CVB FINANCIAL CORP
Form 10-Q
November 10, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

or

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

For the transition period from __________ to __________

Commission File Number: 0-10140

CVB FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

California **(State or other jurisdiction of** **Incorporation or organization)**	**95-3629339** **(I.R.S. Employer** **Identification No.)**
701 North Haven Ave., Suite 350 **Ontario, California** **(Address of principal executive offices)**	**91764** **(Zip Code)**

(909) 980-4030

(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 x 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company ¨

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

Number of shares of common stock of the registrant: 105,824,853 outstanding as of October 30, 2014.

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PART I FINANCIAL INFORMATION (UNAUDITED)

GENERAL

Forward Looking Statements

Certain statements in this Report on Form 10-Q, including, but not limited to, statements under the heading Management Discussion and Analysis of Financial Condition and Results of Operations constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995, including but not limited to, statements about anticipated future operating and financial performance and results, financial position and liquidity, business prospects, strategic alternatives, business strategies, regulatory policies, competitive outlook, capital and financing needs and availability, acquisition and divestiture opportunities, investment and expenditure plans, plans and objectives of management for future operations, management hiring and retention and other similar forecasts and statements of expectations of assumptions underlying any of the foregoing. Words such as will likely result, aims , anticipates , believes , could , estimates , expects , hopes , intends , may , plans , projects , seeks , should , will words and similar expressions are intended to identify these forward looking statements, which involve risks and uncertainties. Our actual results may differ significantly from the results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, local, regional, national and international economic and market conditions and events and the impact they may have on us and our customers; our ability to attract and maintain deposits, borrowings and other sources of funding or liquidity; supply of property inventory and renewed fluctuation or deterioration in values of real estate in California or other jurisdictions where we lend, whether involving residential or commercial property; a prolonged slowdown or decline in sales or construction activity; changes in the financial performance and/or condition of our loan and deposit customers or key vendors or counterparties; changes in the levels of performing and nonperforming assets and charge-offs; the cost or effect of acquisitions or divestitures we may make; the effect of changes in laws and regulations (including laws, regulations and judicial decisions concerning financial reform, taxes, bank or holding company capital levels, securities, employment, executive compensation, insurance, compliance, vendor management and information security) with which we and our subsidiaries must comply; changes in the applicability or costs of deposit insurance; changes in estimates of future reserve requirements and minimum capital requirements based upon the periodic review thereof under relevant legal, regulatory and accounting requirements; inflation, interest rate, securities market and monetary fluctuations; internal and external fraud and cyber-security threats, including theft or loss of Company or customer funds, loss of system functionality or access, or theft or loss of Company or customer information; political instability; acts of war or terrorism, or natural disasters, such as earthquakes, or the effects of pandemic diseases; the timely development and acceptance of new banking products and services (including technology-based services and products) and the perceived overall value of these products and services by customers and potential customers; the Company s relationships with and reliance upon vendors with respect to the operation of certain of the Company key internal or external systems and applications; changes in consumer spending, borrowing and savings preferences or habits; the effects of technological changes, the expanding use of technology in banking (including the adoption of mobile banking applications) and product innovation; the ability to retain or increase market share, retain or grow customers and control expenses; changes in the risk or competitive environment among financial and bank holding companies, banks and other financial service providers; continued volatility in the credit and equity markets and its effects on the general economy or local or regional business conditions; the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as by the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other national or international accounting standard setters; changes in our organization, management, compensation and benefit plans, and our ability to retain or expand our management team and our board of directors; the costs and effects of legal, regulatory and compliance changes or developments; the favorable or unfavorable resolution of legal proceedings or regulatory or other governmental inquiries, including, but not limited to, the current investigation by the Securities and Exchange Commission and the related class-action and derivative action lawsuits filed against us; and the results of regulatory examinations or reviews or other government actions. The Company cautions that the foregoing factors are not exclusive. For additional information concerning these factors and other factors which may cause actual results to differ from the results discussed in our forward-looking statements, see the periodic filings the Company makes with the Securities and Exchange Commission, and, in particular, the information set forth in Item 1A herein and in Item 1A. Risk Factors contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2013. The Company does not undertake, and specifically disclaims, any obligation to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements except as required by law.

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ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

CVB FINANCIAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data)

(Unaudited)

	September 30, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$ 106,002	$ 88,776
Interest-earning balances due from Federal Reserve	134,054	5,917
Total cash and cash equivalents	240,056	94,693
Interest-earning balances due from depository institutions	18,314	70,000
Investment securities available-for-sale, at fair value (with amortized cost of $3,128,869 at September 30, 2014, and $2,679,727 at December 31, 2013)	3,160,056	2,663,642
Investment securities held-to-maturity	1,598	1,777
Investment in stock of Federal Home Loan Bank (FHLB)	25,338	32,331
Non-covered loans held-for-sale		3,667
Loans and lease finance receivables, excluding covered loans	3,573,885	3,385,916
Allowance for loan losses	(59,582)	(75,235)
Net loans and lease finance receivables	3,514,303	3,310,681
Covered loans and lease finance receivables, net	132,351	160,315
Premises and equipment, net	34,609	32,831
Bank owned life insurance	126,369	123,168
Accrued interest receivable	23,459	22,051
Intangibles	3,570	2,261
Goodwill	74,244	55,097
FDIC loss sharing asset	331	4,764
Non-covered other real estate owned	6,225	6,475
Covered other real estate owned	590	504
Income taxes	40,324	59,786
Other assets	21,112	20,924
TOTAL ASSETS	$ 7,422,849	$ 6,664,967
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Deposits:		

