

PACIFIC MERCANTILE BANCORP  
Form 10-Q  
May 12, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2010

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 0-30777

**PACIFIC MERCANTILE BANCORP**

(Exact name of Registrant as specified in its charter)

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**California**  
(State or other jurisdiction of incorporation or organization)

**33-0898238**  
(I.R.S. Employer Identification Number)

**949 South Coast Drive, Suite 300,**

**Costa Mesa, California**  
(Address of principal executive offices)

**92626**  
(Zip Code)

**(714) 438-2500**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed, since last year)

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 website, if any, every interactive data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T (section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

10,434,665 shares of Common Stock as of May 6, 2010

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**PACIFIC MERCANTILE BANCORP**  
**QUARTERLY REPORT ON FORM 10Q**  
**FOR**  
**THE QUARTER ENDED MARCH 31, 2010**  
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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(Dollars in thousands)****(Unaudited)**

|  | <b>March 31<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|--------------------------|------------------------------|
| <b>ASSETS</b>  |                          |                              |
| Cash and due from banks  | \$ 11,492                | \$ 13,866                    |
| Interest bearing deposits with financial institutions  | 140,183                  | 127,785                      |
| Cash and cash equivalents  | 151,675                  | 141,651                      |
| Interest-bearing time deposits with financial institutions   | 9,950                    | 9,800                        |
| Federal Reserve Bank and Federal Home Loan Bank Stock, at cost   | 14,091                   | 14,091                       |
| Securities available for sale, at fair value   | 177,239                  | 170,214                      |
| Loans held for sale, at lower of cost or market  | 16,468                   | 7,572                        |
| Loans (net of allowances of \$20,863 and \$20,345, respectively)   | 790,529                  | 813,194                      |
| Investment in unconsolidated subsidiaries  | 682                      | 682                          |
| Other real estate owned  | 11,231                   | 10,712                       |
| Accrued interest receivable  | 3,672                    | 3,730                        |
| Premises and equipment, net  | 1,230                    | 1,329                        |
| Other assets   | 27,095                   | 27,661                       |
| <b>Total assets</b>  | <b>\$ 1,203,862</b>      | <b>\$ 1,200,636</b>          |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                          |                              |
| Deposits:  |                          |                              |
| Noninterest-bearing  | \$ 180,339               | \$ 183,789                   |
| Interest-bearing   | 816,148                  | 776,649                      |
| Total deposits   | 996,487                  | 960,438                      |
| Borrowings   | 108,025                  | 141,003                      |
| Accrued interest payable   | 1,018                    | 1,901                        |
| Other liabilities  | 4,814                    | 5,295                        |
| Junior subordinated debentures   | 17,527                   | 17,527                       |
| <b>Total liabilities</b>   | <b>1,127,871</b>         | <b>1,126,164</b>             |
| Commitments and contingencies (Note 2)   |                          |                              |
| Shareholders equity:   |                          |                              |
| Preferred stock, no par value, 2,000,000 shares authorized, 88,500 and 80,050 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively; liquidation preference \$100 per share plus accumulated dividends at March 31, 2010 and December 31, 2009 | 8,850                    | 8,050                        |
| Common stock, no par value, 20,000,000 shares authorized, 10,434,665 shares issued and outstanding at March 31, 2010 and December 31, 2009   | 72,936                   | 72,891                       |

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|  |              |              |
|--|--------------|--------------|
| Retained earnings (accumulated deficit)    | (3,473)      | (3,599)      |
| Accumulated other comprehensive loss       | (2,322)      | (2,870)      |
| Total shareholders' equity                 | 75,991       | 74,472       |
| Total liabilities and shareholders' equity | \$ 1,203,862 | \$ 1,200,636 |

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

**Table of Contents****Part I. Item 1. (continued)****PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(Dollars in thousands, except for per share data)****(Unaudited)**

|  | <b>Three Months Ended March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2010</b>                         | <b>2009</b> |
| Interest income:   |                                     |             |
| Loans, including fees  | \$ 11,965                           | \$ 11,985   |
| Federal funds sold   |                                     |             |
| Securities available for sale and stock                                | 1,584                               | 1,439       |
| Interest-bearing deposits with financial institutions                  | 110                                 | 89          |
| Total interest income  | 13,659                              | 13,513      |
| Interest expense:  |                                     |             |
| Deposits   | 4,288                               | 5,908       |
| Borrowings   | 924                                 | 2,213       |
| Total interest expense   | 5,212                               | 8,121       |
| Net interest income  | 8,447                               | 5,392       |
| Provision for loan losses  | 1,200                               | 3,450       |
| Net interest income after provision for loan losses                    | 7,247                               | 1,942       |
| Noninterest income   |                                     |             |
| Total other-than-temporary impairment of securities                    | (1,754)                             |             |
| Portion of losses recognized in other comprehensive loss               | (1,720)                             |             |
| Net impairment loss recognized in earnings                             | (34)                                |             |
| Service fees on deposits and other banking services                    | 339                                 | 372         |
| Mortgage banking (including net gains on sales of loans held for sale) | 569                                 |             |
| Net gain on sale of securities available for sale                      | 205                                 | 1,884       |
| Net gain (loss) on sale of other real estate owned                     |                                     | 2           |
| Other  | 266                                 | 197         |
| Total noninterest income   | 1,345                               | 2,455       |
| Noninterest expense  |                                     |             |
| Salaries and employee benefits   | 4,337                               | 3,658       |
| Occupancy  | 681                                 | 681         |
| Equipment and furniture  | 354                                 | 265         |
| Data processing  | 180                                 | 163         |
| Professional fees  | 913                                 | 526         |
| Customer expense   | 101                                 | 96          |
| FDIC expense   | 458                                 | 324         |
| Other real estate owned expense  | 334                                 | 287         |
| Other operating expense  | 1,009                               | 653         |
| Total noninterest expense  | 8,367                               | 6,653       |

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|  |            |            |
|--|------------|------------|
| Income (loss) before income taxes                  | 225        | (2,256)    |
| Income tax provision (benefit)                     | 99         | (122)      |
| Net income (loss)                                  | 126        | (2,134)    |
| Cumulative undeclared dividends on preferred stock | (208)      |            |
| Net loss available to common stockholders          | \$ (82)    | \$ (2,134) |
| Loss per share                                     |            |            |
| Basic  | \$ (0.01)  | \$ (0.20)  |
| Diluted  | \$ (0.01)  | \$ (0.20)  |
| Dividends paid per share                           | \$         | \$         |
| Weighted average number of shares:                 |            |            |
| Basic  | 10,434,665 | 10,434,665 |
| Diluted  | 10,434,665 | 10,434,665 |

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

**Table of Contents****Part I. Item 1. (continued)**

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)**

(Dollars in thousands)

(Unaudited)

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2010</b>               | <b>2009</b> |
| Net income (loss)   | \$ 126                    | \$ (2,134)  |
| Other comprehensive loss, net of tax:   |                           |             |
| Change in unrealized gain (loss) on securities available for sale, net of tax effect  | 554                       | (1,099)     |
| Change in net unrealized gain (loss) and prior service benefit on supplemental executive retirement plan, net of tax effect | (6)                       | 12          |
| Total comprehensive income (loss)   | \$ 674                    | \$ (3,221)  |

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



**Table of Contents****Part I. Item 1. (continued)****PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Dollars in thousands)**

|   | <b>Three Months Ended March 31,</b> |                |
|---|-------------------------------------|----------------|
|   | <b>2010</b>                         | <b>2009</b>    |
| <b>Cash Flows From Operating Activities:</b>  |                                     |                |
| Net income (loss)   | \$ 126                              | \$ (2,134)     |
| Adjustments to reconcile net income (loss) to net cash used in operating activities:            |                                     |                |
| Depreciation and amortization   | 132                                 | 118            |
| Provision for loan losses   | 1,200                               | 3,450          |
| Net amortization of premium on securities   | 189                                 | 136            |
| Net gains on sales of securities available for sale   | (205)                               | (1,884)        |
| Net gains on sales of mortgage loans held for sale  | (424)                               |                |
| Proceeds from sales of mortgage loans held for sale   | 27,013                              |                |
| Originations and purchases of mortgage loans held for sale                                      | (35,897)                            |                |
| Mark to market gain adjustment of loans held for sale   | (49)                                |                |
| Decrease in current taxes receivable  | 185                                 | 98             |
| Net amortization of deferred fees and unearned income on loans                                  | (125)                               | (8)            |
| Net gain on sales of other real estate owned  |                                     | (2)            |
| Write down of other real estate owned   | 28                                  | 180            |
| Capitalized costs of other real estate owned  | (547)                               | (701)          |
| Stock-based compensation expense  | 45                                  | 105            |
| Other than temporary impairment of securities   | 34                                  |                |
| Changes in operating assets and liabilities:  |                                     |                |
| Net decrease (increase) in accrued interest receivable  | 58                                  | (212)          |
| Net increase in other assets  | (338)                               | (430)          |
| Net decrease (increase) in deferred taxes   | 317                                 | (220)          |
| Net decrease in accrued interest payable  | (883)                               | (684)          |
| Net (decrease) increase in other liabilities  | (472)                               | 29             |
| <b>Net cash used in operating activities</b>  | <b>(9,613)</b>                      | <b>(2,159)</b> |
| <b>Cash Flows From Investing Activities:</b>  |                                     |                |
| Net increase in interest-bearing deposits with financial institutions                           | (150)                               | (38,150)       |
| Maturities of and principal payments received for securities available for sale and other stock | 22,122                              | 7,583          |
| Purchase of securities available for sale and other stock                                       | (59,813)                            | (75,259)       |
| Proceeds from sale of securities available for sale and other stock                             | 31,589                              | 128,035        |
| Proceeds from sales of other real estate owned  |                                     | 211            |
| Net decrease (increase) in loans  | 22,051                              | (5,866)        |
| Purchases of premises and equipment   | (33)                                | (13)           |
| <b>Net cash provided by investing activities</b>  | <b>15,766</b>                       | <b>16,541</b>  |
| <b>Cash Flows From Financing Activities:</b>  |                                     |                |
| Net increase in deposits  | 36,049                              | 74,906         |
| Proceeds from issuances of preferred stock  | 800                                 |                |
| Net decrease in borrowings  | (32,978)                            | (29,179)       |
| <b>Net cash provided by financing activities</b>  | <b>3,871</b>                        | <b>45,727</b>  |
| <b>Net increase in cash and cash equivalents</b>  | <b>10,024</b>                       | <b>60,109</b>  |

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|  |            |            |
|--|------------|------------|
| Cash and Cash Equivalents, beginning of period | 141,651    | 107,133    |
| Cash and Cash Equivalents, end of period       | \$ 151,675 | \$ 167,242 |

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

**Table of Contents****Part I. Item 1. (continued)****PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Dollars in thousands)**

|   | <b>Three Month Ended<br/>March 31,</b> |             |
|---|--|-------------|
|   | <b>2010</b>                            | <b>2009</b> |
| <b>Supplementary Cash Flow Information:</b>   |  |             |
| Cash paid for interest on deposits and other borrowings   | \$ 6,095                               | \$ 8,661    |
| Cash paid for income taxes  | \$                                     | \$          |
| <b>Non-Cash Investing Activities:</b>   |  |             |
| Net (increase) decrease in net unrealized losses and prior year service cost on supplemental employee retirement plan, net of tax | \$ (6)                                 | \$ 12       |
| Net decrease (increase) in net unrealized losses on securities held for sale, net of income tax                                   | \$ 554                                 | \$ (1,099)  |
| Transfer into other real estate owned   | \$                                     | \$ 2,756    |
| Transfer of loans held for sale to loans held for investment  | \$ 1,800                               | \$          |
| Mark to market (gain) loss adjustment of equity securities  | \$ (29)                                | \$ 15       |

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

**Table of Contents****Part I. Item 1. (continued)**

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**  
(Shares and dollars in thousands)

**For The Three Months Ended March 31, 2010**

|  | Preferred Stock  |          | Common Stock     |           | Retained earnings<br>(accumulated deficit) | Accumulated other comprehensive income (loss) | Total     |
|--|------------------|----------|------------------|-----------|--|---|-----------|
|  | Number of Shares | Amount   | Number of Shares | Amount    |  |   |           |
| Balance at December 31, 2009   | 81               | \$ 8,050 | 10,435           | \$ 72,891 | \$ (3,599)                                 | \$ (2,870)                                    | \$ 74,472 |
| Issuances of cumulative preferred stock  | 8                | 800      |                  |           |  |   | 800       |
| Stock based compensation expense   |                  |          |                  | 45        |  |   | 45        |
| Comprehensive income:  |                  |          |                  |           |  |   |           |
| Net income   |                  |          |                  |           | 126  |   | 126       |
| Change in unrealized gain on securities held for sale, net of taxes                  |                  |          |                  |           |  | 554   | 554       |
| Change in unrealized expense on supplemental executive retirement plan, net of taxes |                  |          |                  |           |  | (6)   | (6)       |
| Total comprehensive income   |                  |          |                  |           |  |   | 674       |
| Balance at March 31, 2010  | 89               | \$ 8,850 | 10,435           | \$ 72,936 | \$ (3,473)                                 | \$ (2,322)                                    | \$ 75,991 |

The accompanying notes are an integral part of this consolidated financial statement.

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**Part I. Item 1. (continued)**

**PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**1. Nature of Business**

Pacific Mercantile Bancorp ( PMBC ) is a bank holding company which, through its wholly owned subsidiary, Pacific Mercantile Bank (the Bank ) is engaged in the commercial banking business in Southern California. PMBC is registered as a one bank holding company under the United States Bank Holding Company Act of 1956, as amended. The Bank is chartered by the California Department of Financial Institutions (the DFI ) and is a member of and subject to regulation by the Federal Reserve Bank of San Francisco ( FRB ). In addition, the deposit accounts of the Bank's customers are insured by the Federal Deposit Insurance Corporation ( FDIC ) up to the maximum amount allowed by law. PMBC and the Bank, together, shall sometimes be referred to in this report as the Company or as we , us or our .

Substantially all of our operations are conducted and substantially all our assets are owned by the Bank, which accounts for substantially all of our consolidated revenues and expenses, and earnings. The Bank provides a full range of banking services to small and medium-size businesses, professionals and the general public in Orange, Los Angeles, San Bernardino and San Diego Counties of California and is subject to competition from other financial institutions and from financial services organizations conducting operations in those same markets.

During 2002, we organized three business trusts, under the names Pacific Mercantile Capital Trust I, PMB Capital Trust I, and PMB Statutory Trust III, respectively, to facilitate our issuance of \$5.155 million, \$5.155 million and \$7.217 million, respectively, principal amount of junior subordinated debentures, all with maturity dates in 2032. In October 2004, we organized PMB Capital Trust III to facilitate our issuance of an additional \$10 million principal amount of junior subordinated debentures, with a maturity date in 2034. The financial statements of these trusts are not included in the Company's consolidated financial statements. In July 2007, we redeemed the \$5.155 million principal amount of junior subordinated debentures issued in conjunction with the organization of Pacific Mercantile Capital Trust I and in August 2007, we redeemed the \$5.155 million principal amount of junior subordinated debentures issued in conjunction with the organization of PMB Capital Trust I. Those trusts were dissolved as a result of those redemptions.

**2. Significant Accounting Policies, Recent Accounting Pronouncements, Commitments and Contingencies**

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all footnotes that would be required for a full presentation of financial position, results of operations, changes in cash flows and comprehensive income (loss) in accordance with generally accepted accounting principles in the United States ( GAAP ). However, these interim financial statements reflect all adjustments (consisting of normal recurring adjustments and accruals) which, in the opinion of our management, are necessary for a fair presentation of our financial position and our results of operations for the interim periods presented.

These unaudited consolidated financial statements have been prepared on a basis consistent with prior periods, and should be read in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2009, and the notes thereto, included in our Annual Report on Form 10-K for the year ended December 31, 2009, as filed with the Securities and Exchange Commission ( SEC ) under the Securities Exchange Act of 1934.

Our consolidated financial position at March 31, 2010, and the consolidated results of operations for the three month period ended March 31, 2010, are not necessarily indicative of what our financial position will be as of December 31, 2010, or of the results of our operations that may be expected for the full year ending December 31, 2010.

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**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****2. Significant Accounting Policies, Recent Accounting Pronouncements, Commitments and Contingencies (Cont.)*****Use of Estimates***

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make certain estimates and assumptions that affect the reported amounts of certain of our assets, liabilities, and contingencies at the date of the financial statements and the reported amounts of our revenues and expenses during the reporting periods. For the fiscal periods covered by this Report, those estimates related primarily to our determinations of the allowance for loan losses, the fair value of securities available for sale, loans held for sale and the valuation of deferred tax assets. If circumstances or financial trends on which those estimates were based were to change in the future or there were to occur any currently unanticipated events affecting the amounts of those estimates, our future financial position or results of operations could differ, possibly materially, from those expected at the current time.

