |
| Total risk-based capital  | 8.00%                      | 10.00%               | 15.72%                 | 14.72%                  |
| Leverage ratio            | 4.00%                      | 5.00%                | 12.48%                 | 11.63%                  |

The regulatory capital ratios for the Company exceed those for the Bank primarily because the \$18.6 million junior subordinated debenture offerings that the Company completed in the third quarter of 2003 and the fourth quarter of 2005 are included in the Company's capital for regulatory purposes although such securities are accounted for as a long-term debt in its financial statements. The junior subordinated debentures are not accounted for on the Bank's financial statements nor are they included in its capital. As a result, the Company has \$18.6 million more in regulatory capital than the Bank, which explains the significant difference in the capital ratios for the two entities.

**Off-Balance Sheet Items**

The Company is a party to financial instruments with off-balance sheet risk. Among the off-balance sheet items entered into in the ordinary course of business are commitments to extend credit and the issuance of letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized on the balance sheet. Certain commitments are collateralized. As of September 30, 2010, December 31, 2009 and September 30, 2009, the Company's commitments to extend credit and to provide letters of credit amounted to \$206.5 million, \$183.6 million,

**Table of Contents**

and \$188.4, respectively. Since many of the commitments are expected to expire without being drawn upon, these total commitment amounts do not necessarily represent future cash requirements.

**Capital Expenditures and Commitments**

The Company has no capital commitments as of September 30, 2010.

**ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Interest rate and credit risks are the most significant market risks which affect the Company's performance. The Company relies on loan review, prudent loan underwriting standards, and an adequate allowance for credit losses to mitigate credit risk.

The Company utilizes a simulation model to monitor and manage interest rate risk within parameters established by its internal policy. The model projects the impact of a 100 basis point increase and a 100 basis point decrease, from prevailing interest rates, on the balance sheet for a period of 12 months.

The Company is liability sensitive, meaning that interest-bearing liabilities mature or reprice more quickly than interest-earning assets. Therefore, an increase in market rates of interest could negatively impact net interest income. Conversely, a declining interest rate environment may positively impact net interest income.

Generalized assumptions are made on how investment securities, classes of loans, and various deposit products might respond to interest rate changes. These assumptions are inherently uncertain, and as a result, the model cannot precisely estimate net interest income nor precisely predict the impact of higher or lower interest rates on net interest income. Actual results may differ materially from simulated results due to factors such as timing, magnitude, and frequency of rate changes, customer reaction to rate changes, competitive response, changes in market conditions, the absolute level of interest rates, and management strategies, among other factors.

The results of the simulation model at September 30, 2010, indicate that, if interest rates immediately increased by 100 basis points, the Company would experience a decrease in net interest income of approximately \$453,000 over the next 12 months. Similarly, the simulation model indicates that, if interest rates immediately decreased by 100 basis points, the Company would experience an increase in net interest income of approximately \$610,000 over the next 12 months. While we believe that these results are reasonable for a liability sensitive company, we also believe that they are magnified due to current loan pricing with floors on interest rates that limit the negative effect of a decrease in interest rates. These floors also decrease the positive impact of an increase in interest rates as many loans are priced above their floors.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Our principal executive and financial officers supervised and participated in this evaluation. Based on this evaluation, our principal executive and financial officers each concluded that as of September 30, 2010, the disclosure controls and procedures are effective in timely alerting them to material information required to be included in the periodic reports to the Securities and Exchange Commission. The design of any system of controls is based in part upon various assumptions about the likelihood of future events, and there can be no assurance that any of our plans, products, services or procedures will succeed in achieving their intended goals under future conditions.

**Table of Contents**

**Changes in Internal Control over Disclosure and Reporting**

There was no change in our internal control over financial reporting that occurred during the quarterly period ended September 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

During the normal course of its business, the Company is a party to various debtor-creditor legal actions, which individually or in the aggregate, could be material to the Company's business, operations, or financial condition. These include cases filed as a plaintiff in collection and foreclosure cases, and the enforcement of creditors' rights in bankruptcy proceedings.

**ITEM 1A. RISK FACTORS**

For information regarding risk factors, please refer to Item 1A in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. These risk factors have not materially changed as of September 30, 2010.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

(a)-(b) Not applicable

(c) There were no stock repurchases by the Company during the third quarter of 2010.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. REMOVED AND RESERVED**

**ITEM 5. OTHER INFORMATION**

(a) Not applicable

(b) There have been no material changes to the procedures by which shareholders may nominate directors to the Company's board.

**ITEM 6. EXHIBITS**

31.1 Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a)

31.2 Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a)

32.1 Certification of Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350

32.2 Certification of Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350

**Table of Contents**

**SIGNATURES**

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

NORTHRIM BANCORP, INC.

November 8, 2010

By /s/ R. Marc Langland  
R. Marc Langland  
Chairman, President, and CEO  
(Principal Executive Officer)

November 8, 2010

By /s/ Joseph M Schierhorn  
Joseph M. Schierhorn  
Executive Vice President, Chief  
Financial Officer (Principal Financial  
and Accounting Officer)

- 37 -