Noninterest-bearing	$ 3,037,103	$ 2,562,980
Interest-bearing	2,722,190	2,327,651
Total deposits	5,759,293	4,890,631
Customer repurchase agreements	528,824	643,251
FHLB advances	199,410	199,206
Other borrowings		69,000
Accrued interest payable	1,120	1,111
Deferred compensation	10,175	9,449
Junior subordinated debentures	25,774	25,774
Payable for securities purchased	643	3,533
Other liabilities	48,379	51,125
TOTAL LIABILITIES	6,573,618	5,893,080
COMMITMENTS AND CONTINGENCIES		
Stockholders Equity:		
Common stock, authorized, 225,000,000 shares without par; issued and outstanding 105,796,853 at September 30, 2014 and 105,370,170 at December 31, 2013.	494,323	491,068
Retained earnings	336,820	290,149
Accumulated other comprehensive income, net of tax	18,088	(9,330)
Total stockholders equity	849,231	771,887
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 7,422,849	$ 6,664,967

See accompanying notes to the unaudited condensed consolidated financial statements.

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CVB FINANCIAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME

(Dollars in thousands, except per share amounts)

(Unaudited)

	For the Three Months Ended September 30, 2014	2013	For the Nine Months Ended September 30, 2014	2013
Interest income:				
Loans and leases, including fees	$ 45,551	$ 41,706	$ 130,591	$ 124,879
Accretion on acquired covered loans	1,372	2,947	4,546	10,796
Loans, including fees	46,923	44,653	135,137	135,675
Investment securities:				
Taxable	12,460	7,102	34,425	19,280
Tax-advantaged	5,227	5,517	15,691	16,569
Total investment income	17,687	12,619	50,116	35,849
Dividends from FHLB stock	518	622	1,648	1,432
Federal funds sold	112	58	363	158
Interest-earning deposits with other institutions	55	122	309	366
Total interest income	65,295	58,074	187,573	173,480
Interest expense:				
Deposits	1,228	1,228	3,636	3,627
Borrowings	2,724	2,768	8,283	8,184
Junior subordinated debentures	105	105	315	512
Total interest expense	4,057	4,101	12,234	12,323
Net interest income before provision for loan losses	61,238	53,973	175,339	161,157
Provision for loan losses	(1,000)	(3,750)	(16,100)	(9,950)
Net interest income after provision for loan losses	62,238	57,723	191,439	171,107
Noninterest income:				
Service charges on deposit accounts	4,065	4,011	11,798	11,982
Trust and investment services	2,045	2,021	6,103	6,098
Bankcard services	868	920	2,569	2,697
BOLI income	613	497	1,852	1,867
Gain on sale of loans held-for-sale			5,330	
Gain on sale of securities, net				2,094

Decrease in FDIC loss sharing asset, net	(479)	(3,248)	(3,653)	(10,715)
Gain (loss) on OREO, net	127	(3)	262	3,129
Other	770	759	2,296	2,245
Total noninterest income	8,009	4,957	26,557	19,397
Noninterest expense:				
Salaries and employee benefits	19,366	18,389	57,170	52,777
Occupancy and equipment	4,147	3,641	11,548	10,888
Professional services	2,080	1,316	5,090	4,299
Software licenses and maintenance	1,324	1,077	3,399	3,392
Promotion	1,349	1,105	3,956	3,503
Provision for unfunded loan commitments	(1,250)	500	(1,250)	500
Amortization of intangible assets	466	127	781	1,002
OREO expense	102	21	240	384
Insurance reimbursements	(24)	(4,139)	(42)	(4,139)
Acquisition related expenses	640		1,932	
Other	4,281	3,677	12,138	12,154
Total noninterest expense	32,481	25,714	94,962	84,760
Earnings before income taxes	37,766	36,966	123,034	105,744
Income taxes	13,471	12,727	44,594	35,424
Net earnings	$ 24,295	$ 24,239	$ 78,440	$ 70,320
Other comprehensive (loss) income:				
Unrealized (loss) gain on securities arising during the period	$ (10,291)	$ 421	$ 47,272	$ (65,129)
Less: Reclassification adjustment for net gain on securities included in net income				(2,094)
Other comprehensive (loss) income, before tax	(10,291)	421	47,272	(67,223)
Less: Income tax benefit (expense) related to items of other comprehensive (loss) income	4,322	(176)	(19,854)	28,234
Other comprehensive (loss) income, net of tax	(5,969)	245	27,418	(38,989)
Comprehensive income	$ 18,326	$ 24,484	$ 105,858	$ 31,331
Basic earnings per common share	$ 0.23	$ 0.23	$ 0.74	$ 0.67
Diluted earnings per common share	$ 0.23	$ 0.23	$ 0.74	$ 0.67
Cash dividends declared per common share	$ 0.10	$ 0.10	$ 0.30	$ 0.285

See accompanying notes to the unaudited condensed consolidated financial statements.