***Recent Accounting Pronouncements***

In September 2009, the Financial Accounting Standards Board ( FASB ) issued an update to Accounting Standard Codification 105-10, Generally Accepted Accounting Principles . This standard establishes the FASB Accounting Standard Codification ( Codification or ASC ) as the source of authoritative U.S. Generally Accepted Accounting Principles ( GAAP ) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC companies. The Codification supersedes all then-existing non-SEC accounting and reporting standards. This Statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which became effective on November 13, 2008, identified the sources of accounting principles and the framework for selecting the principles used in preparing the financial statements in conformity with GAAP. Statement 162 arranged these sources of GAAP in a hierarchy for users to apply accordingly. The Codification, and all of its content, will carry the same level of authority, effectively superseding Statement 162. In other words, the GAAP hierarchy is modified to include only two levels of GAAP: authoritative and non-authoritative. As a result, this Statement replaces Statement 162 to indicate this change to the GAAP hierarchy.

In January 2010, the FASB issued Accounting Standards Update 2010-06 ( ASU 2010-06 ), an update of ASC 820-10, *Fair Value Measurements and Disclosures*, which now requires new disclosures that expand on activity included in the three fair value levels, as defined in ASC 820-10. ASU 2010-06 also provides amendments to ASC 820-10 in that a reporting entity should provide fair value measurement disclosures for each class of assets and liabilities, and provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either Level 2 or Level 3. New disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for certain Level 3 roll forward disclosures, which are effective for fiscal years beginning after December 15, 2010. We adopted the former disclosures and clarifications (those effective after December 15, 2009) as of January 1, 2010, and they did not have a material effect on our financial statements.

In February 2010, the FASB issued Accounting Standards Update No. 2010-09, Subsequent Events (Topic 855), Amendments to Certain Recognition and Disclosure Requirements ( Topic 855 ), which states an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. This change alleviates potential conflicts between Subtopic 855-10 and SEC requirements.

***Commitments and Contingencies******Commitments***

To meet the financing needs of our customers in the normal course of business, we are a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. At March 31, 2010, loan commitments and letters of credit

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**Notes to Interim Consolidated Financial Statements (Cont.-)**

**(Unaudited)**

**2. Significant Accounting Policies, Recent Accounting Pronouncements, Commitments and Contingencies (Cont.)**

totaled \$171 million and \$11.4 million, respectively. The contractual amount of a credit-related financial instrument such as a commitment to extend credit, a credit-card arrangement or a letter of credit represents the amounts of potential accounting loss should the commitment be fully drawn upon, the customer were to default, and the value of any existing collateral securing the customer's payment obligation become worthless.

As a result, we use the same credit policies in making commitments to extend credit and conditional obligations as we do for on-balance sheet instruments. Commitments generally have fixed expiration dates; however, since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis, using the same credit underwriting standards that are employed in making commercial loans. The amount of collateral obtained, if any, upon an extension of credit is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, real estate and income-producing commercial properties.

*Legal Proceedings*

James Laliberte, et al. vs. Pacific Mercantile Bank, filed in May 2003 in the California Superior Court for the County of Orange (Case No. 030007092). Information regarding this law suit is contained under the caption "Commitments and Contingencies - Legal Proceeding" in Note 17 of Item 8 of Part II of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 (the "2009 10-K") filed on April 1, 2010 with the SEC.

We also are subject to legal actions that arise from time to time in the ordinary course of our business. Currently there are no such pending legal proceedings that we believe will become material to our financial condition or results of operations.

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****3. Income (Loss) Per Share**

Basic income (loss) per share is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted income (loss) per share reflects the potential dilution that would occur if stock options or other contracts to issue common stock were exercised or converted into shares of common stock which would share in our earnings. For the three month period ended March 31, 2010, (i) stock options to purchase 1,146,344 shares of our common stock and (ii) 1,156,695 shares of our common stock issuable on conversion of our Series A Preferred Stock, were not considered in computing diluted income (loss) per common share because they were antidilutive. For the three month period ended March 31, 2009 stock options to purchase 1,127,744 shares were not considered in computing diluted earnings per common shares because they were antidilutive.

The following table illustrates our computation of basic and diluted income (loss) for the three month periods ended March 31, 2010 and 2009.

| (In thousands, except earnings per share data)                | Three Months Ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2010                            | 2009       |
| Net income (loss) available for common shareholders (A)       | \$ (82)                         | \$ (2,134) |
| Weighted average outstanding shares of common stock (B)       | 10,435                          | 10,435     |
| Dilutive effect of employee stock options and preferred stock |                                 |            |
| Common stock and common stock equivalents (C)                 | 10,435                          | 10,435     |
| Income (loss) per share:                                      |                                 |            |
| Basic (A/B)   | \$ (0.01)                       | \$ (0.20)  |
| Diluted (A/C)   | \$ (0.01)                       | \$ (0.20)  |

**4. Stock-Based Employee Compensation Plans**

We have in effect three equity incentive compensation plans that provide for the grant of equity incentives to our officers, other key employees and directors: (i) a 1999 Stock Option Plan (the 1999 Plan), which authorized the granting of options to purchase up to a total of 1,248,230 shares of our common stock (which number has been adjusted for stock splits effectuated subsequent to the Plan's adoption), (ii) a 2004 Stock Incentive Plan (the 2004 Plan) which set aside 400,000 shares of our common stock for the grant of stock options and rights to purchase restricted stock (restricted shares); and (iii) a 2008 Equity Incentive Plan (the 2008 Plan), which set aside an additional 400,000 shares of our common stock for the grant of stock options, restricted shares and stock appreciation rights (SARs). All three Plans have been approved by our shareholders. Options may no longer be granted under the 1999 Plan as the right to grant options under that Plan expired earlier in 2009.

Stock options entitle the recipients to purchase common stock at a price per share that may not be less than 100% of the fair market value of the Company's shares on the respective grant dates of the stock options. Restricted shares may be granted at such purchase prices and on such other terms, including restrictions and Company repurchase rights, as are fixed by the Compensation Committee at the time rights to purchase such shares are granted. SARs entitle the recipient to receive a cash payment in an amount equal to the difference between the fair market value of the Company's shares on the date of vesting and a base price (which, in most cases, will be equal to fair market value of the Company's shares on the date of grant), subject to the right of the Company to make such payment in shares of its common stock at their then fair market value. Options, restricted shares and SARs may vest immediately or in installments over various periods generally ranging up to five years, subject to the recipient's continued employment or service or the achievement of specified performance goals, as determined by the Compensation Committee at the time it grants the options, the rights to purchase the restricted shares or the SARs. Stock options and SARs may be granted for terms of up to 10 years after the date of grant, but will terminate sooner upon or shortly after a termination of service occurring prior to the expiration of the term of the option. The Company will become entitled to repurchase any unvested restricted shares, at the same price that was paid for the shares by the recipient, in the event of a termination of employment or service of the holder of such shares. To date, the Company has not granted any restricted shares or any SARs.

Under ASC 718-10, we (and other public companies in the United States) are required to recognize, in our financial statements, the fair value of the options or any restricted shares that we grant as compensation cost over their respective service periods.





**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****4. Stock-Based Employee Compensation Plans (Cont.)**

The fair values of the options that were outstanding under the 1999, 2004 and 2008 Plans were estimated as of their respective dates of grant using the Black-Scholes option-pricing model. For additional information regarding the Company's stock based compensation plans, refer to Note 12 "Stock-Based Employee Compensation Plans" in the Notes to Consolidated Financial Statements included in the Company's Form 10-K for the year ended December 31, 2009.

The following table summarizes the weighted average assumptions used for grants in the following periods:

| Assumptions with respect to:                                 | Three Months Ended<br>March 31, |         |
|--|---------------------------------|---------|
|  | 2010                            | 2009    |
| Expected volatility  | 34%                             | 29%     |
| Risk-free interest rate                                      | 3.07%                           | 1.65%   |
| Expected dividends   | 0.26%                           | 0.26%   |
| Expected term (years)  | 6.9                             | 6.9     |
| Weighted average fair value of options granted during period | \$ 1.20                         | \$ 1.52 |

The following tables summarize the stock option activity under the Company's 1999, 2004 and 2008 Plans during the three month periods ended March 31, 2010 and 2009, respectively.

|                     |            | Three Months Ended March 31,              |  |   |  |
|---------------------|------------|---|--|---|--|
|                     |            | 2010                                      |  | 2009                                      |  |
|                     |            | Number of<br>Shares Subject<br>to Options | Weighted-<br>Average<br>Exercise<br>Price<br>Per Share | Number of<br>Shares Subject<br>to Options | Weighted-<br>Average<br>Exercise<br>Price<br>Per Share |
| Outstanding         | January 1, | 1,162,744                                 | \$ 8.93  | 1,137,244                                 | \$ 9.31  |
| Granted             |            | 169,122                                   | 2.97   | 3,000                                     | 4.35   |
| Exercised           |            |   |  |   |  |
| Forfeited/Canceled  |            | (185,522)                                 | 7.44   | (12,500)                                  | 11.57  |
| Outstanding         | March 31,  | 1,146,344                                 | 8.29   | 1,127,744                                 | 9.27   |
| Options Exercisable | March 31,  | 796,047                                   | \$ 10.11   | 921,130                                   | \$ 9.54  |

There were no options exercised during the three months ended March 31, 2010 and March 31, 2009. The fair values of vested options at March 31, 2010 and 2009, were \$82,000 and \$145,000, respectively.

|         |        | Options Outstanding as of March 31, 2010 |          |  | Options Exercisable as of<br>March 31, 2010 <sup>(1)</sup>      |        |  |
|---------|--------|--|----------|--|---|--------|--|
|         |        | Vested                                   | Unvested | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) | Shares | Weighted<br>Average<br>Exercise<br>Price |
| \$ 2.97 | \$5.99 | 23,145                                   | 319,977  | \$ 3.34                                  | 9.38  | 23,145 | \$ 3.79                                  |

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|         |         |         |         |       |      |         |       |
|---------|---------|---------|---------|-------|------|---------|-------|
| \$ 6.00 | \$9.99  | 340,179 | 9,600   | 7.60  | 1.13 | 340,179 | 7.62  |
| \$10.00 | \$12.99 | 310,600 | 1,000   | 11.23 | 3.88 | 310,600 | 11.22 |
| \$13.00 | \$17.99 | 106,523 | 15,820  | 15.11 | 5.40 | 106,523 | 15.07 |
| \$18.00 | \$18.84 | 15,600  | 3,900   | 18.06 | 5.84 | 15,600  | 18.06 |
|         |         | 796,047 | 350,297 | 8.29  | 4.88 | 796,047 | 10.11 |

(1) The weighted average remaining contractual life of the options that were exercisable as of March 31, 2010 was 2.97 years.

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****4. Stock-Based Employee Compensation Plans (Cont.)**

The aggregate intrinsic values of options that were outstanding and exercisable under the Plans at March 31, 2010, and 2009, were zero.

A summary of the status of the unvested options as of December 31, 2009, and changes during the three month period ended March 31, 2010, are set forth in the following table.

|                               | Number of<br>Shares Subject<br>to Options | Weighted-<br>Average<br>Grant Date<br>Fair Value |
|-------------------------------|---|--|
| Unvested at December 31, 2009 | 207,032                                   | \$ 2.35  |
| Granted                       | 169,122                                   | 1.20   |
| Vested                        | (13,557)                                  | 6.02   |
| Forfeited/Canceled            | (12,300)                                  | 3.99   |
| Unvested at March 31, 2010    | 350,297                                   | \$ 1.59  |

The aggregate amounts charged against income in relation to stock-based compensation awards was \$7,000 net of \$5,000 in taxes and \$99,000 net of \$6,000 in taxes for the three months ended March 31, 2010 and 2009, respectively. The weighted average period over which nonvested awards are expected to be recognized was 1.69 years at March 31, 2010. The income tax compensation expense at March 31, 2010 related to non-vested stock options is expected to be recognized in the respective amounts set forth in the table below:

|                                   | Stock Based<br>Compensation Expense<br>(In thousands) |
|-----------------------------------|---|
| Remainder of 2010                 | \$ 144  |
| For the years ending December 31, |   |
| 2011                              | 153   |
| 2012                              | 116   |
| 2013                              | 48  |
| 2014                              | 5   |
| Total                             | \$ 466  |

**5. Employee Benefit Plan**

The Company has established a Supplemental Retirement Plan ( SERP ) for its Chief Executive Officer. The components of net periodic benefit cost for the SERP are set forth in the table below:

|              | Three Months Ended<br>March 31,<br>2010      2009<br>(In thousands) |       |
|--------------|---|-------|
| Service cost | \$ 47   | \$ 48 |

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|                                    |       |       |
|------------------------------------|-------|-------|
| Interest cost                      | 32    | 30    |
| Expected return on plan assets     |       |       |
| Amortization of prior service cost | 4     | 4     |
| Amortization of net actuarial loss | 6     | 16    |
| Net periodic SERP cost             | \$ 89 | \$ 98 |

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**Notes to Interim Consolidated Financial Statements (Cont.-)**

**(Unaudited)**

**6. Income Taxes**

The provision for income taxes was an expense of \$98,500 and a benefit of \$122,000 for the three months ended March 31, 2010 and 2009, respectively, representing effective tax rates of 44% and 5% during those periods. The Company applied an estimated annual effective tax rate to the year-to-date pre-tax earnings to derive the provision for income taxes for the three months ended March 31, 2010 and 2009.

We recognize deferred tax assets and liabilities for the future tax consequences related to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for tax credits. Our deferred tax assets, net of a valuation allowance, totaled \$11.2 million and \$11.7 million as of March 31, 2010 and December 31, 2009, respectively. We evaluate our deferred tax assets for recoverability using a consistent approach which considers the relative impact of negative and positive evidence, including our historical profitability and projections of future taxable income. We are required to establish a valuation allowance for deferred tax assets and record a charge to income or stockholders' equity if we determine, based on available evidence at the time the determination is made, that it is more likely than not that some portion or all of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance, we estimate future taxable income based on management-approved business plans and ongoing tax planning strategies. This process involves significant management judgment about assumptions that are subject to change from period to period based on changes in tax laws or variances between our projected operating performance, our actual results and other factors.

During the fourth quarter of 2008, we concluded that it was more likely than not that we would not generate sufficient future taxable income in the foreseeable future to realize all of our deferred tax assets. Our conclusion was based on our consideration of the relative weight of the available evidence, including the rapid deterioration of market and economic conditions, and the uncertainty of future market conditions on our results of operations. As a result, we recorded a \$3.0 million valuation allowance to our deferred tax asset for the portion of the future tax benefit that more likely than not will not be utilized in the future. We did not, however, establish a valuation allowance for the deferred tax asset amount that is related to unrealized losses recorded through other comprehensive income on our available-for-sale securities. We believe this deferred tax amount is recoverable because we have the intent and ability to hold these securities until recovery of the unrealized loss amounts.

The Company files income tax returns with the U.S. federal government and the state of California. As of March 31, and January 1, 2010, we were subject to examination by the Internal Revenue Service with respect to our U.S. federal tax returns and the Franchise Tax Board for California, for the 2005 to 2008 tax years. We do not believe there will be any material adverse changes in our unrecognized tax benefits over the next 12 months.

In general, net operating losses ( NOL ) on U.S. federal income tax returns may be carried back two years and forward twenty years. The federal NOLs generated in 2008 and 2009 may be carried back five years. NOLs on California state income tax returns maybe carried forward twenty years. The Company filed an amended prior year U.S. federal tax return and carry back the U.S. federal tax net operating loss. The state of California has suspended the net operating carryover deduction in for 2009, but corporations may continue to compute and carryover an NOL during the suspension period. Beginning in 2011, California taxpayers may carry back losses for two years and carry forward for twenty years which will conform to the U.S. tax laws by 2013. The Company expects to have taxable income in future years to offset the California NOL generated in 2008 and 2009.

Our policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of tax expense. We did not have any accrued interest or penalties associated with any unrecognized tax benefits, and no interest expense was recognized during the three months ended March 31, 2010 and 2009. Our effective tax rate differs from the federal statutory rate primarily due to tax free income on municipal bonds and certain non-deductible expenses recognized for financial reporting purposes and state taxes.

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****7. Fair Value Measurements**

**Fair Value Hierarchy.** Under ASC 820-10, we group assets and liabilities 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 markets.

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

Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market.

These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

**Assets Measured at Fair Value on a Recurring Basis**

**Investment Securities Available for Sale.** Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 investments securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 investment securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

The following table shows the recorded amounts of assets (in thousands of dollars) measured at fair value on a recurring basis.

|  | <b>At March 31, 2010</b> |                 |                   |                |
|--|--------------------------|-----------------|-------------------|----------------|
|  | <b>(in thousands)</b>    |                 |                   |                |
|  | <b>Total</b>             | <b>Level 1</b>  | <b>Level 2</b>    | <b>Level 3</b> |
| <b>Assets at Fair Value:</b>                             |                          |                 |                   |                |
| Investment securities available for sale                 |                          |                 |                   |                |
| Mortgage backed securities issued by U.S. agencies       | \$ 161,274               | \$              | \$ 161,274        | \$             |
| Municipal securities                                     | 9,452                    |                 | 9,452             |                |
| Collateralized mortgage obligations issued by non agency | 3,296                    |                 | 3,296             |                |
| Asset backed securities                                  | 938                      |                 |                   | 938            |
| Mutual funds   | 2,279                    | 2,279           |                   |                |
| <b>Total assets at fair value on a recurring basis</b>   | <b>\$ 177,239</b>        | <b>\$ 2,279</b> | <b>\$ 174,022</b> | <b>\$ 938</b>  |

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****7. Fair Value Measurements (Cont-)**

The \$3.3 million in collateralized mortgage obligations were transferred into level 2 from level 3, as there is an active market for these securities.

The changes in Level 3 assets measured at fair value on a recurring basis are summarized in the following table:

|   | <b>Investment<br/>Securities Available<br/>for Sale<br/>(In thousands)</b> |
|---|--|
| Balance of recurring Level 3 instruments at January 1, 2010 | \$ 4,103   |
| Total gains or losses (realized/unrealized):                |  |
| Included in earnings-realized                               |  |
| Included in earnings-unrealized <sup>(1)</sup>              | (34)   |
| Included in other comprehensive income                      | 1,720  |
| Purchases   |  |
| Sales   |  |
| Issuances   |  |
| Settlements   |  |
| Transfers in and/or out of Level 3                          | (4,851)  |
| Balance of Level 3 assets at March 31, 2010                 | \$ 938   |

(1) Amount reported as an other than temporary impairment loss in the noninterest income portion of the income statement.

***Assets Recorded at Fair Value on a Nonrecurring Basis***

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market or that were recognized at a fair value below cost at the end of the period.

**Loans Held for Sale.** Mortgage loans held for sale are reported at fair value if, on an aggregate basis, the fair value of the loans is less than cost. In determining whether the fair value of loans held for sale is less than cost when quoted market prices are not available, the Company may consider outstanding investor commitments, discounted cash flow analysis with market assumptions or the fair value of the collateral if the loan is collateral dependent. Such loans are classified within either level 2 or level 3 of the fair value hierarchy. Where assumptions are made using significant unobservable inputs, such loans held for sale are classified as level 3.

**Impaired Loans.** ASC 820-10 applies to loans measured for impairment in accordance with ASC 310-10, *Accounting by Creditors for Impairment of a Loan*, including impaired loans measured at an observable market price (if available), and at the fair value of the loan's collateral (if the loan is collateral dependent). The fair value of an impaired loan is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance for possible losses represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan at Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the impaired loan at Level 3.

**Foreclosed Assets.** Foreclosed assets are adjusted to fair value, less estimated costs to sell, at the time the loans are transferred to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value less estimated costs to sell. Fair value is determined based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair



value of the collateral is based

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****7. Fair Value Measurements (Cont-)**

on an observable market price or a current appraised value, we record the foreclosed asset at Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the foreclosed asset at Level 3.

Information regarding assets measured at fair value on a nonrecurring basis is set forth in the table below.

|                                     | Total            | At March 31, 2010<br>(in thousands) |                  |                  |
|-------------------------------------|------------------|-------------------------------------|------------------|------------------|
|                                     |                  | Level 1                             | Level 2          | Level 3          |
| <b><u>Assets at Fair Value:</u></b> |                  |                                     |                  |                  |
| Loans                               | \$ 46,000        | \$                                  | \$ 38,840        | \$ 7,160         |
| Loans held for sale                 | 16,468           |                                     |                  | 16,468           |
| Foreclosed assets                   | 11,231           |                                     | 11,231           |                  |
| <b>Total</b>                        | <b>\$ 73,699</b> | <b>\$</b>                           | <b>\$ 50,071</b> | <b>\$ 23,628</b> |

There were no significant transfers in or out of level 3 measurements for nonrecurring items during the three months ended March 31, 2010.

We have elected to use fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other assets on a nonrecurring basis, such as loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Fair value estimates are made at a discrete point in time based on relevant market information and other information about the financial instruments. Because no active market exists for a significant portion of our financial instruments, fair value estimates are based in large part on judgments we make primarily regarding current economic conditions, risk characteristics of various financial instruments, prepayment rates, and future expected loss experience. These estimates are subjective in nature and invariably involve some inherent uncertainties. Additionally unexpected changes in events or circumstances can occur that could require us to make changes to our assumptions and which, in turn, could significantly affect and require us to make changes to our previous estimates of fair value.

In addition, the fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of existing and anticipated future customer relationships and the value of assets and liabilities that are not considered financial instruments, such as premises and equipment and other real estate owned.

The following methods and assumptions were used to estimate the fair value of financial instruments.

*Cash and Cash Equivalents.* The fair value of cash and cash equivalents approximates its carrying value.

*Interest-Bearing Deposits with Financial Institutions.* The fair values of interest-bearing deposits maturing within ninety days approximate their carrying values.

*Investment Securities Available for Sale.* Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate

debt securities. Securities classified as level 3 include asset-backed securities in less liquid markets.

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**Notes to Interim Consolidated Financial Statements (Cont.-)**

**(Unaudited)**

**7. Fair Value Measurements (Cont-)**

*Federal Home Loan Bank and Federal Reserve Bank Stock.* The Bank is a member of the Federal Home Loan Bank (the FHLB) and the Federal Reserve Bank of San Francisco (the FRB). As members, we are required to own stock of the FHLB and the FRB, the amount of which is based primarily on the level of our borrowings from those institutions. We also have the right to acquire additional shares of stock in either or both of the FHLB and the FRB; however, to date, we have not done so. The fair values of that stock are equal to their respective carrying amounts, are classified as restricted securities and are periodically evaluated for impairment based on our assessment of the ultimate recoverability of our investments in that stock. Any cash or stock dividends paid to us on such stock are reported as income.

*Loans Held for Sale.* Loans held for sale are carried at the lower of cost or market value. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies loans subjected to nonrecurring fair value adjustments as Level 3. There were no fair value adjustments related to the \$16.5 million of loans held for sale at March 31, 2010.

*Loans.* The fair value for loans with variable interest rates is the carrying amount. The fair value of fixed rate loans is derived by calculating the discounted value of future cash flows expected to be received by the various homogeneous categories of loans. All loans have been adjusted to reflect changes in credit risk.

*Impaired Loans.* ASC 820-10 applies to loans measured for impairment in accordance with ASC 310-10, Accounting by Creditors for Impairment of a Loan, including impaired loans measured at an observable market price (if available), and at the fair value of the loan's collateral (if the loan is collateral dependent) less selling cost. The fair value of an impaired loan is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance for possible losses represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan at nonrecurring Level 2. When an appraised value is not available, or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price or a discounted cash flow has been used to determine the fair value, we record the impaired loan at nonrecurring Level 3.

*Foreclosed Assets.* Foreclosed assets are adjusted to the lower of cost or fair value, less estimated costs to sell, at the time the loans are transferred to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value, less estimated costs to sell. Fair value is determined on the basis of independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the foreclosed asset at nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the foreclosed asset at nonrecurring Level 3.

*Deposits.* The fair value of demand deposits, savings deposits, and money market deposits is defined as the amounts payable on demand at quarter-end. The fair value of fixed maturity certificates of deposit is estimated based on the discounted value of the future cash flows expected to be paid on the deposits.

*Borrowings.* The fair value of borrowings is the carrying amount for those borrowings that mature on a daily basis. The fair value of term borrowings is derived by calculating the discounted value of future cash flows expected to be paid out by the Company.

*Junior subordinated debentures.* The fair value of the junior subordinated debentures is defined as the carrying amount. These securities are variable rate in nature and reprice quarterly.

*Commitments to Extend Credit and Standby Letters of Credit.* The fair value of commitments to extend credit and standby letters of credit, are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. These fees were not material in amount either at March 31, 2010 or December 31, 2009.

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****7. Fair Value Measurements (Cont-)**

The following table sets forth the estimated fair values and related carrying amounts of our financial instruments as March 31, 2010 and December 31, 2009, respectively.

|   | <b>March 31, 2010</b>         |                  | <b>December 31, 2009</b> |                  |
|---|-------------------------------|------------------|--------------------------|------------------|
|   | <b>Carrying</b>               | <b>Estimated</b> | <b>Carrying</b>          | <b>Estimated</b> |
|   | <b>Amount</b>                 | <b>Fair</b>      | <b>Amount</b>            | <b>Fair</b>      |
|   | <b>(Dollars in thousands)</b> |                  |                          |                  |
| <b>Financial Assets:</b>                              |                               |                  |                          |                  |
| Cash and cash equivalents                             | \$ 151,675                    | \$ 151,675       | \$ 141,651               | \$ 141,651       |
| Interest-bearing deposits with financial institutions | 9,950                         | 9,950            | 9,800                    | 9,800            |
| Federal Reserve Bank and Federal Home Loan Bank stock | 14,091                        | 14,091           | 14,091                   | 14,091           |
| Securities available for sale                         | 177,239                       | 177,239          | 170,214                  | 170,214          |
| Loans held for sale                                   | 16,468                        | 16,468           | 7,572                    | 7,572            |
| Loans, net  | 790,529                       | 777,039          | 813,194                  | 807,707          |
| <b>Financial Liabilities:</b>                         |                               |                  |                          |                  |
| Noninterest bearing deposits                          | 180,339                       | 180,339          | 183,789                  | 183,789          |
| Interest-bearing deposits                             | 816,148                       | 822,696          | 776,649                  | 779,924          |
| Borrowings  | 108,025                       | 108,596          | 141,003                  | 141,443          |
| Junior subordinated debentures                        | 17,527                        | 17,527           | 17,527                   | 17,527           |

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****8. Investment Securities Available For Sale**

The following table summarizes the major components of securities available for sale and compares the amortized cost, estimated fair market values of, and gross unrealized gains and losses on, such securities at March 31, 2010 and December 31, 2009:

|  | March 31, 2010    |                              | Fair Value<br>(Dollars in thousands) | December 31, 2009 |                              | Fair Value        |
|--|-------------------|------------------------------|--------------------------------------|-------------------|------------------------------|-------------------|
|  | Amortized Cost    | Gross Unrealized Gain / Loss |                                      | Amortized Cost    | Gross Unrealized Gain / Loss |                   |
| <b>Securities Available for Sale</b>                                       |                   |                              |                                      |                   |                              |                   |
| U.S. Treasury Securities   | \$                | \$                           | \$                                   | \$ 18,040         | \$ 11                        | \$ 18,051         |
| Mortgage backed securities issued by U.S. Agencies <sup>(1)</sup>          | 161,998           | 115 (839)                    | 161,274                              | 134,331           | 89 (1,651)                   | 132,769           |
| Collateralized mortgage obligations issued by U.S. Agencies <sup>(1)</sup> | \$                | \$                           | \$                                   |                   |                              |                   |
| <b>Total government and agencies securities</b>                            | <b>161,998</b>    | <b>115 (839)</b>             | <b>161,274</b>                       | <b>152,371</b>    | <b>100 (1,651)</b>           | <b>150,820</b>    |
| Municipal securities   | 9,811             | 2 (361)                      | 9,452                                | 10,545            | 13 (431)                     | 10,127            |
| Collateralized mortgage obligations issued by non agency <sup>(1)</sup>    | 4,311             | (1,015)                      | 3,296                                | 7,094             | 10 (1,069)                   | 6,035             |
| Asset backed securities <sup>(2)</sup>                                     | 2,658             | (1,720)                      | 938                                  | 2,704             | (1,732)                      | 972               |
| Mutual funds <sup>(3)</sup>  | 2,279             |                              | 2,279                                | 2,260             |                              | 2,260             |
| <b>Total securities available for sale</b>                                 | <b>\$ 181,057</b> | <b>\$ 117 \$ (3,935)</b>     | <b>\$ 177,239</b>                    | <b>\$ 174,974</b> | <b>\$ 123 \$ (4,883)</b>     | <b>\$ 170,214</b> |

(1) Secured by close-end first lien 1-4 family residential mortgages.

(2) Comprised of a security that represents an interest in a pool of trust preferred securities issued by U.S.-based banks and insurance companies

(3) Consists primarily of mutual fund investments in closed-end first lien 1-4 family residential mortgages.

The amortized cost and estimated fair values of securities available for sale at March 31, 2010 and December 31, 2009, are shown in the table below by contractual maturities and historical prepayments based on the prior twelve months of principal payments. Expected maturities will differ from contractual maturities and historical prepayments, particularly with respect to collateralized mortgage obligations, primarily because prepayment rates are affected by changes in conditions in the interest rate market and, therefore, future prepayment rates may differ from historical prepayment rates.

| (Dollars in thousands)                              | At March 31, 2010 Maturing in |                                  |                                   |                |            |
|---|-------------------------------|----------------------------------|-----------------------------------|----------------|------------|
|   | One year or less              | Over one year through five years | Over five years through ten years | Over ten Years | Total      |
| Securities available for sale, amortized cost       | \$ 13,903                     | \$ 43,984                        | \$ 49,612                         | \$ 73,558      | \$ 181,057 |
| Securities available for sale, estimated fair value | 13,824                        | 43,834                           | 48,929                            | 70,652         | 177,239    |

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|                        |       |       |       |       |       |
|------------------------|-------|-------|-------|-------|-------|
| Weighted average yield | 3.12% | 3.41% | 3.55% | 3.49% | 3.46% |
|------------------------|-------|-------|-------|-------|-------|

| (Dollars in thousands)                              | At December 31, 2009 Maturing in |                                  |                                   |                |            |
|---|----------------------------------|----------------------------------|-----------------------------------|----------------|------------|
|   | One year or less                 | Over one year through five years | Over five years through ten years | Over ten Years | Total      |
| Securities available for sale, amortized cost       | \$ 29,819                        | \$ 40,075                        | \$ 36,000                         | \$ 69,080      | \$ 174,974 |
| Securities available for sale, estimated fair value | 29,497                           | 38,696                           | 35,505                            | 66,516         | 170,214    |
| Weighted average yield                              | 1.63%                            | 3.58%                            | 3.58%                             | 3.49%          | 3.21%      |

The Company recognized net gains on sales of securities available for sale of \$121,000, net of \$84,000 taxes on sale proceeds of \$32 million during the three months ended March 31, 2010 and \$1.1 million, net of \$773,000 of taxes on sale proceeds of \$190 million, during the first quarter ended March 31, 2010.

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****8. Investment Securities Available For Sale (Cont-)**

The table below shows, as of March 31, 2010, the gross unrealized losses and fair values of our investments, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

| (Dollars In thousands)                                      | Securities With Unrealized Loss as of March 31, 2010 |                 |                   |                 |            |                 |
|---|--|-----------------|-------------------|-----------------|------------|-----------------|
|   | Less than 12 months                                  |                 | 12 months or more |                 | Total      |                 |
|   | Fair Value   | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| US agencies and mortgage backed securities                  | \$ 145,316   | \$ (836)        | \$ 742            | \$ (3)          | \$ 146,058 | \$ (839)        |
| Collateralized mortgage obligations issued by U.S. agencies |  |                 |                   |                 |            |                 |
| Non-agency collateralized mortgage obligations              | 4,634  | (76)            | 3,979             | (285)           | 8,613      | (361)           |
| Asset backed securities                                     |  |                 | 3,296             | (1,015)         | 3,296      | (1,015)         |
| Municipal securities  |  |                 | 938               | (1,720)         | 938        | (1,720)         |
| Total temporarily impaired securities                       | \$ 149,950   | \$ (912)        | \$ 8,955          | \$ (3,023)      | \$ 158,905 | \$ (3,935)      |

Impairment exists when the fair value of the security is less than its cost. The company performs a quarterly assessment of its securities that have an unrealized loss to determine whether the decline in fair value of these securities below their cost is other-than-temporary.

The Company adopted ASC 321-10 effective April 1, 2009, and recognizes other-than-temporary impairment for its available-for-sale debt securities. In accordance with ASC 321-10, when there are credit losses associated with an impaired debt security and the Company does not have the intent to sell the security and it is more likely than not that it will not have to sell the security before recovery of its cost basis, the Company will separate the amount of impairment into the amount that is credit related and the amount related to non-credit factors. The credit-related impairment is recognized in net gain on sale of securities on the consolidated statements of operations. The non-credit-related impairment is recognized and reflected in other comprehensive income.

Through the impairment assessment process, the company determined that the investments discussed below were other-than-temporarily impaired at March 31, 2010. The Company recorded impairment credit losses in earnings on available for sale securities of \$34,000 for the three month period ended March 31, 2010.