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CVB FINANCIAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

Nine months ended September 30, 2014 and 2013

(Dollars and shares in thousands)

(Unaudited)

	Common Shares Outstanding	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance January 1, 2013	104,890	$ 484,709	$ 235,010	$ 43,251	$ 762,970
Repurchase of common stock	(36)	(459)			(459)
Exercise of stock options	259	2,651			2,651
Tax benefit from exercise of stock options		215			215
Shares issued pursuant to stock-based compensation plan	97	1,439			1,439
Cash dividends declared on Common ($0.285 per share)			(29,925)		(29,925)
Net earnings			70,320		70,320
Other comprehensive income				(38,989)	(38,989)
Balance September 30, 2013	105,210	$ 488,555	$ 275,405	$ 4,262	$ 768,222
Balance January 1, 2014	105,370	$ 491,068	$ 290,149	$ (9,330)	$ 771,887
Repurchase of common stock	(377)	(5,383)			(5,383)
Exercise of stock options	498	5,378			5,378
Tax benefit from exercise of stock options		983			983
Shares issued pursuant to stock-based compensation plan	306	2,277			2,277
Cash dividends declared on Common ($0.30 per share)			(31,769)		(31,769)
Net earnings			78,440		78,440
Other comprehensive income				27,418	27,418
Balance September 30, 2014	105,797	$ 494,323	$ 336,820	$ 18,088	$ 849,231

See accompanying notes to the unaudited condensed consolidated financial statements.

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CVB FINANCIAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	For the Nine Months Ended September 30, 2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Interest and dividends received	$ 193,605	$ 181,608
Service charges and other fees received	22,653	23,103
Interest paid	(12,120)	(12,506)
Net cash paid to vendors and employees	(92,766)	(69,441)
Income taxes paid	(44,000)	(50,200)
(Payments to) proceeds from FDIC loss share agreement	(1,186)	239
Net cash provided by operating activities	66,186	72,803
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from redemption of FHLB stock	10,413	17,231
Proceeds from maturity of interest-earning balances from depository institutions	62,491	
Proceeds from sale of investment securities	14,271	99,155
Proceeds from repayment of investment securities	238,495	344,660
Proceeds from maturity of investment securities	63,216	62,175
Purchases of investment securities	(738,882)	(759,609)
Net decrease in loan and lease finance receivables	101,432	13,375
Proceeds from sales of premises and equipment	663	9
Purchase of premises and equipment	(1,668)	(2,080)
Proceeds from sales of other real estate owned	2,588	12,922
Cash acquired on purchase of American Security Bank, net of cash paid	50,038	
Net cash used in investing activities	(196,943)	(212,162)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in transaction deposits	492,720	147,349
Net decrease in time deposits	(2,433)	(25,850)
Repayment of junior subordinated debentures		(41,238)
Net decrease in other borrowings	(69,000)	16,482
Net (decrease) increase in customer repurchase agreements	(114,427)	92,639
Cash dividends on common stock	(31,718)	(19,419)
Repurchase of common stock	(5,383)	(459)
Proceeds from exercise of stock options	5,378	2,651
Tax benefit related to exercise of stock options	983	215

Net cash provided by financing activities	276,120	172,370
NET INCREASE IN CASH AND CASH EQUIVALENTS	145,363	33,011
CASH AND CASH EQUIVALENTS, beginning of period	94,693	98,431
CASH AND CASH EQUIVALENTS, end of period	$ 240,056	$ 131 ,442

See accompanying notes to the unaudited condensed consolidated financial statements.

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CVB FINANCIAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Dollars in thousands)

(Unaudited)

	For the Nine Months Ended September 30, 2014	For the Nine Months Ended September 30, 2013
RECONCILIATION OF NET EARNINGS TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Net earnings	$ 78,440	$ 70,320
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Gain on sale of loans held-for-sale	(5,330)	
Gain on sale of investment securities		(2,094)
Loss on sale of premises and equipment, net	68	2
Gain on sale of other real estate owned	(222)	(3,048)
Amortization of capitalized prepayment penalty on borrowings	204	204
Increase in bank owned life insurance	(1,757)	(1,805)
Net amortization of premiums and discounts on investment securities	15,515	20,770
Accretion of SJB discount	(4,546)	(10,796)
Provision for loan losses	(16,100)	(9,950)
Provision for unfunded loan commitments	(1,250)	500
Valuation adjustment on other real estate owned	65	87
Change in FDIC loss share asset	3,653	10,715
(Payments to) proceeds from FDIC loss share agreement	(1,186)	239
Stock-based compensation	2,277	1,439
Depreciation and amortization, net	488	2,029
Change in accrued interest receivable	(684)	495
Change in accrued interest payable	(36)	(387)
Change in other assets and liabilities	(3,413)	(5,917)
Total adjustments	(12,254)	2,483
Net cash provided by operating activities	$ 66,186	$ 72,803
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES		
Securities purchased and not settled	$ 643	$
Transfer of loans to other real estate owned	$ 640	$ 1,492

See accompanying notes to the unaudited condensed consolidated financial statements.