Certain of the OTTI amounts were related to credit losses and recognized into earnings, with the remainder recognized into other comprehensive loss. The table below presents the other-than-temporary impairments (in thousands of dollars) where a portion related to other factors was recognized in other comprehensive loss for the three months ended March 31, 2010:

|                        | Gross Other than Temporary Impairments | Temporary Impairments Included in Other Comprehensive Loss | Net Other-Than Temporary Impairments Included in Earnings |
|------------------------|--|--|---|
| Balance March 31, 2010 | \$ (1,754)                             | \$ (1,720)   | \$ (34)   |



**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****8. Investment Securities Available For Sale (Cont.-)*****Non-Agency CMO***

We have identified one non-agency collateralized mortgage obligation security (CUSIP 94982HAK3) that required an assessment for OTTI at December 31, 2009. This CMO is a Super Senior Support bond, which was originated in 2005 and issued by Wells Fargo & Company, was rated AAA by Standard & Poor's and Aa1 by Moody's, and had a credit support of 2.5% of the total balance at issuance. As of March 31, 2010, the security was rated AAA- and A3- by Standard and Poor's and Moody's, respectively, has an amortized cost of \$1.3 million and a fair value of \$720 thousand, for an approximate loss of \$579 thousand. The principal collateral for this security is a pool of one-to-four family, fully amortizing residential first mortgage loans that have a fixed payment for approximately five years, after which they bear interest at variable rates with annual resets. Credit support at March 31, 2010 was approximately 5.4% and delinquencies 60 days and over totaled approximately 9.5%. Factors considered in the impairment include the rating change of the security, the current level of subordination from other CMO classes, anticipated prepayment rates, cumulative default rates and the loss severity given a default. We recognized \$101,000 impairment loss with respect to this CMO, constituting a credit loss, in earnings for the year ended December 31, 2009. The remaining loss of \$640,000 on this security was recognized through other comprehensive loss. This non credit portion of OTTI is attributed to external market conditions, primarily the lack of liquidity in these securities and risks of potential additional declines in the housing market. There was no credit impairment of this security for the three month period ending March 31, 2010.

***Asset Backed Securities***

The Company has one asset backed security in its investment securities available for sale portfolio. The security is a multi-class, cash flow collateralized bond obligation backed by a pool of trust preferred securities issued by a diversified pool of 56 issuers consisting of 45 U.S. depository institutions and eleven insurance companies at the time of issuance in November 2007. The total size of this security at issuance was \$363 million. The security that the Company owns (CUSIP 74042CAE8) is the mezzanine class B piece that floats with 3 month libor +60 basis points and had a rating of Aa2/AA by Moody's and Fitch at the time of issuance. The Company purchased \$3.0 million face value at a price of 95.21 for \$2,856,420 in November 2007.

As of March 31, 2010 the book value of this security was \$2.7 million with a fair value of \$937 thousand for an approximate unrealized loss of \$1.7 million. Currently, the security has a Caa1 rating from Moody's and BB rating from Fitch and has experienced \$32.5 million in defaults (11% of total current collateral) and \$33 million in payment deferrals (11% of total current collateral) from issuance to March 31, 2010. We estimate that there is approximately \$1.5 million in potential payment deferrals and defaults (approximately 1% of performing collateral) before there is a temporary interest shortfall and \$79.5 million before the Company would not receive all of its contractual cash flows. This analysis is based on the following assumptions: future default rates of 2.6%, prepayment rates of 1% until maturity, and 15% recovery of future defaults.

**Impairment Losses on OTTI Securities**

|                       | 2010           | 2009 |
|-----------------------|----------------|------|
|                       | (In thousands) |      |
| Asset backed security | \$ 34          | \$   |
|                       | \$ 34          | \$   |

As a part of our OTTI assessment, we consider information available about the performance of the underlying collateral, including credit enhancements, default rates, loss severities, delinquency rates, vintage, as well as rating agency reports and historical prepayment speeds. As a result, significant judgments are required in connection with our analysis to determine the expected cash flows for impaired securities. In determining the component of the OTTI related to credit losses, we compare the amortized cost basis of each other-than-temporarily impaired security to the present value of its expected cash flows, discounted using its effective interest rate implicit in the security at the date of acquisition.

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****8. Investment Securities Available For Sale (Cont.-)**

Our assessment that it has the ability to continue to hold impaired investment securities along with its evaluation of their future performance, as indicated by the criteria discussed above, provide the basis for it to conclude that the remainder of its impaired securities are not other-than-temporarily impaired. In assessing whether it is more likely than not that the Company will be required to sell any impaired security before its anticipated recovery, which may be at their maturity, it considers the significance of each investment, the amount of impairment, as well as the Company's liquidity position and the impact on the Company's capital position. As a result of its analyses, the Company determined at March 31, 2010 that the unrealized losses on its securities portfolio on which impairments have not been recognized are temporary.

**9. Loans**

The composition of the Company's loan portfolio as of March 31, 2010 and December 31, 2009 is as follows:

|   | March 31, 2010    |               | December 31, 2009 |               |
|---|-------------------|---------------|-------------------|---------------|
|   | Amount            | Percent       | Amount            | Percent       |
| Commercial loans                              | \$ 253,714        | 31.2%         | \$ 290,406        | 34.8%         |
| Commercial real estate loans - owner occupied | 186,339           | 23.0%         | 179,682           | 21.5%         |
| Commercial real estate loans - all other      | 139,931           | 17.2%         | 135,152           | 16.2%         |
| Residential mortgage loans - multi-family     | 96,579            | 11.9%         | 101,961           | 12.2%         |
| Residential mortgage loans - single family    | 68,098            | 8.4%          | 67,023            | 8.0%          |
| Construction loans                            | 20,304            | 2.5%          | 20,443            | 2.6%          |
| Land development loans                        | 30,601            | 3.8%          | 30,042            | 3.6%          |
| Consumer loans                                | 16,362            | 2.0%          | 9,370             | 1.1%          |
| <b>Gross loans</b>                            | <b>811,928</b>    | <b>100.0%</b> | <b>834,079</b>    | <b>100.0%</b> |
| Deferred fee (income) costs, net              | (536)             |               | (540)             |               |
| Allowance for loan losses                     | (20,863)          |               | (20,345)          |               |
| <b>Loans, net</b>                             | <b>\$ 790,529</b> |               | <b>\$ 813,194</b> |               |

Changes in the allowance for loan losses (in thousands of dollars) for the three months ended March 31, 2010 and the year ended December 31, 2009 are as follows:

|  | Three Months Ended | Year Ended        |
|--|--------------------|-------------------|
|  | March 31, 2010     | December 31, 2009 |
| Balance, beginning of period               | \$ 20,345          | \$ 15,453         |
| Provision for loan losses                  | 1,200              | 23,673            |
| Recoveries on loans previously charged off | 276                | 357               |
| Net, amounts charged off                   | (958)              | (19,138)          |
| <b>Balance, end of period</b>              | <b>\$ 20,863</b>   | <b>\$ 20,345</b>  |

**Table of Contents****Notes to Interim Consolidated Financial Statements (Cont.-)****(Unaudited)****9. Loans (Cont-)**

The following table sets forth information regarding nonaccrual loans and restructured loans at March 31, 2010:

|   | March 31, 2010 | December 31, 2009 |
|---|----------------|-------------------|
| Impaired loans:                                 |                |                   |
| Nonaccruing loans                               | \$ 26,238      | \$ 28,092         |
| Nonaccruing restructured loans                  | 18,555         | 21,357            |
| Accruing restructured loans                     | 1,222          | 1,243             |
| Accruing loans                                  |                | 6,697             |
| <br>Total impaired loans                        | <br>\$ 46,015  | <br>\$ 57,389     |
| <br>Impaired loans less than 90 days delinquent | <br>\$ 27,141  | <br>\$ 27,408     |

The Company's allowance for loan losses for March 31, 2010 and December 31, 2009 had \$5.3 million of reserves to \$46.0 million in impaired loans and \$4.8 million of reserves to \$57.4 million of impaired loans, respectively. The impaired loan balances at March 31, 2010 and December 31, 2009 with no allocated reserves totaled \$23.8 million and \$29.2 million respectively, due to sufficient collateral against any loan deficiency.

**10. Subsequent Events**

As of May 7, 2010, the Company had issued an additional 8,050 shares of Series A Convertible 10% Cumulative Preferred Stock (the Series A Shares). Through May 7, 2010, we had sold a total of \$9.7 million of the Series A Shares in the private offering.

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

**Introduction**

Pacific Mercantile Bancorp is a bank holding company that owns all of the stock of Pacific Mercantile Bank (the "Bank"), which is a commercial bank that provides a full range of banking services to small and medium-size businesses and to professionals and the general public in Orange, Los Angeles, San Bernardino and San Diego counties, in Southern California. Substantially all of our operations are conducted and substantially all of our assets are owned by the Bank, which accounts for substantially all of our consolidated revenues, expenses and operating income.

The following discussion presents information about (i) our consolidated results of operations for the three months ended March 31, 2010 and comparisons of those results with the results of operations for the corresponding three month period of 2009, and (ii) our consolidated financial condition, liquidity and capital resources at March 31, 2010. The information in the following discussion should be read in conjunction with our interim consolidated financial statements and the notes thereto included elsewhere in this Report.

***Forward-Looking Information***

Statements contained in this Report that are not historical facts or that discuss our expectations, beliefs or views regarding our future operations or future financial performance, or financial or other trends in our business or in the markets in which we operate, constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Often, they include words such as believe, expect, anticipate, intend, plan, estimate, project, forecast or words of similar meaning, or future conditional verbs such as will, would, should, could, or may. The information contained in such forward-looking statements is based on current information and on assumptions that we make about future events over which we do not have control. In addition, our business and the markets in which we operate are subject to a number of risks and uncertainties. Unexpected future events and such risks and uncertainties could cause our financial condition or actual operating results in the future to differ significantly from our expected financial condition or operating results that are set forth in the forward looking statements contained in this Report and could, therefore, also affect the price performance of our shares. Certain of those risks and uncertainties are discussed below in this Item 2 of this Report, in Item 1A, entitled "Risk Factors" contained in our Annual Report on Form 10-K for our fiscal year ended December 31, 2009 (our "2009 10-K"), and in Item 1A, entitled "Risk Factors" in Part II of this Report below. Therefore, you are urged to read not only the information contained in this section of this Report, but also the risk factors that are discussed in our 2009 10-K and in this report in conjunction with your review of the following discussion regarding our results of operations for the three months ended, and our financial condition at, March 31, 2010.

Due to those risks and uncertainties, readers are cautioned not to place undue reliance on the forward-looking statements contained in this Report, which speak only as of the date of this Report, or to make predictions about future performance based solely on historical financial performance. We also disclaim any obligation to update forward-looking statements contained in this Report or in our 2009 10-K, except as may otherwise be required by law or Nasdaq rules.

**Table of Contents****Overview of Operating Results in the Three Months Ended March 31, 2010**

The following table sets forth information regarding the interest income that we generated, the interest expense that we incurred, our net interest income, noninterest income, noninterest expense, and our net income (loss) and net income (loss) per share for the three months ended March 31, 2010 and 2009, respectively.

| (Dollars in thousands, except per share amounts)           | Three Months Ended March 31, |                 | Percent Change<br>2010 vs. 2009 |
|--|------------------------------|-----------------|---------------------------------|
|  | Amounts<br>2010              | Amounts<br>2009 |                                 |
| Interest income  | \$ 13,659                    | \$ 13,513       | 1.1%                            |
| Interest expense   | 5,212                        | 8,121           | (35.8)%                         |
| Net interest income  | 8,447                        | 5,392           | 56.7%                           |
| Provision for loan losses                                  | 1,200                        | 3,450           | (65.2)%                         |
| Net interest income (loss) after provision for loan losses | 7,247                        | 1,942           | 273.2%                          |
| Noninterest income   | 1,345                        | 2,455           | (45.2)%                         |
| Noninterest expense  | 8,367                        | 6,653           | 25.8%                           |
| Income (loss) before income tax                            | \$ 225                       | (2,256)         | 110.0%                          |
| Income tax (benefit) provision                             | 99                           | (122)           | 181.1%                          |
| Net income (loss)  | 126                          | (2,134)         | 105.9%                          |
| Cumulative undeclared dividends on preferred stock         | (208)                        |                 | N/A                             |
| Net loss available to common stockholders                  | \$ (82)                      | \$ (2,134)      | 96.2%                           |
| Net Loss per diluted share                                 | \$ (0.01)                    | \$ (0.20)       | 95.0%                           |
| Weighted average number of diluted shares                  | 10,434,665                   | 10,434,665      |                                 |

As the table above indicates, we generated net income of \$126,000 in the three months ended March 31, 2010 as compared to a net loss of \$2.1 million in the same three months of 2009, which represents a \$2.2 million, or 106% improvement over the first quarter of 2009. That improvement was primarily attributable to an increase in net interest income of \$3.1 million, or 56.7%, and a decrease of \$2.3 million, or 65%, in the provision we made for possible loan losses, which more than offset a \$1.1 million decline in non-interest income and a \$1.7 million increase in non-interest expense, in the three months ended March 31, 2010, as compared to the same three months of 2009.

The increase in net interest income was primarily attributable to a \$2.9 million, or 36%, decrease in interest expense primarily as a result of a change in the mix of deposits to a higher proportion of lower-cost core deposits and decreases in the interest rates paid on time deposits. The decrease in the provision for loan losses was made possible by a 74% reduction in loan charge-offs to \$682,000 in this year's first quarter from \$2.6 million during the same quarter of 2009 and an \$11.4 million, or 19.8%, decrease in impaired loans during the three months ended March 31, 2010.

In the three months ended March 31, 2010, net income allocable to common shareholders was reduced by accumulated, but unpaid, dividends of \$208,000 on our Series A Convertible 10% Cumulative Preferred Stock ( Series A Preferred Shares ), resulting in a net loss allocable to common shareholders of \$82,000, or \$0.01 per diluted common share, for the quarter ended March 31, 2010. However, this compares favorably to the net loss allocable to common shareholders of \$2.1 million, or \$0.20 per diluted common share, in the quarter ended March 31 2009.

The following table indicates the impact that the increase in our net interest income and the improvement in our operating results in the three months ended March 31, 2010 had on our net interest margin and the returns on average assets and average equity during that period, as compared to the same three months of 2009:

|   | Three Months Ended March 31, |          |
|---|------------------------------|----------|
|   | 2010                         | 2009     |
| Net interest margin <sup>(1)(2)</sup>                 | 2.96%                        | 1.92%    |
| Return on average assets <sup>(1)</sup>               | 0.04%                        | (0.74)%  |
| Return on average shareholders' equity <sup>(1)</sup> | 0.69%                        | (10.43)% |

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- (1) Annualized.
- (2) Net interest income expressed as a percentage of total average interest earning assets.

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Notwithstanding the reduction in the provision we made for loan losses in the three months ended March 31, 2010, the allowance for loan losses totaled nearly \$20.9 million at March 31, 2010, or 2.57% of the loans then outstanding, as compared to \$20.3 million, or 2.44% of the loans outstanding at December 31, 2009 and \$16.3 million, or 1.93% of the loans outstanding at March 31, 2009. Non-performing loans, together with other nonperforming assets consisting of other real estate owned ( OREO ), totaled \$56 million, or 4.7% of total assets at March 31, 2010, as compared to \$60 million, or 5.0% of total assets, at December 31, 2009.

### ***Critical Accounting Policies***

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States ( GAAP ) and general practices in the banking industry. Certain of those accounting policies are considered critical accounting policies, because they require us to make assumptions and judgments regarding circumstances or trends that could affect the value of those assets, such as, for example, assumptions regarding economic conditions or trends that could impact our ability to fully collect our loans or ultimately realize the carrying value of certain of our other assets, such as securities available for sale and our deferred tax assets. Those assumptions and judgments are made based on current information available to us regarding those economic conditions or trends or other circumstances. If adverse changes were to occur in the events, trends or other circumstances on which our assumptions or judgments had been based, or other unanticipated events were to happen that might affect our operating results, under GAAP it could become necessary for us to reduce the carrying values of the affected assets on our balance sheet. In addition, because reductions in the carrying value of assets are sometime effectuated by or require charges to income, such reductions also may have the effect of reducing our income.

Our critical accounting policies consist of the accounting policies and practices we follow in determining (i) the sufficiency of the allowance we establish for loan losses; (ii) the fair values of our investment securities that we hold for sale, and (iii) the amount of our deferred tax asset, consisting primarily of tax loss carryforwards and tax credits, that we believe will be able to use to offset income taxes in future periods.

Additional information regarding our critical accounting policies is contained in the sections captioned *Critical Accounting Policies* and *Allowance for Loan Losses* in Item 6, entitled *Management's Discussion and Analysis of Financial Condition and Results of Operations*, and in Note 2 *Significant Accounting Policies* in the Notes to our Consolidated Financial Statements contained in Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2009 and readers of this Report are urged to read those sections of that Annual Report. There were no significant changes in the Company's critical accounting policies or their application during the quarter ended March 31, 2010.

### **Results of Operations**

#### ***Net Interest Income***

One of the principal determinants of a bank's income is its net interest income, which is the difference between (i) the interest that a bank earns on loans, investment securities and other interest-earning assets, on the one hand, and (ii) its interest expense, which consists primarily of the interest it must pay to attract and retain deposits and the interest that it pays on borrowings and other interest-bearing liabilities, on the other hand. As a general rule, all other things being equal, the greater the difference or *spread* between the amount of our interest income and the amount of our interest expense, the greater will be our net income; whereas, a decline in that difference or *spread* will generally result in a decline in our net income. A bank's interest income and interest expense are, in turn, affected by a number of factors, some of which are outside of its control, including national and local economic conditions and the monetary policies of the Federal Reserve Board which affect interest rates, competition in the market place for loans and deposits, the demand for loans and the ability of borrowers to meet their loan payment obligations. Net interest income, when expressed as a percentage of total average interest earning assets, is a banking organization's *net interest margin*.

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The following table sets forth our interest income, interest expense and net interest income (in thousands of dollars) and our net interest margin in the three months ended March 31, 2010 and 2009, respectively:

|                            | <b>Three Months Ended March 31,</b> |                        |   |
|----------------------------|-------------------------------------|------------------------|---|
|                            | <b>Amount<br/>2010</b>              | <b>Amount<br/>2009</b> | <b>Percent Change<br/>2010 vs. 2009</b> |
| Interest income            | \$ 13,659                           | \$ 13,513              | 1.1%                                    |
| Interest expense           | 5,212                               | 8,121                  | (35.8)%                                 |
| <b>Net interest income</b> | <b>\$ 8,447</b>                     | <b>\$ 5,392</b>        | <b>56.7%</b>                            |
| Net interest margin        | 2.96%                               | 1.92%                  |   |

As the above table indicates, our net interest income increased by \$3.1 million, or 56.7%, in the first quarter of 2010, as compared to the same quarter of 2009, due primarily to a decrease in interest expense of \$2.9 million, or 35.8%, in the three month period ended March 31, 2010. That decline in interest expense was primarily attributable to a change in the mix of deposits to a higher proportion of lower-cost core deposits and a lower proportion of higher-cost time deposits and decreases in market rates of interest, which enabled us to reduce the interest we paid on time deposits. Those factors more than offset the effects on interest expense of an overall increase of 10% in the total volume of interest-bearing deposits at March 31, 2010 as compared to March 31, 2009.

Due primarily to the increase in net interest income, our net interest margin increased by 104 basis points to 2.96% in the three months ended March 31, 2010 from 1.92% in the same period of 2009. In the three months ended March 31, 2010, the yield on interest-earning assets declined slightly to 4.72% from 4.80% in the same period of 2009; whereas the average interest rate paid on interest bearing liabilities decreased to 2.21%, from 3.68%.



**Table of Contents****Average Balances****Information Regarding Average Assets and Average Liabilities**

The following table sets forth information regarding our average balance sheet, yields on interest earning assets, interest expense on interest-bearing liabilities, the interest rate spread and the interest rate margin for the three months ended March 31, 2010 and 2009.

|  | Three Months Ended March 31, |                               |  |                     |                               |                        |
|--|------------------------------|-------------------------------|--|---------------------|-------------------------------|------------------------|
|  | Average Balance              | 2010 Interest Earned/<br>Paid | Average Yield/<br>Rate<br>(Dollars in thousands) | Average Balance     | 2009 Interest Earned/<br>Paid | Average Yield/<br>Rate |
| <b>Interest earning assets:</b>                        |                              |                               |  |                     |                               |                        |
| Short-term investments <sup>(1)</sup>                  | \$ 122,795                   | \$ 110                        | 0.36%  | \$ 138,607          | \$ 89                         | 0.26%                  |
| Securities available for sale and stock <sup>(2)</sup> | 202,597                      | 1,584                         | 3.17%  | 151,135             | 1,439                         | 3.86%                  |
| Loans  | 832,785                      | 11,965                        | 5.83%  | 851,596             | 11,985                        | 5.71%                  |
| <b>Total earning assets</b>                            | <b>1,158,177</b>             | <b>13,659</b>                 | <b>4.72%</b>                                     | <b>1,141,338</b>    | <b>13,513</b>                 | <b>4.80%</b>           |
| Noninterest earning assets                             | 38,358                       |                               |  | 38,479              |                               |                        |
| <b>Total Assets</b>                                    | <b>\$ 1,196,535</b>          |                               |  | <b>\$ 1,179,817</b> |                               |                        |
| <b>Interest-bearing liabilities:</b>                   |                              |                               |  |                     |                               |                        |
| Interest-bearing checking accounts                     | \$ 40,810                    | 74                            | 0.74%  | \$ 25,237           | 26                            | 0.42%                  |
| Money market and savings accounts                      | 123,248                      | 395                           | 1.30%  | 101,351             | 280                           | 1.12%                  |
| Certificates of deposit                                | 641,254                      | 3,819                         | 2.42%  | 524,965             | 5,603                         | 4.33%                  |
| Other borrowings                                       | 118,694                      | 799                           | 2.73%  | 213,425             | 2,028                         | 3.85%                  |
| Junior subordinated debentures                         | 17,682                       | 125                           | 2.87%  | 17,682              | 184                           | 4.22%                  |
| <b>Total interest-bearing liabilities</b>              | <b>941,688</b>               | <b>5,212</b>                  | <b>2.21%</b>                                     | <b>882,660</b>      | <b>8,121</b>                  | <b>3.68%</b>           |
| Noninterest-bearing liabilities                        | 180,557                      |                               |  | 213,932             |                               |                        |
| <b>Total Liabilities</b>                               | <b>1,122,245</b>             |                               |  | <b>1,096,592</b>    |                               |                        |
| Shareholders' equity                                   | 74,290                       |                               |  | 83,225              |                               |                        |
| <b>Total Liabilities and Shareholders' Equity</b>      | <b>\$ 1,196,535</b>          |                               |  | <b>\$ 1,179,817</b> |                               |                        |
| <b>Net interest income</b>                             |                              | <b>\$ 8,447</b>               |  |                     | <b>\$ 5,392</b>               |                        |
| Interest rate spread                                   |                              |                               | 2.51%  |                     |                               | 1.12%                  |
| <b>Net interest margin</b>                             |                              |                               | <b>2.96%</b>                                     |                     |                               | <b>1.92%</b>           |

(1) Short-term investments consist of federal funds sold and interest bearing deposits with financial institutions.

(2) Stock consists of Federal Home Loan Bank Stock and Federal Reserve Bank Stock.



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The following table sets forth the changes in interest income, including loan fees, and interest paid in the three months ended March 31, 2010, as compared to the same period of 2009, and the extent to which those changes were attributable to changes in (i) the volumes of or in the rates of interest earned on interest-earning assets and (ii) the volumes of or the rates of interest paid on our interest-bearing liabilities.

|  | <b>Three Months Ended<br/>March 31, 2010 vs. 2009</b> |                           |                 |
|--|---|---------------------------|-----------------|
|  | <b>Increase (Decrease) due to:</b>                    |                           |                 |
|  | <b>Volume</b>   | <b>Rate<sup>(1)</sup></b> | <b>Total</b>    |
| <b>Interest income:</b>                                |   |                           |                 |
| Short-term investments <sup>(1)</sup>                  | \$ (11)   | \$ 32                     | \$ 21           |
| Securities available for sale and stock <sup>(2)</sup> | 433   | (288)                     | 145             |
| Loans  | (269)   | 249                       | (20)            |
| <b>Total earning assets</b>                            | <b>153</b>  | <b>(7)</b>                | <b>146</b>      |
| <b>Interest expense:</b>                               |   |                           |                 |
| Interest-bearing checking accounts                     | 22  | 26                        | 48              |
| Money market and savings accounts                      | 66  | 49                        | 115             |
| Certificates of deposit                                | 1,060   | (2,844)                   | (1,784)         |
| Borrowings   | (742)   | (487)                     | (1,229)         |
| Junior subordinated debentures                         |   | (59)                      | (59)            |
| <b>Total interest-bearing liabilities</b>              | <b>406</b>  | <b>(3,315)</b>            | <b>(2,909)</b>  |
| <b>Net interest income</b>                             | <b>\$ (253)</b>                                       | <b>\$ 3,308</b>           | <b>\$ 3,055</b> |

(1) Short-term investments consist of federal funds sold and interest bearing deposits with financial institutions.

(2) Stock consists of Federal Home Loan Bank Stock and Federal Reserve Bank Stock.

The above table indicates that the increase in our net interest income of \$3.1 million in the three months ended March 31, 2010, was primarily due to \$3.3 million, or 147 basis points, decrease in interest rates paid on interest bearing liabilities, which more than offset the \$7,000, or eight basis points, decreases in interest rates on average earning assets.

**Provision for Loan Losses**

The failure of borrowers to repay their loans is an inherent risk of the banking business. Therefore, like other banks and lending institutions, we follow the practice of maintaining an allowance to provide for loan losses that occur from time to time as an incidental part of the banking business. When it is determined that the payment in full of a loan has become unlikely, the carrying value of the loan is reduced to what management believes is its realizable value. This reduction, which is referred to as a loan charge-off, or write-down is charged against the allowance for loan losses.

The amount of the allowance for loan losses is increased periodically (i) to replenish the allowance after it has been reduced due to loan charge-offs, (ii) to reflect changes in the volume of outstanding loans, and (iii) to take account of increases in the risk of potential future losses due to a deterioration in the condition of borrowers or in the value of property securing non-performing loans or adverse changes in economic conditions. Increases in the allowance are made through a charge, recorded as an expense in our statement of operations, referred to as the provision for loan losses. Recoveries of loans previously charged-off are added back to the allowance and, therefore, have the effect of increasing the allowance and reducing the amount of the provision that might otherwise have had to be made to replenish or increase the allowance. See Financial Condition Nonperforming Loans, Other Non-Performing Assets and the Allowance for Loan Losses below in this Section of this Report.

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We employ economic models that are based on bank regulatory guidelines, industry standards and our own historical loan loss experience, as well as a number of more subjective qualitative factors, to determine both the sufficiency of the allowance for loan losses and the amount of the provisions that we need to make for potential loan losses. However, those determinations involve judgments about trends in current economic conditions and other events or circumstances that can affect the ability of borrowers to meet their loan obligations to us and a weighting among the quantitative and qualitative factors we consider in determining the amount of the allowance. Moreover, the duration and anticipated effects of prevailing economic conditions or trends can be uncertain and can be affected by number of risks and circumstances that are outside of our ability to control. See the discussion below in this Section under the caption Financial Condition Nonperforming Loans, Other Nonperforming Assets, and the Allowance for Loan Losses . If changes in economic or market

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conditions or unexpected subsequent events were to occur, or if changes were made to bank regulatory guidelines or industry standards that are used to assess the sufficiency of the allowance for loan losses, it could become necessary for us to incur additional, and possibly significant, charges to increase the allowance for loan losses, which would have the effect of reducing our income or causing us to incur losses.

In addition, the Federal Reserve Bank of San Francisco (the FRB or Reserve Bank ) and the California Department of Financial Institutions (the DFI ), as an integral part of their examination processes, periodically review the adequacy of our allowance for loan losses. These agencies may require us to make additional provisions for possible loan losses, over and above the provisions that we have already made, the effect of which would be to reduce our income or increase any losses we might incur.

We were able to reduce the provisions for loan losses by \$2.3 million, or 65.2%, to \$1.2 million in the three months ended March 31, 2010, from \$3.5 million in the same three months of 2009, due primarily to (i) a 74% reduction in loan charge-offs, to \$682,000, in this year's first quarter, down from \$2.6 million in the same quarter of 2009, and (ii) an \$11.4 million, or nearly 20%, reduction in impaired loans between December 31, 2009 and March 31, 2010. Notwithstanding the reduction in the provision we made for loan losses in the three months ended March 31, 2010, the allowance for loan losses totaled nearly \$20.9 million at March 31, 2010, or 2.57% of the loans then outstanding, as compared to \$20.3 million, or 2.44% of the outstanding at December 31, 2009 and \$16.3 million, or 1.93% of the loans outstanding at March 31, 2009.

**Noninterest Income**

Noninterest income consists primarily of fees charged for services provided by the Bank on deposit account transactions, gains on sales of assets and revenues from the origination and sale of residential mortgages by our mortgage loan division (which commenced operations in the second quarter of 2009), net gains or losses on sales of securities available for sale and net gains or losses on sales of other real estate owned. The following table identifies the amounts (in thousands of dollars) of, and sets forth the percentage changes in, the components of noninterest income in the three months ended March 31, 2010, as compared to the same period of 2009.

|   | Three Months Ended March 31, |                 | Percent Change<br>2010 vs. 2009 |
|---|------------------------------|-----------------|---------------------------------|
|   | 2010                         | 2009            |                                 |
| Service fees on deposits  | \$ 339                       | \$ 372          | (8.9)%                          |
| Mortgage banking income (including net gains on sales of loans held for sale) | 569                          |                 | N/M                             |
| Net gains on sales of securities available for sale                           | 205                          | 1,884           | (89.1)%                         |
| Net gain (loss) on sale of other real estate owned                            |                              | 2               | N/M                             |
| Other than temporary impairment of securities                                 | (34)                         |                 | N/M                             |
| Other   | 266                          | 197             | 35.0%                           |
| <b>Total Noninterest Income</b>   | <b>\$ 1,345</b>              | <b>\$ 2,455</b> | <b>(45.2)%</b>                  |

As the table above indicates, the 45.2% decrease in noninterest income in the three months ended March 31, 2010, as compared to the same period in 2009, was primarily attributable to a \$1.7 million, or 89.1%, decrease in net gains on sales of securities available for sale, partially offset by \$569,000 of revenues generated by our new mortgage banking division which commenced its operations during the second quarter 2009.

**Table of Contents****Noninterest Expense**

The following table compares the amounts (in thousands of dollars) of the principal components of noninterest expense in the three month ended March 31, 2010 and 2009.

|                                | Three Months Ended March 31, |                 | Percent Change<br>2010 vs. 2009 |
|--------------------------------|------------------------------|-----------------|---------------------------------|
|                                | 2010                         | 2009            |                                 |
| Salaries and employee benefits | \$ 4,337                     | \$ 3,658        | 18.6%                           |
| Occupancy expense              | 681                          | 681             |                                 |
| Equipment and depreciation     | 354                          | 265             | 33.6%                           |
| Data processing                | 180                          | 163             | 10.4%                           |
| Professional fees              | 913                          | 526             | 73.6%                           |
| FDIC insurance                 | 458                          | 324             | 41.4%                           |
| Other real estate owned        | 334                          | 287             | 16.4%                           |
| Other operating expenses       | 1,110                        | 749             | 48.2%                           |
| <b>Total</b>                   | <b>\$ 8,367</b>              | <b>\$ 6,653</b> | <b>25.8%</b>                    |

(1) Other operating expenses consist primarily of telephone, stationery and office supplies, regulatory expenses, customer expense, investor relations expenses, insurance premiums, postage and correspondent banking fees.

The increase in noninterest expense in the three months ended March 31, 2010, as compared to the same three months of 2009, was primarily attributable to (i) a \$679,000, or 18.6%, increase in compensation expense due principally to the addition, subsequent to the end of the first quarter of 2009, of mortgage banking personnel for our new mortgage banking division and credit administrators to address the increase in non-performing loans during 2009, (ii) a \$387,000 increase in professional fees, primarily due to increased legal fees and costs incurred to manage our increased level of non-performing loans, to initiate legal proceeding to recover amounts due to us by defaulting borrowers, to foreclose real properties and other assets securing non-performing loans, and to implement loan restructurings for those borrowers who demonstrated to us an ability to meet their loan obligations on extended or modified terms; and (iii) a \$134,000 increase in FDIC insurance premiums, due to the imposition by the FDIC of substantially higher insurance premiums on all federally insured depository institutions in order to replenish the FDIC's bank insurance fund which had been depleted by bank failures in 2009.

A measure of our ability to control noninterest expense is our efficiency ratio, which is the ratio of noninterest expense to net revenue (net interest income plus noninterest income). As a general rule, a lower efficiency ratio indicates an ability to generate increased revenue without a commensurate increase in the staffing and equipment and third party services and, therefore, would be indicative of greater operational efficiencies. However, a bank's efficiency ratio can be adversely affected by factors such as the opening of new banking offices or, in the Bank's case, the commencement, in the second quarter of 2009, of our mortgage banking operations, and increases in FDIC insurance premiums. Notwithstanding the increase in noninterest expense in the three months ended March 31, 2010, our efficiency ratio remained essentially unchanged, at 85.5%, as compared to 84.8% in the same three months of 2009, due primarily to the \$3.1 million increase in our net interest income in the three months ended March 31, 2010.

*Expense Reduction Initiatives.* In February 2010, we initiated a number of cost-cutting measures that are designed to improve the efficiency of our operations and reduce our noninterest expense. Those measures included a work force reduction, a freeze on salaries, elimination of a bonus program for 2010, and suspension of Company 401-K plan matching contributions. Our objective is to reduce noninterest expense by at least 8% in 2010. However, there is no assurance that we will achieve that objective, because the amount of our noninterest expense can be affected by events that are outside of our control, such as the costs of managing non-performing loans and foreclosing and reselling other real estate owned and the amount of the FDIC insurance premiums that we are required to pay.

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### ***Income Tax Provision (Benefit)***

We recorded income tax expense of \$99,000 for the three months ended March 31, 2010, as compared to an income tax benefit of \$122,000 in the corresponding period of 2009 that was attributable to the pre-tax loss incurred in the three months ended March 31, 2009.