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CVB FINANCIAL CORP. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BUSINESS

The condensed consolidated financial statements include the accounts of CVB Financial Corp. (referred to herein on an unconsolidated basis as CVB and on a consolidated basis as we, our or the Company) and its wholly owned subsidiaries: Citizens Business Bank (the Bank or CBB) after elimination of all intercompany transactions and balances. The Company has one inactive subsidiary, Chino Valley Bancorp. The Company is also the common stockholder of CVB Statutory Trust III. CVB Statutory Trust III was created in January 2006 to issue trust preferred securities in order to raise capital for the Company. In accordance with ASC 810 Consolidation (previously Financial Accounting Standards Board (FASB) Interpretation No. 46R Consolidation of Variable Interest Entities), this trust does not meet the criteria for consolidation.

The Company s primary operations are related to traditional banking activities, including the acceptance of deposits and the lending and investing of money through the operations of the Bank. The Bank also provides automobile and equipment leasing to customers through its Citizens Financial Services Group and trust and investment-related services to customers through its CitizensTrust Division. The Bank s customers consist primarily of small to mid-sized businesses and individuals located in San Bernardino County, Riverside County, Los Angeles County, Orange County, San Diego County, Madera County, Fresno County, Tulare County and Kern County, California. The Bank operates 40 Business Financial Centers, six Commercial Banking Centers, and three trust office locations. The Company is headquartered in the city of Ontario, California.

On May 15, 2014, we announced the completion of our acquisition of American Security Bank (ASB), a Newport Beach, CA headquartered regional bank with approximately $433 million in total assets and five branch locations throughout Orange County, San Bernardino County, and Los Angeles County. Our condensed consolidated financial statements for 2014 include ASB operations, post-merger. In the latter half of the third quarter of 2014, we converted the ASB core operating system into the CBB application infrastructure, consolidated two branch locations, and closed two electronic banking vestibules. See Note 4 Business Combinations, included herein.

2. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements and notes thereto have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) for Form 10-Q and conform to practices within the banking industry and include all of the information and disclosures required by accounting principles generally accepted in the United States of America (GAAP) for interim financial reporting. The accompanying unaudited condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments), which are necessary for a fair presentation of financial results for the interim periods presented. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results for the full year. Certain information and note disclosures normally included in annual financial statements prepared in accordance with GAAP have been condensed or omitted. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements, accounting policies and financial notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2013, filed with the Securities and Exchange Commission. A summary of the significant accounting policies consistently applied in the preparation of the accompanying unaudited condensed consolidated financial statements follows.

Reclassification Certain amounts in the prior periods condensed consolidated financial statements and related footnote disclosures have been reclassified to conform to the current presentation with no impact on previously reported net income or stockholders equity.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Investment Securities The Company classifies as held-to-maturity those debt securities that the Company has the positive intent and ability to hold to maturity. Securities classified as trading are those securities that are bought and held principally for the purpose of selling them in the near term. All other debt and equity securities are classified as available-for-sale. Securities held-to-maturity are accounted for at cost and adjusted for amortization of premiums and accretion of discounts. Trading securities are accounted for at fair value with the unrealized gains and losses being included in current earnings. Available-for-sale securities are accounted for at fair value, with the net unrealized gains and losses, net of income tax effects, presented as a separate component of stockholders equity. Realized gains and losses on sales of securities are recognized in earnings at the time of sale and are determined on a specific-identification basis. Purchase premiums and discounts are recognized in interest income using the effective-yield method over the terms of the securities. For mortgage-backed securities (MBS), the amortization or accretion is based on estimated average lives of the securities. The lives of these securities can fluctuate based on the amount of prepayments received on the underlying collateral of the securities. The Company s investment in the Federal Home Loan Bank of San Francisco (FHLB) stock is carried at cost.

At each reporting date, securities are assessed to determine whether there is an other-than-temporary impairment (OTTI). Other-than-temporary impairment on investment securities is recognized in earnings when there are credit losses on a debt security for which management does not intend to sell and for which it is more-likely-than-not that the Company will not have to sell prior to recovery of the noncredit impairment. In those situations, the portion of the total impairment that is attributable to the credit loss would be recognized in earnings, and the remaining difference between the debt security s amortized cost and its fair value would be included in other comprehensive income.

Loans and Lease Finance Receivables Non-covered loans and lease finance receivables that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, less deferred net loan origination fees and purchase price discounts. In the ordinary course of business, the Company enters into commitments to extend credit to its customers. To the extent that such commitments are unfunded, the related unfunded amounts are not reflected in the accompanying condensed consolidated financial statements.

The Company receives collateral to support loans, lease finance receivables, and commitments to extend credit for which collateral is deemed necessary. The most significant categories of collateral are real estate, principally commercial and industrial income-producing properties, real estate mortgages, and assets utilized in dairy & livestock and agribusiness, and various personal property assets utilized in commercial and industrial business governed by the Uniform Commercial Code.

Nonrefundable fees and direct costs associated with the origination or purchase of non-covered loans are deferred and netted against outstanding loan balances. The deferred net loan fees and costs and purchase price discounts are recognized in interest income over the loan term using the effective-yield method.

Interest on non-covered loans and lease finance receivables is credited to income based on the principal amounts of such loans or receivables outstanding. Non-covered loans are considered delinquent when principal or interest payments are past due 30 days or more and generally remain on accrual status between 30 and 89 days past due. Interest income is not recognized on non-covered loans and lease finance receivables when collection of interest is deemed by management to be doubtful. Non-covered loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. In general, the accrual of interest on non-covered loans is discontinued when the loan becomes 90 days past due, or when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors considered in determining that the full collection of principal and interest is no longer probable include cash flow and liquidity of the borrower or property, the financial position of the guarantors and their willingness to support the loan as well as other factors, and this determination involves significant judgment. When an asset is placed on nonaccrual status, previously accrued but unpaid interest is reversed against income. Subsequent collections of cash are applied as reductions to the principal balance unless the loan is returned to accrual status. Interest is not recognized using a cash-basis method. Nonaccrual loans may be restored to accrual status when principal and interest become current and when the borrower is able to demonstrate payment performance for a sustained period, typically for six months. A nonaccrual loan may return to accrual status sooner based on other significant events or mitigating circumstances. This policy is consistently applied to all classes of non-covered financing receivables.

Troubled Debt Restructurings Loans are reported as a Troubled Debt Restructuring (TDR) if the Company for economic or legal reasons related to the debtor s financial difficulties grants a concession to the debtor that it would not otherwise consider. Types of modifications that may be considered concessions, which in turn result in a TDR include, but are not limited to, (i) a reduction of the stated interest rate for the remaining original life of the debt, (ii) an extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk, (iii) a reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement, or (iv) a reduction of interest. As a result of these concessions, restructured loans are considered impaired, and the measurement of impairment is based on the Company s policy for impaired loans. In addition, the Company may provide a concession to the debtor where it offers collateral and the value of such collateral is significant in proportion to the nature of the concession requested, and it substantially reduces the Company s risk of loss. In such cases, these modifications are not considered a TDR as, in substance, no concession was made as a result of the significant additional collateral obtained.

When determining whether or not a loan modification is a TDR under ASC 310-40, the Company evaluates loan modification requests from borrowers experiencing financial difficulties on a case-by-case basis. Any such modifications granted are unique to the borrower s circumstances. Because of the Company s focus on the commercial lending sector, each business customer has unique attributes, which in turn means that modifications of loans to those customers are not easily categorized by type, key features, or other terms, but are evaluated individually based on all relevant facts and circumstances pertaining to the modification request and the borrower s/guarantor s financial condition at the time of the request. The evaluation of whether or not a borrower is experiencing financial difficulties will include, among other relevant factors considered by the Company, a review of significant factors such as (i)

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whether the borrower is in default on any of its debt, (ii) whether the borrower is experiencing payment delinquency, (iii) whether the global cash flows of the borrower and the owner guarantor(s) of the borrower have diminished below what is necessary to service existing debt obligations, (iv) whether the borrowers forecasted cash flows will be insufficient to service the debt in future periods or in accordance with the contractual terms of the existing agreement through maturity, (v) whether the borrower is unable to refinance the subject debt from other financing sources with similar terms, and (vi) whether the borrower is in jeopardy as a going-concern and/or considering bankruptcy. In any case, the debtor is presumed to be experiencing financial difficulties if the Company determines it is probable the debtor will default on the original loan if the modification is not granted.

The types of loans subject to modification vary greatly, but during the subject period are concentrated in commercial and industrial loans, dairy and agricultural loans, and term loans to commercial real estate investors. Some examples of key features include payment deferrals and delays, interest rate reductions, and extensions or renewals where the contract rate may or may not be below the market rate of interest for debt with similar characteristics as those of the modified debt. The typical length of the modified terms ranges from three (3) to twelve (12) months; however, all actual modified terms will depend on the facts, circumstances and attributes of the specific borrower requesting a modification. In general, after a careful evaluation of all relevant facts and circumstances taken together, including the nature of any concession, certain modification requests will result in troubled debt restructurings while certain other modifications will not, pursuant to the criteria and judgments as discussed throughout this report. In certain cases, modification requests for delays or deferrals of principal were evaluated and determined to be exempt from TDR reporting because they constituted insignificant delays under ASC 310-40-15.

In situations where the Company has determined that the borrower is experiencing financial difficulties and is evaluating whether a concession is *insignificant,* and therefore does not result in a troubled debt restructuring, such analysis is based on an evaluation of both the *amount* and the *timing* of the restructured payments, including the following factors:

1. Whether the amount of the restructured payments subject to delay is insignificant relative to the unpaid principal balance or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due; and

2. The delay is insignificant relative to any of the following:

    The frequency of payments due;

    The debt s original contractual maturity; or

    The debt s original expected duration.