### ***Asset/Liability Management***

The primary objective of asset/liability management is to reduce our exposure to interest rate fluctuations, which can affect our net interest margins and, therefore, our net interest income and net earnings. We seek to achieve this objective by matching interest rate sensitive assets and liabilities, and maintaining the maturities of and repricing these assets and liabilities in response to the changes in the interest rate environment. Generally, if rate sensitive assets exceed rate sensitive liabilities, net interest income will be positively impacted during a rising interest rate environment and negatively impacted during a declining interest rate environment. When rate sensitive liabilities exceed rate sensitive assets, net interest income generally will be positively impacted during a declining interest rate environment and negatively impacted during a rising interest rate environment. However, interest rates for different asset and liability products offered by depository institutions respond differently to changes in the interest rate environment. As a result, the relationship or *gap* between interest sensitive assets and interest sensitive liabilities is only a general indicator of interest rate sensitivity and how our net interest income might be affected by changing rates of interest.

For example, rates on certain assets or liabilities typically lag behind changes in market rates of interest. Additionally, prepayments of loans and securities available for sale, and early withdrawals of certificates of deposit, can cause the interest sensitivities to vary.

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The table below sets forth information concerning our rate sensitive assets and liabilities at March 31, 2010. The assets and liabilities are classified by the earlier of maturity or repricing dates in accordance with their contractual terms. As described above, certain shortcomings are inherent in the method of analysis presented in this table.

|  | Three<br>Months<br>or<br>Less | Over Three<br>Through<br>Twelve<br>Months | Over One<br>Year<br>Through<br>Five Years | Over<br>Five<br>Years | Non-<br>Interest-<br>Bearing | Total               |
|--|-------------------------------|---|---|-----------------------|------------------------------|---------------------|
| (Dollars in thousands)   |                               |   |   |                       |                              |                     |
| <b>Assets</b>  |                               |   |   |                       |                              |                     |
| Interest-bearing time deposits in other financial institutions                     | \$ 9,551                      | \$ 399                                    | \$  | \$                    | \$                           | \$ 9,950            |
| Investment in unconsolidated trust subsidiaries                                    |                               |   |   | 682                   |                              | 682                 |
| Securities available for sale  | 14,733                        | 23,684                                    | 95,992                                    | 42,830                |                              | 177,239             |
| Federal Reserve Bank and Federal Home Loan Bank stock                              | 14,091                        |   |   |                       |                              | 14,091              |
| Interest bearing deposits with financial institutions                              | 140,183                       |   |   |                       |                              | 140,183             |
| Loans held for sale, at Fair value   | 16,468                        |   |   |                       |                              | 16,468              |
| Loans, gross   | 314,626                       | 75,127                                    | 365,367                                   | 56,322                |                              | 811,442             |
| Non-interest earning assets, net   |                               |   |   |                       | 33,807                       | 33,807              |
| <b>Total assets</b>  | <b>\$ 509,652</b>             | <b>\$ 99,210</b>                          | <b>\$ 461,359</b>                         | <b>\$ 99,834</b>      | <b>\$ 33,807</b>             | <b>\$ 1,203,862</b> |
| <b>Liabilities and Shareholders Equity</b>   |                               |   |   |                       |                              |                     |
| Noninterest-bearing deposits   | \$                            | \$  | \$  | \$                    | \$ 180,339                   | \$ 180,339          |
| Interest-bearing deposits <sup>(1)(2)</sup>  | 184,241                       | 473,571                                   | 74,527                                    | 83,809                |                              | 816,148             |
| Borrowings   | 32,025                        | 13,000                                    | 63,000                                    |                       |                              | 108,025             |
| Junior subordinated debentures   | 17,527                        |   |   |                       |                              | 17,527              |
| Other liabilities  |                               |   |   |                       | 5,832                        | 5,832               |
| Shareholders equity  |                               |   |   |                       | 75,991                       | 75,991              |
| <b>Total liabilities and shareholders equity</b>                                   | <b>\$ 233,793</b>             | <b>\$ 486,571</b>                         | <b>\$ 137,527</b>                         | <b>\$ 83,809</b>      | <b>\$ 262,162</b>            | <b>\$ 1,203,862</b> |
| <b>Interest rate sensitivity gap</b>   | <b>\$ 275,859</b>             | <b>\$ (387,361)</b>                       | <b>\$ 323,832</b>                         | <b>\$ 16,025</b>      | <b>\$ (228,355)</b>          | <b>\$</b>           |
| <b>Cumulative interest rate sensitivity gap</b>                                    | <b>\$ 275,859</b>             | <b>\$ (111,502)</b>                       | <b>\$ 212,330</b>                         | <b>\$ 228,355</b>     | <b>\$</b>                    | <b>\$</b>           |
| <b>Cumulative % of rate sensitive assets in maturity period</b>                    | <b>42%</b>                    | <b>51%</b>                                | <b>89%</b>                                | <b>97%</b>            | <b>100%</b>                  |                     |
| <b>Rate sensitive assets to rate sensitive liabilities and shareholders equity</b> | <b>218%</b>                   | <b>20%</b>                                | <b>335%</b>                               | <b>119%</b>           | <b>13%</b>                   |                     |
| <b>Cumulative ratio</b>  | <b>218%</b>                   | <b>85%</b>                                | <b>125%</b>                               | <b>124%</b>           | <b>100%</b>                  |                     |

(1) Excludes savings accounts we maintain at the Bank totaling \$4.3 million and maturing within three months of March 31, 2010.

(2) Excludes a \$250,000 certificate of deposit issued to us by the Bank, which matures January 2011.

At March 31, 2010, our rate sensitive balance sheet was shown to be in a negative twelve-month gap position. This would imply that our net interest margin would decrease in the short-term if interest rates were to rise and would increase in the short-term if interest rates were to fall.



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However, as noted above, the extent to which our net interest margin will be impacted by changes in prevailing interest rates will depend on a number of factors, including how quickly rate sensitive assets and liabilities react to interest rate changes, the mix of our interest earning assets (loans versus other lower yielding interest earning assets, such as securities or federal funds sold) and the mix of our interest bearing deposits (between, for example, lower interest core deposits and higher cost time certificates of deposit) and our other interest-bearing liabilities.

**Table of Contents****Financial Condition***Assets*

Our total consolidated assets were \$1.204 billion at March 31, 2010, essentially unchanged from our total consolidated assets of \$1.201 billion at December 31, 2009.

The following table sets forth the composition of our interest-earning assets (in thousands of dollars) at:

|  | <b>March 31,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|---------------------------|------------------------------|
| Interest-bearing deposits with financial institutions <sup>(1)</sup> | \$ 140,183                | \$ 127,785                   |
| Interest-bearing time deposits with financial institutions           | 9,950                     | 9,800                        |
| Federal Reserve Bank and Federal Home Loan Bank Stock, at cost       | 14,091                    | 14,091                       |
| Securities available for sale, at fair value                         | 177,239                   | 170,214                      |
| Loans held for sale, at lower of cost or market                      | 16,468                    | 7,572                        |
| Loans (net of allowances of \$20,863 and \$20,345, respectively)     | 790,529                   | 813,194                      |

(1) Includes interest-earning balances maintained at the Federal Reserve Bank of San Francisco.

***Loans Held for Sale***

We commenced a new mortgage banking business during the second quarter of 2009 to originate residential real estate mortgage loans that qualify for resale into the secondary mortgage markets. Our mortgage originations have been primarily loans for residential purchases and to a lesser extent, refinancing of existing residential mortgage loans. We offer loan programs for low to moderate income families and conventional programs. In the quarter ended March 31, 2010, we originated approximately \$37.7 million of conventional and FHA/VA single-family mortgages, of which (i) approximately \$26.7 million were sold by us in the secondary mortgage market, (ii) approximately \$12.2 million were held for sale at March 31, 2010 and (iii) approximately \$1.8 million were added to our loan portfolio and classified as loans held for investment. Loans held for sale are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses on loans held for sale, if any, would be recognized through a valuation allowance established by a charge to income. As of March 31, 2010, the loans held for sale included \$16.0 million of loans with interest rate lock commitments providing an effective hedge to interest rates and \$625,000 of loans pending investor commitments.

**Table of Contents****Loans**

The following table sets forth, in thousands of dollars, the composition, by loan category, of our loan portfolio at March 31, 2010 and December 31, 2009, respectively:

|   | March 31, 2010    |               | December 31, 2009 |               |
|---|-------------------|---------------|-------------------|---------------|
|   | Amount            | Percent       | Amount            | Percent       |
| Commercial loans                            | \$ 253,714        | 31.2%         | \$ 290,406        | 34.8%         |
| Commercial real estate loans owner occupied | 186,339           | 23.0%         | 179,682           | 21.5%         |
| Commercial real estate loans all other      | 139,931           | 17.2%         | 135,152           | 16.2%         |
| Residential mortgage loans multi- family    | 96,579            | 11.9%         | 101,961           | 12.2%         |
| Residential mortgage loans single-family    | 68,098            | 8.4%          | 67,023            | 8.0%          |
| Construction loans                          | 20,304            | 2.5%          | 20,443            | 2.6%          |
| Land development loans                      | 30,601            | 3.8%          | 30,042            | 3.6%          |
| Consumer loans                              | 16,362            | 2.0%          | 9,370             | 1.1%          |
| <b>Gross loans</b>                          | <b>811,928</b>    | <b>100.0%</b> | <b>834,079</b>    | <b>100.0%</b> |
| Deferred fee (income) costs, net            | (536)             |               | (540)             |               |
| Allowance for loan losses                   | (20,863)          |               | (20,345)          |               |
| <b>Loans, net</b>                           | <b>\$ 790,529</b> |               | <b>\$ 813,194</b> |               |

Commercial loans are loans to businesses to finance capital purchases or improvements, or to provide cash flow for operations. Commercial real estate and residential mortgage loans are loans secured by trust deeds on real property, including commercial property and single family and multi-family residences. Construction and land development loans are interim loans to finance specific construction projects. Consumer loans consist primarily of installment loans to consumers.

The following table sets forth, in thousands of dollars, the maturity distribution of our loan portfolio (excluding consumer and residential mortgage loans) at March 31, 2010:

|   | March 31, 2010    |                                  |                  |                   |
|---|-------------------|----------------------------------|------------------|-------------------|
|   | One Year or Less  | Over One Year through Five Years | Over Five Years  | Total             |
| Real estate and construction loans <sup>(1)</sup> |                   |                                  |                  |                   |
| Floating rate                                     | \$ 64,931         | \$ 114,582                       | \$ 9,981         | \$ 189,494        |
| Fixed rate  | 41,374            | 98,617                           | 47,690           | 187,681           |
| Commercial loans                                  |                   |                                  |                  |                   |
| Floating rate                                     | 27,408            | 225                              |                  | 27,633            |
| Fixed rate  | 105,400           | 89,850                           | 30,831           | 226,081           |
| <b>Total</b>                                      | <b>\$ 239,113</b> | <b>\$ 303,274</b>                | <b>\$ 88,502</b> | <b>\$ 630,889</b> |

(1) Does not include mortgage loans on single and multi-family residences and consumer loans, which totaled \$164.7 million and \$16.4 million, respectively, at March 31, 2010.

*Non-Performing Loans, Other Non-Performing Assets and Allowance for Loan Losses*

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*Non-Performing Loans.* Non-performing loans consist of (i) loans on non-accrual status, which include loans restructured when there has not been a history of past performance on debt service in accordance with the contractual terms of such loans, as restructured, and (ii) loans 90 days or more past due and still accruing interest. Generally, the accrual of interest is discontinued on a loan when principal or interest become more than 90 days past due, unless management believes the loan is adequately collateralized and the loan is in the process of collection. However, in certain instances, we may place a particular loan on non-accrual status earlier, depending on the individual circumstances involved in loan s delinquency. When a loan is placed on non-accrual status, previously accrued but unpaid interest is reversed against current income. Subsequent collections of cash on such loans are applied as principal reductions when received, except when the ultimate collectability of principal is probable, in which case interest payments are credited to income. Non-accrual loans may be restored to accrual status when principal and interest become current and full repayment is expected. Interest income is recognized on the accrual basis for impaired loans not meeting the criteria for non-accrual.

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*Other Non-Performing Assets.* Other non-performing assets consist of real properties that have been acquired on or in lieu of foreclosure of non-performing loans (which are commonly referred to as other real estate owned or OREO ).

The following table sets forth information regarding nonaccrual loans and other real estate owned (which, together, comprise our nonperforming assets), and restructured loans, at March 31, 2010 and December 31, 2009:

|  | At<br>March 31, 2010 | At<br>December 31, 2009 |
|--|----------------------|-------------------------|
| <b>Nonaccrual loans:</b>                               |                      |                         |
| Commercial loans                                       | \$ 10,733            | \$ 17,150               |
| Commercial real estate                                 | 19,890               | 20,779                  |
| Residential real estate                                | 586                  | 1,358                   |
| Construction and land development                      | 13,348               | 10,162                  |
| Consumer loans   | 236                  |                         |
| <b>Total nonaccrual loans</b>                          | <b>44,793</b>        | <b>49,449</b>           |
| <b>Other real estate owned (OREO):</b>                 |                      |                         |
| Construction and land development                      | 11,231               | 10,712                  |
| Residential-multi family                               |                      |                         |
| Residential-single family                              |                      |                         |
| Commercial real estate                                 |                      |                         |
| <b>Total other real estate owned</b>                   | <b>11,231</b>        | <b>10,712</b>           |
| <b>Total nonperforming assets</b>                      | <b>\$ 56,024</b>     | <b>\$ 60,161</b>        |
| <b>Restructured loans:</b>                             |                      |                         |
| Accruing loans   | \$ 1,222             | \$ 1,243                |
| Nonaccruing loans (included in nonaccrual loans above) | 18,555               | 20,114                  |
| <b>Total Restructured Loans</b>                        | <b>\$ 19,777</b>     | <b>\$ 21,357</b>        |

Non-performing assets have been trending downward since they reached their peak at September 30, 2009, when they totaled \$73.6 million. At March 31, 2010 non-performing assets had decreased by \$4.0 million, or 4%, from \$60 million at December 31, 2009 and by \$17.6 million, or 23.9%, from \$73.6 million at September 30, 2009.

Loans that have been restructured remain in a non-accrual status unless and until there has been six months of satisfactory performance by the borrowers in accordance with the restructured terms of those loans, at which time the loans usually are returned to accrual status. At March 31, 2010, we had entered into loan restructuring agreements with respect to \$18.6 million of loans carried on a non-accrual basis. If and when such loans perform as restructured for a period of six consecutive months, we expect that they will be returned to accrual status.

*Information Regarding Impaired Loans.* A loan is deemed impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. At March 31, 2010, there were \$46.0 million of loans deemed impaired as compared to \$57.4 million at December 31, 2009. We had an average investment in impaired loans for the three months ended March 31, 2010 of \$49.2 million as compared to \$52.3 million for the year ended December 31, 2009. The interest that would have been earned during the three month period ended March 31, 2010 had the impaired loans remained current in accordance with their original terms was \$608,000.

The following table sets forth the amount of impaired loans for which there is a related allowance for credit losses determined in accordance with ASC 310-10 and the amount of that allowance and the amount of impaired loans for which there is no allowance for credit losses, at March 31, 2010 and December 31, 2009:

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|                                 | March 31, 2010   |   |                                       | December 31, 2009 |   |                                       |
|---------------------------------|------------------|---|---------------------------------------|-------------------|---|---------------------------------------|
|                                 |                  | (Dollars in thousands)                  |                                       |                   |   |                                       |
| <b>Impaired Loans</b>           | <b>Loans</b>     | <b>Reserves for<br/>Loan<br/>Losses</b> | <b>% of<br/>Reserves to<br/>Loans</b> | <b>Loans</b>      | <b>Reserves for<br/>Loan<br/>Losses</b> | <b>% of<br/>Reserves to<br/>Loans</b> |
| Impaired loans with reserves    | \$ 22,251        | \$ 5,308                                | 23.9%                                 | \$ 28,237         | \$ 4,779                                | 16.9%                                 |
| Impaired loans without reserves | 23,764           |   |                                       | 29,152            |   |                                       |
| <b>Total impaired loans</b>     | <b>\$ 46,015</b> | <b>\$ 5,308</b>                         | <b>11.5%</b>                          | <b>\$ 57,389</b>  | <b>\$ 4,779</b>                         | <b>8.3%</b>                           |

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*Allowance for Loan Losses.* The allowance for loan losses (the Allowance ) at March 31, 2010 was \$20.9 million, which represented approximately 2.57% of the loans outstanding at March 31, 2010, as compared to \$20.3 million, or 2.44%, of the loans outstanding at December 31, 2009.

The adequacy of the Allowance is determined through periodic evaluations of the loan portfolio and other factors that can reasonably be expected to affect the ability of borrowers to meet their loan obligations. However, those factors are inherently subjective as the evaluation process calls for various significant estimates and assumptions, including, among others, estimates of the amounts and timing of expected future cash flows of borrowers of, and the fair value of collateral on, the impaired loans, estimates of losses on loans determined on the basis of historical loss experience and industry loss factors, and assessments of various qualitative factors. Moreover, those estimates and assessments are subject to risks and uncertainties and future events that are outside of our control, which could cause the performance of our loan portfolio to differ, possibly significantly, from the performance expected on the basis of those estimates and assessments and, therefore, could require us to increase the Allowance in future periods.