Most modified loans *not* classified and accounted for as troubled debt restructurings were performing and paying as agreed under their original terms in the six-month period immediately preceding a request for modification. Subsequently, these modified loans have continued to perform under the modified terms and deferrals that amounted to insignificant delays, which in turn is supported by the facts and circumstances of each individual customer and loan as described above. Payment performance continues to be monitored once modifications are made. The Company s favorable experience regarding re-defaults under modified terms, or upon return of the loan to its original terms, indicates that such relief may improve ultimate collection and reduces the Company s risk of loss.

Impaired Loans A loan is generally considered impaired when based on current events and information it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. A loan, including a restructured loan, for which there is an insignificant delay relative to the frequency of payments due, and/or the original contractual maturity, is not considered an impaired loan. Generally, impaired loans include loans on nonaccrual status and TDRs.

The Company s policy is to record a specific valuation allowance, which is included in the allowance for loan losses, or to charge off that portion of an impaired loan that represents the impairment or shortfall amount as determined utilizing one of the three methods described in ASC 310-10-35-22. Impairment on non-collateral dependent restructured loans is measured by comparing the present value of expected future cash flows on the restructured loans discounted at the interest rate of the original loan agreement to the loan s carrying value. The impairment amount, if any, is generally charged off and recorded against the allowance for loan losses at the time impairment is measurable and a probable loss is determined. As a result, most of the TDRs have no specific allowance allocated because, consistent with the Company s stated practice, any impairment is typically charged off in the period in which it is identified. The Company measures impairment based on the present value of expected future cash flows discounted at the loan s effective interest rate, except that as a practical expedient, the Company may also measure impairment based on an observable market price for the loan, or the value of the collateral, for collateral dependent loans. Impairment on collateral dependent restructured loans is measured by determining the amount by which our recorded investment in the impaired loan exceeds the fair value of the collateral less estimated selling costs. The fair value is generally determined by one or more appraisals of the collateral, performed by a Company-approved third-party independent appraiser. The majority of impaired loans that are collateral dependent are charged off down to their estimated fair value of the collateral (less selling costs) at each reporting date based on current appraised value.

Appraisals of the collateral for impaired collateral dependent loans are typically ordered at the time the loan is identified as showing signs of inherent weakness. These appraisals are normally updated at least annually, or more frequently, if there are concerns or indications that the value of the collateral may have changed significantly since the previous appraisal. On an exception basis, a specific valuation allowance is recorded on collateral dependent impaired loans when a current appraisal is not yet available, a recent appraisal is still under review or on single-family mortgage loans if the loans are currently under review for a loan modification. Such valuation allowances are generally based on previous appraisals adjusted for current market conditions, based on preliminary appraisal values that are still being reviewed or for single-family loans under review for modification on an appraisal or indications of comparable home sales from external sources.

Charge-offs of unsecured consumer loans are recorded when the loan reaches 120 days past due or sooner as circumstances indicate. Except for the charge-offs of unsecured consumer loans, the charge-off policy is applied consistently across all portfolio segments. Impaired single-family mortgage loans that have been modified in accordance with the various government modification programs are also measured based on the present value of the expected cash flows discounted at the loan s pre-modification interest rate. The Company recognizes the change in present value attributable to the passage of time as interest income on such performing single-family mortgage loans and the amount of interest income recognized to date has been insignificant.

Provision and Allowance for Loan Losses The allowance for loan losses is management s estimate of probable losses inherent in the loan and lease receivables portfolio. The allowance is increased by the provision for losses and decreased by charge-offs when management believes the uncollectability of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance. The determination of the balance in the allowance for loan losses is based on an analysis of the loan and lease finance receivables portfolio using a systematic methodology and reflects an amount that, in management s judgment, is appropriate to provide for probable loan losses inherent in the portfolio, after giving consideration to the character of the loan portfolio, current economic conditions, past loan loss experience, and such other factors that would deserve current recognition in estimating inherent loan losses.

There are different qualitative risks for the loans in each portfolio segment. The construction and real estate segments predominant risk characteristics are the collateral and the geographic location of the property collateralizing the loan as well as the operating cash flow for commercial real estate properties. The commercial and industrial segments predominant risk characteristics are the cash flows of the businesses we lend to, the global cash flows and liquidity of the guarantors of such losses, as well as economic and market conditions. The dairy & livestock segment s predominant risk characteristics are milk and beef prices in the market as well as the cost of feed and cattle. The municipal lease segment s predominant risk characteristics are the municipality s general financial condition and tax revenues or if applicable the specific project related financial condition. The consumer, auto and other segments predominant risk characteristics are employment and income levels as they relate to consumers and cash flows of the businesses as they relate to equipment and vehicle leases to businesses. The agribusiness segment s predominant risk characteristics are the supply and demand conditions of the product, production seasonality, the scale of operations and ability to control costs, the availability and cost of water, and operator experience.

The Company s methodology is consistently applied across all portfolio segments taking into account the applicable historical loss rates and the qualitative factors applicable to each pool of loans. A key factor in the Company s methodology is the loan risk rating (Pass, Special Mention, Substandard, Doubtful and Loss). Loan risk ratings are updated as facts related to the loan or borrower become available. In addition, all term loans in excess of $1.0 million are subject to an annual internal credit review process where all factors underlying the loan, borrower and guarantors are subject to review which may result in changes to the loan s risk rating. Periodically, we assess various attributes utilized in adjusting our historical loss factors to reflect our view of current economic conditions. The estimate is reviewed quarterly by the Board of Directors and management and periodically by various regulatory agencies and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

Our methodology for assessing the appropriateness of the allowance is conducted on a regular basis and considers the Bank s overall loan portfolio. The Bank s methodology consists of two major phases.

In the first phase, individual loans are reviewed to identify loans for impairment and, if impaired, whether they are collateral-dependent loans. Impairment is measured based on the Company s policy which requires that impaired loans are individually evaluated for impairment utilizing one of three valuation methods, as prescribed under ASC 310-10. Generally, the Company measures impairment based on the present value of expected cash flows discounted at the loan s effective interest rate, except that as a practical expedient, the Company may measure impairment based on a loan s observable market price, or the fair value of the collateral if the loan is a collateral-dependent loan. Impaired loans are deemed collateral-dependent if repayment is expected to be provided solely by the underlying collateral, which includes repayment from the proceeds from the sale of the collateral, cash flow from the continued operation of the collateral, or both, and cash flows to repay the loan from all other available sources are expected to be no more than nominal. If the Company deems the impaired loan to be a collateral-dependent loan, the impairment is measured using the fair value of the collateral. If the Company determines that a loan s present value of expected cash flows or fair value of the collateral, if the loan is collateral-dependent, is less than the recorded investment in the loan, the Company either recognizes an impairment reserve as a specific allowance, or charges off the impaired balance if it is determined that such amount represents a confirmed loss. Loans determined to be impaired are excluded from the formula allowance that evaluates loans collectively for impairment, as discussed in the second phase below.

The second phase is conducted by evaluating or segmenting the remainder of the loan portfolio into groups or pools of loans with similar characteristics. In this second phase, groups or pools of homogeneous loans are reviewed to determine a portfolio formula allowance. In the case of the portfolio formula allowance, homogeneous portfolios, such as small business loans, consumer loans, agricultural loans, and real estate loans, are aggregated or pooled in determining the appropriate allowance. The risk assessment process in this case emphasizes trends in the different portfolios for delinquency, loss, and other behavioral characteristics of the subject portfolio over a relevant period.

Included in this second phase is our consideration of qualitative factors, including, all known relevant internal and external factors that may affect the collectability of a loan. This includes our estimates of the amounts necessary for concentrations, economic uncertainties, the volatility of the market value of collateral, and other relevant factors. These qualitative factors are used to adjust the historical loan loss rates for each pool of loans to determine the probable loan losses inherent in the portfolio.

Periodically, we assess various attributes utilized in adjusting our historical loss factors to reflect current economic conditions. The methodology is consistently applied across all the portfolio segments taking into account the applicable historical loss rates and the qualitative factors applicable to each pool of loans.

In the fourth quarter ended December 31, 2013, the Bank implemented a change in its methodology to calculate the ALLL. Previously, the Bank used an annual three-year look-back period of historical losses, segmented by loan type, with the loss factors updated annually to include the current year s loss experience in the fourth quarter of each year. External factors that were considered were the improving credit environment and the stabilizing economy. In determining the look-back period, management considered the period used to develop the historical loss rate should be long enough to capture sufficient loss data. We determined that a rolling twenty quarters look-back period was appropriate as of December 31, 2013 because the most recent three-year period provided insufficient data, with very low loss experience, and in some cases recoveries actually exceeded losses within certain loan segments during the three year period. We believe the rolling twenty quarters look-back period is the best indicator of inherent losses within the loan portfolio as many of the economic factors in the early stages of the economic recovery still exist.

Covered Loans We refer to covered loans as those loans that we acquired in the San Joaquin Bank (SJB) acquisition for which we will be reimbursed for a substantial portion of any future losses under the terms of the Federal Deposit Insurance Corporation (FDIC) loss sharing agreement. We account for loans under ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality (acquired impaired loan accounting) when (i) we acquire loans deemed to be impaired when there is evidence of credit deterioration since their origination and it is probable at the date of acquisition that we would be unable to collect all contractually required payments and (ii) as a general policy election for non-impaired loans that we acquire in a distressed bank acquisition. Acquired impaired loans are accounted for individually or in pools of loans based on common risk characteristics. The excess of the loan s or pool s scheduled contractual principal and interest payments over all cash flows expected at acquisition is the nonaccretable difference. The remaining amount, representing the excess of the loan s cash flows expected to be collected over the fair value is the accretable yield (accreted into interest income over the remaining life of the loan or pool).