The Allowance is first determined by assigning reserve ratios for all loans. All non-accrual loans and other loans classified as special mention, substandard or doubtful ( classified loans or classification categories ) are then assigned certain allocations according to type of loans, with greater reserve ratios or percentages applied to loans deemed to be of a higher risk. These ratios are determined based on prior loss history and industry guidelines and loss factors, by loan category, adjusted for current economic factors and trends.

On a quarterly basis, we utilize a classification migration model and individual loan review analysis tools as starting points for determining the adequacy of the Allowance. Our loss migration analysis tracks a number of quarters of loan loss history and industry loss factors to determine historical losses by classification category for each loan type, except certain loans (automobile, mortgage and credit cards), which are analyzed as homogeneous loan pools. These calculated loss factors are then applied to outstanding loan balances. We also conduct individual loan review analysis, as part of the Allowance allocation process, applying specific monitoring policies and procedures in analyzing the existing loan portfolio.

In determining whether and the extent to which we will make adjustments to our loan loss migration model for purposes of determining the Allowance, we also consider a number of qualitative factors that can affect the performance and the collectability of the loans in our loan portfolio. Such qualitative factors include:

The effects of changes that we may make in our loan policies or underwriting standards on the quality of the loans and the risks in our loan portfolios;

Trends and changes in local, regional and national economic conditions, as well as changes in industry specific conditions, and any other reasonably foreseeable events that could affect the performance or the collectability of the loans in our loan portfolios;

Material changes that may occur in the mix or in the volume of the loans in our loan portfolios that could alter, whether positively or negatively, the risk profile of those portfolios;

Changes in management or loan personnel or other circumstances that could, either positively or negatively, impact the application of our loan underwriting standards, the monitoring of nonperforming loans or our loan collection efforts;

Changes in the concentration of risk in the loan portfolio; and

External factors that, in addition to economic conditions, can affect the ability of borrowers to meet their loan obligations, such as fires, earthquakes and terrorist attacks.

Determining the effects that these qualitative factors may have on the performance of our loan portfolio requires numerous judgments, assumptions and estimates about conditions, trends and events which may subsequently prove to have been incorrect due to circumstances outside of our control. Moreover, the effects of qualitative factors such as these on the performance of our loan portfolios are often difficult to

quantify. As a result, we may sustain loan losses in any particular period that are sizable in relation to the Allowance or that may even exceed the Allowance.



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In response to the economic recession, which has resulted in increased and relatively persistent high rates of unemployment, and the credit crisis that has led to a severe tightening in the availability of credit, preventing borrowers from refinancing their loans, we have (i) implemented more stringent loan underwriting standards, (ii) strengthened loan underwriting and approval processes and (iii) added personnel with experience in addressing problem assets and collecting non-performing loans.

The following table compares the total amount of loans outstanding, and the allowance for loan losses, by loan category, in each case, in thousands of dollars, and certain related ratios, as of March 31, 2010 and December 31, 2009.

|   | March 31, 2010 | December 31, 2009 | Increase (Decrease)<br>December 31,<br>2009<br>to March 31,<br>2010 |
|---|----------------|-------------------|---|
| Commercial loans                        | \$ 253,714     | \$ 290,406        | \$ (36,692)   |
| Loans impaired <sup>(1)</sup>           | 11,003         | 20,910            | (9,907)   |
| Loans 90 days past due                  | 5,830          | 13,158            | (7,328)   |
| Loans 30 days past due                  | 4,038          | 1,127             | 2,911   |
| Allowance for loan losses               |                |                   |   |
| General component                       | \$ 8,825       | \$ 9,050          | \$ (225)  |
| Specific component <sup>(1)</sup>       | 2,086          | 2,069             | 17  |
| Total allowance                         | \$ 10,911      | \$ 11,119         | \$ (208)  |
| Ratio of allowance to loan category     | 4.30%          | 3.83%             | 0.47%   |
| Real estate loans:                      | \$ 422,849     | \$ 416,795        | \$ 6,054  |
| Loans impaired <sup>(1)</sup>           | 19,890         | 20,779            | (889)   |
| Loans 90 days past due                  | 9,481          | 11,230            | (1,749)   |
| Loans 30 days past due                  | 10,963         | 727               | 10,236  |
| Allowance for loan losses               |                |                   |   |
| General component                       | \$ 4,274       | \$ 4,003          | \$ 271  |
| Specific component <sup>(1)</sup>       | 2,606          | 1,965             | 641   |
| Total allowance                         | \$ 6,880       | \$ 5,968          | \$ 912  |
| Ratio of allowance to loan category     | 1.63%          | 1.43%             | 0.20%   |
| Construction loans and land development | \$ 50,905      | \$ 50,485         | \$ 420  |
| Loans impaired <sup>(1)</sup>           | 13,789         | 13,830            | (41)  |
| Loans 90 days past due                  | 5,382          | 5,373             | 9   |
| Loans 30 days past due                  | 3,228          |                   | 3,228   |
| Allowance for loan losses               |                |                   |   |
| General component                       | \$ 1,710       | \$ 1,702          | \$ 8  |
| Specific component <sup>(1)</sup>       | 289            | 477               | (188)   |
| Total allowance                         | \$ 1,999       | \$ 2,179          | \$ (180)  |
| Ratio of allowance to loan category     | 3.93%          | 4.32%             | (0.39)%   |
| Consumer loans                          | \$ 84,460      | \$ 76,393         | \$ 8,067  |
| Loans impaired <sup>(1)</sup>           | 1,333          | 1,870             | (537)   |
| Loans 90 days past due                  |                | 87                | (87)  |
| Loans 30 days past due                  | 695            | 91                | 604   |
| Allowance for loan losses               |                |                   |   |
| General component                       | \$ 746         | \$ 811            | \$ (65)   |
| Specific component <sup>(1)</sup>       | 327            | 268               | 59  |
| Total allowance                         | \$ 1,073       | \$ 1,079          | \$ (6)  |
| Ratio of allowance to loan category     | 1.27%          | 1.41%             | (0.14)%   |
| Total loans outstanding                 | \$ 811,928     | \$ 834,079        | \$ (22,151)   |
| Loans impaired <sup>(1)</sup>           | 46,015         | 57,389            | (11,374)  |

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|   |           |           |         |
|---|-----------|-----------|---------|
| Loans 90 days past due                        | 20,693    | 29,848    | (9,155) |
| Loans 30 days past due                        | 18,924    | 1,945     | 16,979  |
| Allowance for loan losses                     |           |           |         |
| General component                             | \$ 15,555 | \$ 15,566 | \$ (11) |
| Specific component <sup>(1)</sup>             | 5,308     | 4,779     | 529     |
| Total allowance                               | \$ 20,863 | \$ 20,345 | \$ 518  |
| Ratio of allowance to total loans outstanding | 2.57%     | 2.44%     | 0.13%   |

(1) Amounts in impaired loans and in specific components include nonperforming delinquent loans.

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Set forth below is a summary, in thousands of dollars, of the transactions in the allowance for loan losses in the three months ended March 31, 2010 and the year ended December 31, 2009:

|  | Three Months Ended<br>March 31, 2010 | Year Ended<br>December 31, 2009 |
|--|--------------------------------------|---------------------------------|
| Balance, beginning of period               | \$ 20,345                            | \$ 15,453                       |
| Provision for loan losses                  | 1,200                                | 23,673                          |
| Recoveries on loans previously charged off | 276                                  | 357                             |
| Amounts charged off                        | (958)                                | (19,138)                        |
| Balance, end of period                     | \$ 20,863                            | \$ 20,345                       |

The table below indicates the trend in loan delinquencies, by quarter, from March 31, 2010 to December 31, 2009.

|   | 2010           |                | 2009            |            |             |
|---|----------------|----------------|-----------------|------------|-------------|
|   | At March 31    | At December 31 | At September 30 | At June 30 | At March 31 |
|   | (In thousands) |                |                 |            |             |
| <b>Loans Delinquent:</b>                |                |                |                 |            |             |
| 90 days or more:                        |                |                |                 |            |             |
| Commercial loans                        | \$ 5,830       | \$ 13,158      | \$ 15,220       | \$ 8,880   | \$ 762      |
| Commercial real estate                  | 9,481          | 10,550         | 10,049          | 11,724     | 3,133       |
| Residential mortgages                   |                | 767            | 269             | 346        | 1,166       |
| Construction and land development loans | 5,382          | 5,373          | 6,030           | 6,463      | 2,504       |
| Consumer loans                          |                |                |                 | 17         | 27          |
|   | 20,693         | 29,848         | 31,568          | 27,430     | 7,592       |
| 30-89 days:                             |                |                |                 |            |             |
| Commercial loans                        | 4,038          | 1,127          | 3,652           | 12,623     | 2,986       |
| Commercial real estate                  | 10,963         | 726            | 364             | 2,242      |             |
| Residential mortgages                   | 695            | 92             | 1,152           | 270        | 346         |
| Construction and land development loans | 3,228          |                | 2,215           |            | 6,409       |
| Consumer loans                          |                |                | 248             |            |             |
|   | 18,924         | 1,945          | 7,631           | 15,135     | 9,741       |
| Total Past Due <sup>(1)</sup> :         | \$ 39,617      | \$ 31,793      | \$ 39,199       | \$ 42,565  | \$ 17,333   |

(1) Past due balances include nonaccrual loans.

As indicated above, total past due increased by \$7.8 million, or 24.5%, to \$39.6 million at March 31, 2010, from \$31.8 million at December 31, 2009. Loans 30 to 89 days delinquent increased by \$17 million, to \$18.9 million at March 31, 2010, from \$1.9 million at December 31, 2009. That increase was primarily attributable to loans to two customers that became delinquent during the quarter ended March 31, 2010. Ordinarily, loans such as these, that are delinquent for less than 90 days, are not classified as non-performing loans and reserves are not typically allocated for such loans. However, we decided to classify these loans as non-performing loans and, as a result, they are included in the total of non-performing loans at March 31, 2010 and we allocated specific reserves for these loans within the allowance for loan losses at March 31, 2010.



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**Deposits**

*Average Balances of and Average Interest Rates Paid on Deposits.*

Set forth below are the average amounts (in thousands of dollars) of, and the average rates paid on, deposits in the three months ended March 31, 2010:

|                                     | <b>Three Months Ended<br/>March 31, 2010</b> |                         |
|-------------------------------------|--|-------------------------|
|                                     | <b>Average<br/>Balance</b>                   | <b>Average<br/>Rate</b> |
| Noninterest-bearing demand deposits | \$ 171,735                                   |                         |
| Interest-bearing checking accounts  | 40,810                                       | 0.74%                   |
| Money market and savings deposits   | 123,248                                      | 1.30%                   |
| Time deposits                       | 641,254                                      | 2.42%                   |
| <b>Average total deposits</b>       | <b>\$ 977,047</b>                            | <b>1.78%</b>            |

*Deposit Totals.* Deposits totaled \$996 million at March 31, 2010 as compared to \$960 million at December 31, 2009 and \$897 million at March 31, 2009. The following table compares the mix of our deposits, as between lower cost core deposits and higher cost time deposits, at March 31, 2010, December 31, 2009 and March 31, 2009, respectively:

|   | <b>At March 31, 2010</b> |  | <b>At December 31, 2009</b>   |  | <b>At March 31, 2009</b> |  |
|---|--------------------------|--|-------------------------------|--|--------------------------|--|
|   | <b>Amounts</b>           | <b>Percent of<br/>Total<br/>Deposits</b> | <b>Amounts</b>                | <b>Percent of<br/>Total<br/>Deposits</b> | <b>Amounts</b>           | <b>Percent of<br/>Total<br/>Deposits</b> |
|   |                          |  | <b>(Dollars in thousands)</b> |  |                          |  |
| <b>Core deposits</b>                                    |                          |  |                               |  |                          |  |
| Non-interest bearing demand deposits                    | \$ 180,339               | 18.1%                                    | \$ 183,789                    | 19.1%                                    | \$ 151,911               | 16.9%                                    |
| Savings and other interest-bearing transaction deposits | 169,945                  | 17.1%                                    | 154,968                       | 16.2%                                    | 129,701                  | 14.5%                                    |
| Time deposits   | 646,203                  | 64.8%                                    | 621,681                       | 64.7%                                    | 614,980                  | 68.6%                                    |
| <b>Total deposits</b>                                   | <b>\$ 996,487</b>        | <b>100.0%</b>                            | <b>\$ 960,438</b>             | <b>100.0%</b>                            | <b>\$ 896,592</b>        | <b>100.0%</b>                            |

As indicated in the above table, non interest bearing demand deposit increased to 18.1% of total deposits at March 31, 2010, from 16.9% of total deposits at March 31, 2009, while time deposits, which bear higher rates of interest than our core deposits, decreased to 64.8% of total deposits at March 31, 2010 from 68.6% of total deposits at March 31, 2009. That change in the mix of deposits contributed to an improvement in our net interest income and net interest margin in this year's first quarter as compared to the same quarter of 2009. See Results of Operations *Net Interest Income* above in this Section of this Report.

Set forth below, in thousands of dollars, is a maturity schedule of domestic time certificates of deposit outstanding at March 31, 2010:

|                                      | <b>At March 31, 2010</b>                                   |   |
|--------------------------------------|--|---|
|                                      | <b>Certificates<br/>of Deposit<br/>Under<br/>\$100,000</b> | <b>Certificates<br/>of Deposit<br/>of \$100,000<br/>or More</b> |
| <b>Maturities</b>                    |  |   |
| Three months or less                 | \$ 22,131  | \$ 73,894   |
| Over three and through twelve months | 101,520  | 372,029   |

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|                               |            |            |
|-------------------------------|------------|------------|
| Over twelve months            | 25,410     | 51,219     |
| Total certificates of deposit | \$ 149,061 | \$ 497,142 |

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We actively manage our liquidity needs to ensure that sufficient funds are available to meet our needs for cash, including to fund new loans to and deposit withdrawals by our customers. We project the future sources and uses of funds and maintain liquid funds for unanticipated events. Our primary sources of cash include cash we have on deposit at other financial institutions, payments on loans, proceeds from the sale or maturity of securities, and from sales of residential mortgage loans, increases in deposits and increases in borrowings principally from the Federal Home Loan Bank. The primary uses of cash include funding new loans and making advances on existing lines of credit, purchasing investments, including securities available for sale, funding new residential mortgage loans, funding deposit withdrawals and paying operating expenses. We maintain funds in overnight federal funds and other short-term investments to provide for short-term liquidity needs. We also have obtained credit lines from the Federal Home Loan Bank and other financial institutions to meet any additional liquidity requirements.

Our liquid assets, which included cash and due from banks, federal funds sold, interest earning deposits with financial institutions and unpledged securities available for sale (excluding Federal Reserve Bank and Federal Home Loan Bank stock) totaled \$312 million, which represented 26% of total assets, at March 31, 2010.

*Cash Flow Used in Operating Activities.* We used net cash flow of \$9.6 million from operating activities primarily to fund the origination of \$35.9 million of mortgage loans in the three months ended March 31, 2010, partially offset by \$27 million in proceeds on sales of mortgage loans.

*Cash Flow Provided by Investing Activities.* In the three months ended March 31, 2010, investing activities provided net cash of \$15.8 million, primarily due to loan repayments during that period.

*Cash Flow Used by Financing Activities.* In the three months ended March 31, 2010, financing activities provided net cash of \$3.9 million, due to an increase in deposits of \$36 million, partially offset by a net decrease of \$33 million in borrowings.

*Ratio of Loans to Deposits.* The relationship between gross loans and total deposits can provide a useful measure of a bank's liquidity. Since repayment of loans tends to be less predictable than the maturity of investments and other liquid resources, the higher the loan-to-deposit ratio the less liquid are our assets. On the other hand, since we realize greater yields on loans than we do on investments, a lower loan-to-deposit ratio can adversely affect interest income and earnings. As a result, our goal is to achieve a loan-to-deposit ratio that appropriately balances the requirements of liquidity and the need to generate a fair return on assets. At March 31, 2010 and December 31, 2009, the ratios of loans-to-deposits were 81% and 86%, respectively. The reduction in that ratio at March 31, 2010, as compared to December 31, 2009, was primarily attributable to our decision to increase our liquidity, which we believe was prudent due to the continuing economic recession and credit crisis and uncertainties as to their ultimate duration.

**Off Balance Sheet Arrangements**

*Loan Commitments and Standby Letters of Credit.* In order to meet the financing needs of our customers, in the normal course of business we make commitments to extend credit and issue standby commercial letters of credit to or for our customers. At March 31, 2010 and December 31, 2009, we were committed to fund certain loans, including letters of credit, amounting to approximately \$182 million and \$184 million, respectively.

Commitments to extend credit and standby letters of credit generally have fixed expiration dates or other termination clauses and the customer may be required to pay a fee and meet other conditions in order to draw on those commitments or standby letters of credit. We expect, based on historical experience, that many of the commitments will expire without being drawn upon and, therefore, the total commitment amounts do not necessarily represent future cash requirements.