A provision for loan losses on the covered portfolio will be recorded if there is deterioration in the expected cash flows on covered loans as a result of deteriorated credit quality, compared to those previously estimated without regard to the reimbursement from the FDIC under the FDIC loss sharing agreement. The portion of the loss on covered loans reimbursable from the FDIC is recorded in noninterest income as a (decrease) increase in the FDIC loss sharing asset. Decreases in expected cash flows on the acquired impaired loans as of the measurement date compared to previously estimated are recognized by recording a provision for loan losses on acquired impaired loans. Loans accounted for as part of a pool are measured based on the expected cash flows of the entire pool.

FDIC Loss Sharing Asset On October 16, 2009, the Bank acquired substantially all of the assets and assumed substantially all of the liabilities of San Joaquin Bank (SJB) from the FDIC in an FDIC-assisted transaction. The Bank entered into a loss sharing agreement with the FDIC, whereby the FDIC will cover a substantial portion of any future losses on certain acquired assets. The acquired assets subject to the loss sharing agreement are referred to collectively as covered assets. Under the terms of such loss sharing agreement, the FDIC will absorb 80% of losses and share in 80% of loss recoveries up to $144.0 million with respect to covered assets, after a first loss amount of $26.7 million. The FDIC will reimburse the Bank for 95% of losses and share in 95% of loss recoveries in excess of $144.0 million with respect to covered assets. The loss sharing agreement is in effect for 5 years for commercial loans and 10 years for single-family residential loans from the October 16, 2009 acquisition date and the loss recovery provisions are in effect for 8 and 10 years, respectively, for commercial and single-family residential loans from the acquisition date.

The FDIC loss sharing asset was initially recorded at fair value which represents the present value of the estimated cash payments from the FDIC for future losses on covered loans. The ultimate collectability of this asset is dependent upon the performance of the underlying covered loans, the passage of time and claims paid by the FDIC. The loss estimates used in calculating the FDIC loss sharing asset are determined on the same basis as the loss estimates on the related covered loans and is the present value of the cash flows the Company expects to collect from the FDIC under the loss sharing agreement. The difference between the present value and the undiscounted cash flow the Company expects to collect from the FDIC is accreted (or amortized) into noninterest income over the life of the FDIC indemnification asset. The FDIC indemnification asset is adjusted for any changes in expected cash flows based on covered loan performance. Any increases in the cash flows of covered loans over those expected will reduce the FDIC indemnification asset and any decreases in the cash flows of covered loans over those expected will increase the FDIC indemnification asset, with the remaining balance amortized on the same basis as the discount, not to exceed its remaining contract life. These increases and decreases to the FDIC indemnification asset are recorded as adjustments to noninterest income.

Goodwill and Intangible Assets Goodwill resulting from business combinations prior to January 1, 2009, represents the excess of the purchase price over the fair value of the net assets of the businesses acquired. Goodwill resulting from business combinations after January 1, 2009, is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interest in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually, or more frequently if events and circumstances exists that indicate that a goodwill impairment test should be performed.

Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet. Based on the Company s annual impairment test, there was zero recorded impairment as of September 30, 2014.

Other intangible assets consist of core deposit intangible assets arising from business combinations and are amortized using an accelerated method over their estimated useful lives.

Fair Value of Financial Instruments We use fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. Investment securities available-for-sale and interest-rate swaps are financial instruments recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other financial assets on a non-recurring basis, such as impaired loans and other real estate owned (OREO). These nonrecurring fair value adjustments typically involve application of lower-of-cost-or-market accounting or write-downs of individual assets. Further, we include in Note 9 of the unaudited condensed consolidated financial statements information about the extent to which fair value is used to measure assets and liabilities, the valuation methodologies used and its impact to earnings. Additionally, for financial instruments not recorded at fair value we disclose the estimate of their fair value.

Earnings per Common Share The Company calculates earnings per common share (EPS) using the two-class method. The two-class method requires the Company to present EPS as if all of the earnings for the period are distributed to common shareholders and any participating securities. All outstanding unvested share-based payment awards that contain rights to non-forfeitable dividends are considered participating securities. The Company grants restricted shares under the 2008 Equity Incentive Plan that qualify as participating securities. Restricted shares issued under this plan are entitled to dividends at the same rate as common stock. A reconciliation of the numerator and the denominator used in the computation of basic and diluted earnings per common share is included in Note 8 of these unaudited condensed consolidated financial statements.

Stock-Based Compensation Consistent with the provisions of ASC 718, Stock Compensation , we recognize expense for the grant date fair value of stock options and restricted shares issued to employees, officers and non-employee directors over the their requisite service periods (generally the vesting period). The service periods may be subject to performance conditions.

At September 30, 2014, the Company had three stock-based employee compensation plans. The Company accounts for stock compensation using the modified prospective method. Under this method, awards that are granted, modified, or settled after December 31, 2005, are measured at fair value as of the grant date with compensation costs recognized over the vesting period on a straight-lined basis. Also under this method, unvested stock awards as of January 1, 2006 are recognized over the remaining service period with no change in historical reported earnings.

The fair value of each stock option grant is estimated as of the grant date using the Black-Scholes option-pricing model. Management assumptions used at the time of grant impact the fair value of the option calculated under the Black-Scholes option-pricing model, and ultimately, the expense that will be recognized over the life of the option.

The grant date fair value of restricted stock awards is measured at the fa