To varying degrees, commitments to extend credit involve elements of credit and interest rate risk for us that are in excess of the amounts recognized in our balance sheets. Our maximum exposure to credit loss in the event of nonperformance by the customers to whom such commitments are made could potentially be equal to the amount of those commitments. As a result, before making such a commitment to a customer, we evaluate the customer's creditworthiness using the same underwriting standards that we would apply if we were approving loans to the customer. In addition, we often require the customer to secure its payment obligations for amounts drawn on such commitments with collateral such as accounts receivable, inventory, property, plant and equipment, income-producing

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commercial properties, residential properties and properties under construction. As a consequence, our exposure to credit and interest rate risk on such commitments is not different in character or amount than risks inherent in the outstanding loans in our loan portfolio.

Standby letters of credit are conditional commitments issued by the Bank to guarantee a payment obligation of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

We believe that our cash and cash equivalent resources, together with available borrowings under our credit facilities, will be sufficient to enable us to meet any increases in demand for loans or in the utilization of outstanding loan commitments or standby letters of credit and any increase in deposit withdrawals that might occur in the foreseeable future.

**Contractual Obligations**

*Borrowings.* As a source of additional funds that we have used primarily to fund loans and to purchase other interest earning assets, and to provide us with a supplemental source of liquidity, we have obtained long and short term borrowings from the Federal Home Loan Bank (the FHLB ). As of March 31, 2010, we had \$63 million of outstanding long-term borrowings, with maturities ranging from August 2011 to February 2013, and \$45 million of outstanding short-term borrowings, with maturities ranging from April 2010 to December 2010 that we had obtained from the Federal Home Loan Bank. These borrowings, together with securities sold under agreements to repurchase, have a weighted-average annualized interest rate of 1.89%. By comparison, as of December 31, 2009, we had \$14 million of outstanding long-term borrowings and \$127 million of outstanding short-term borrowings that we had obtained from the Federal Home Loan Bank, which, together with the securities sold under agreements to repurchase, had a weighted-average annualized interest rate of 3.65%.

At March 31, 2010, U.S. agency and mortgage backed securities, U.S. Government agency securities and collateralized mortgage obligations with an aggregate fair market value of \$31 million and \$134 million of residential mortgage and other real estate secured loans were pledged to secure these Federal Home Loan Bank borrowings, repurchase agreements, local agency deposits, and treasury, tax and loan accounts.

The highest amount of borrowings that were outstanding at any month-end during the three months ended March 31, 2010 consisted of \$132 million of borrowings from the Federal Home Loan Bank and \$25,000 of overnight borrowings in the form of securities sold under repurchase agreements. During 2009, the highest amount of borrowings outstanding at any month-end consisted of \$208 million of advances from the Federal Home Loan Bank and \$13 million of overnight borrowings in the form of securities sold under repurchase agreements.

*Junior Subordinated Debentures.* Pursuant to rulings of the Federal Reserve Board, bank holding companies are permitted to issue long term subordinated debt instruments that will, subject to certain conditions, qualify as and, therefore, augment capital for regulatory purposes. At March 31, 2010, we had outstanding approximately \$17.5 million principal amount of 30-year junior subordinated floating rate debentures (the Debentures ). The Debentures are redeemable at our option, without premium or penalty, beginning five years after their respective original issue dates, and require quarterly interest payments. Subject to certain conditions, we have the right, at our discretion, to defer those interest payments for up to five years.

Set forth below is certain information regarding the terms of the Debentures that remained outstanding as of March 31, 2010:

| Original Issue Dates | Principal Amount<br>(In thousands) | Interest Rates   | Maturity Dates |
|----------------------|------------------------------------|------------------|----------------|
| September 2002       | \$ 7,217                           | LIBOR plus 3.40% | September 2032 |
| October 2004         | 10,310                             | LIBOR plus 2.00% | October 2034   |
| <b>Total</b>         | <b>\$ 17,527</b>                   |                  |                |



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In July 2009, we entered into a Memorandum of Understanding (an "MOU") with the FRB and the DFI. The stated objective of the MOU is to enable the Company and the Bank to maintain their financial soundness in what has been and continues to be a very difficult economic and market environment by, among other things, imposing certain restrictions on actions that would have the effect of reducing the Company's capital or cash flows. Those restrictions include a requirement that the Company obtain prior regulatory approval to pay interest on the Debentures. During the quarter ended March 31, 2009, we were advised by the FRB that it would not approve the payment of interest on the Debentures scheduled for April 19, 2010. As a result, we exercised our right, pursuant to the terms of the Debentures, to defer that interest payment. Moreover, we may be required to exercise our deferral right with respect to subsequent interest payments on the Debentures if we are not able to obtain FRB approval to make those interest payments. Since we have the right, under the terms of the Debentures to defer interest payments, the deferral of the April 2010 interest payment did not, and deferrals of subsequent interest payments will not, constitute a default under or with respect to the Debentures.

Under the Federal Reserve Board rulings, the borrowings evidenced by the Debentures, which are subordinated to all of our other borrowings that are outstanding or which we may obtain in the future, are eligible (subject to certain dollar limitations) to qualify, and at March 31, 2010, \$16.8 million principal amount of those Debentures then outstanding qualified, as Tier I capital for regulatory purposes. See discussion below under the subcaption "Capital Resources-Regulatory Capital Requirements."

### **Investment Policy and Securities Available for Sale**

Our investment policy is designed to provide for our liquidity needs and to generate a favorable return on investments without undue interest rate risk, credit risk or asset concentrations.

Our investment policy:

authorizes us to invest in obligations issued or fully guaranteed by the United States Government, certain federal agency obligations, time deposits issued by federally insured depository institutions, municipal securities and in federal funds sold;

provides that the weighted average maturities of U.S. Government obligations and federal agency securities cannot exceed 10 years and municipal obligations cannot exceed 25 years;

provides that time deposits must be placed with federally insured financial institutions, cannot exceed the current federally insured amount in any one institution and may not have a maturity exceeding 60 months, unless that time deposit is matched to a liability instrument issued by the Bank; and

prohibits engaging in securities trading activities.

Securities available for sale are those that we intend to hold for an indefinite period of time, but which may be sold in response to changes in liquidity needs, changes in interest rates, changes in prepayment risks or other similar factors. Such securities are recorded at fair value. Any unrealized gains and losses are reported as "Other Comprehensive Income (Loss)" rather than included in or deducted from earnings.

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The following is a summary of the major components of securities available for sale and a comparison of the amortized cost, estimated fair values and gross unrealized gains and losses, in thousands of dollars, as of March 31, 2010 and December 31, 2009:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gain | Gross<br>Unrealized<br>Loss | Estimated<br>Fair Value |
|---|-------------------|-----------------------------|-----------------------------|-------------------------|
| <b>March 31, 2010</b>   |                   |                             |                             |                         |
| Securities Available For Sale:  |                   |                             |                             |                         |
| US Treasury securities  | \$                | \$                          | \$                          | \$                      |
| Mortgage-backed securities issued by US agencies                      | 161,998           | 115                         | (839)                       | 161,274                 |
| Collateralized mortgage obligations issued by US agencies             |                   |                             |                             |                         |
| Total securities issued or guaranteed by US government or US agencies | 161,998           | 115                         | (839)                       | 161,274                 |
| Municipal securities  | 9,811             | 2                           | (361)                       | 9,452                   |
| Non-agency collateralized mortgage obligations                        | 4,311             |                             | (1,015)                     | 3,296                   |
| Asset-backed securities   | 2,658             |                             | (1,720)                     | 938                     |
| Mutual fund   | 2,279             |                             |                             | 2,279                   |
| <b>Total Securities Available For Sale</b>                            | <b>\$ 181,057</b> | <b>\$ 117</b>               | <b>\$ (3,935)</b>           | <b>\$ 177,239</b>       |
| <b>December 31, 2009</b>  |                   |                             |                             |                         |
| Securities Available For Sale:  |                   |                             |                             |                         |
| US Treasury securities  | \$ 18,040         | \$ 11                       | \$                          | \$ 18,051               |
| US agencies and mortgage-backed securities                            | 134,331           | 89                          | (1,651)                     | 132,769                 |
| Collateralized mortgage obligations                                   |                   |                             |                             |                         |
| Total government and agencies securities                              | 152,371           | 100                         | (1,651)                     | 150,820                 |
| Municipal securities  | 10,545            | 13                          | (431)                       | 10,127                  |
| Non-agency collateralized mortgage obligations                        | 7,094             | 10                          | (1,069)                     | 6,035                   |
| Asset backed securities   | 2,704             |                             | (1,732)                     | 972                     |
| Mutual fund   | 2,260             |                             |                             | 2,260                   |
| <b>Total Securities Available For Sale</b>                            | <b>\$ 174,974</b> | <b>\$ 123</b>               | <b>\$ (4,883)</b>           | <b>\$ 170,214</b>       |

At March 31, 2010, U.S. agencies and mortgage backed securities, U.S. Government agency securities, collateralized mortgage obligations and time deposits with an aggregate fair market value of \$40 million were pledged to secure Federal Home Loan Bank borrowings, repurchase agreements, local agency deposits, to secure lines of credit at our correspondent banks and treasury, tax and loan accounts.

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The amortized cost, at March 31, 2010, of securities available for sale are shown, in thousands of dollars, in the following table, by contractual maturities and historical prepayments based on the prior three months of principal payments. Expected maturities will differ from contractual maturities and historical prepayments, particularly with respect to collateralized mortgage obligations, because borrowers may react to interest rate market conditions differently than the historical prepayment rates.

|  | March 31, 2010 Maturing in |                        |                                  |                        |                                   |                        |                  |                        |                   |                        |
|--|----------------------------|------------------------|----------------------------------|------------------------|-----------------------------------|------------------------|------------------|------------------------|-------------------|------------------------|
|  | One year or less           |                        | Over one year through five years |                        | Over five years through ten years |                        | Over ten years   |                        | Total             |                        |
|  | Book Value                 | Weighted Average Yield | Book Value                       | Weighted Average Yield | Book Value                        | Weighted Average Yield | Book Value       | Weighted Average Yield | Book Value        | Weighted Average Yield |
| (Dollars in thousands)                         |                            |                        |                                  |                        |                                   |                        |                  |                        |                   |                        |
| Securities available for sale:                 |                            |                        |                                  |                        |                                   |                        |                  |                        |                   |                        |
| US Treasury securities                         | \$                         |                        | \$                               |                        | \$                                |                        | \$               |                        | \$                |                        |
| US agency/mortgage-backed securities           | 12,692                     | 3.15%                  | 41,705                           | 3.38%                  | 46,462                            | 3.53%                  | 61,139           | 3.47%                  | 161,998           | 3.44%                  |
| Agency collateralized mortgage obligations     |                            |                        |                                  |                        |                                   |                        |                  |                        |                   |                        |
| Non-agency collateralized mortgage obligations | 1,211                      | 2.80%                  |                                  |                        | 1,802                             | 3.57%                  | 1,298            |                        | 4,311             | 3.26%                  |
| Municipal securities                           |                            |                        |                                  |                        | 1,348                             | 4.10%                  | 8,463            | 4.28%                  | 9,811             | 4.25%                  |
| Asset backed securities                        |                            |                        |                                  |                        |                                   |                        | 2,658            | 1.18%                  | 2,658             | 1.18%                  |
| Mutual funds                                   |                            |                        | 2,279                            | 3.93%                  |                                   |                        |                  |                        | 2,279             | 3.93%                  |
| <b>Total Securities Available for sale</b>     | <b>\$ 13,903</b>           | <b>3.12%</b>           | <b>\$ 43,984</b>                 | <b>3.78%</b>           | <b>\$ 49,612</b>                  | <b>3.55%</b>           | <b>\$ 73,558</b> | <b>3.95%</b>           | <b>\$ 181,057</b> | <b>3.46%</b>           |

The table below shows, as of March 31, 2010, the gross unrealized losses and fair values (in thousands of dollars) of our investments, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

| (Dollars In thousands)                         | Securities With Unrealized Loss as of March 31, 2010 |                 |                   |                   |                   |                   |
|--|--|-----------------|-------------------|-------------------|-------------------|-------------------|
|  | Less than 12 months                                  |                 | 12 months or more |                   | Total             |                   |
|  | Fair Value   | Unrealized Loss | Fair Value        | Unrealized Loss   | Fair Value        | Unrealized Loss   |
| US agency mortgage backed securities           | \$ 145,316   | \$ (836)        | \$ 742            | \$ (3)            | \$ 146,058        | \$ (839)          |
| Agency collateralized mortgage obligations     |  |                 |                   |                   |                   |                   |
| Non agency collateralized mortgage obligations | 4,634  | (76)            | 3,979             | (285)             | 8,613             | (361)             |
| Asset backed securities                        |  |                 | 3,296             | (1,015)           | 3,296             | (1,015)           |
| Municipal securities                           |  |                 | 938               | (1,720)           | 938               | (1,720)           |
| <b>Total temporarily impaired securities</b>   | <b>\$ 149,950</b>                                    | <b>\$ (912)</b> | <b>\$ 8,955</b>   | <b>\$ (3,023)</b> | <b>\$ 158,905</b> | <b>\$ (3,935)</b> |

We regularly monitor investments for significant declines in fair value. In our judgment, the declines in the fair values of these investments below their amortized costs, as set forth in the table above, are temporary, based on the following factors: (i) those declines are due to interest rate changes and not due to a deterioration in the creditworthiness of the issuers of those investment securities, and (ii) we have the ability to hold those securities until there is a recovery in their values or until their maturity.

**Table of Contents****Capital Resources**

*Capital Regulatory Requirements Applicable to Banking Institutions.* Under federal banking regulations that apply to all United States based bank holding companies and federally insured banks, the Company (on a consolidated basis) and the Bank (on a stand-alone basis) must meet specific capital adequacy requirements that, for the most part, involve quantitative measures, primarily in terms of the ratios of their capital to their assets, liabilities, and certain off-balance sheet items, calculated under regulatory accounting practices. Under those regulations, which are based primarily on those quantitative measures, each bank holding company must meet a minimum capital ratio and each federally insured bank is determined by its primary federal bank regulatory agency to come within one of the following categories.

well capitalized

adequately capitalized

undercapitalized

significantly undercapitalized; or

critically undercapitalized

Certain qualitative assessments also are made by a banking institution's primary federal regulatory agency that could lead the agency to determine that a banking institution should be assigned to a lower capital category than the one indicated by the quantitative measures used to assess the institution's capital adequacy. At each successive lower capital category, a banking institution is subject to greater operating restrictions and increased regulatory supervision by its federal bank regulatory agency.

The following table sets forth the capital and capital ratios of the Company (on a consolidated basis) and the Bank (on a stand-alone basis) at March 31, 2010, as compared to the respective regulatory requirements applicable to them.

|  | Actual     |       | Applicable Federal Regulatory Requirement<br>Capital Adequacy<br>Purposes |               | To be Categorized Well<br>Capitalized |                |
|--|------------|-------|---|---------------|---------------------------------------|----------------|
|  | Amount     | Ratio | Amount  | Ratio         | Amount                                | Ratio          |
| (Dollars in thousands)                         |            |       |   |               |                                       |                |
| <b>Total Capital to Risk Weighted Assets:</b>  |            |       |   |               |                                       |                |
| Company  | \$ 101,933 | 11.4% | \$ 71,452   | At least 8.0% | N/A                                   | N/A            |
| Bank   | 98,297     | 11.0% | 71,312  | At least 8.0% | \$ 89,044                             | At least 10.0% |
| <b>Tier 1 Capital to Risk Weighted Assets:</b> |            |       |   |               |                                       |                |
| Company  | \$ 90,646  | 10.2% | \$ 35,726   | At least 4.0% | N/A                                   | N/A            |
| Bank   | 87,031     | 9.8%  | 35,656  | At least 4.0% | \$ 53,426                             | At least 6.0%  |
| <b>Tier 1 Capital to Average Assets:</b>       |            |       |   |               |                                       |                |
| Company  | \$ 90,646  | 7.6%  | \$ 47,681   | At least 4.0% | N/A                                   | N/A            |
| Bank   | 87,031     | 7.3%  | 47,577  | At least 4.0% | \$ 59,471                             | At least 5.0%  |

At March 31, 2010 the Bank (on a stand-alone basis) continued to qualify as a well-capitalized institution, and the Company continued to exceed the minimum required capital ratios, under the capital adequacy guidelines described above. During the three months ended March 31, 2010, the Company made a \$3.3 million capital contribution to the Bank to offset a decline in the Bank's capital due to the losses incurred during that period and to better enable the Bank to absorb any additional loan losses that could occur as a result of economic and financial crisis in the United States and, at the same time, maintain its capital ratios above those required to qualify as a well capitalized banking institution for regulatory purposes.



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The consolidated total capital and Tier 1 capital of the Company, at March 31, 2010, include an aggregate of \$16.8 million principal amount of Junior Subordinated Debentures that we issued in 2002 and 2004. We contributed that amount to the Bank over a six year period ended December 31, 2009, thereby providing it with additional cash to fund the growth of its banking operations and, at the same time, to increase its total capital and Tier 1 capital.

*Sale of Series A Convertible 10% Cumulative Preferred Stock.* As previously reported in a Current Report filed with the SEC on Form 8-K dated October 6, 2009, we have commenced a private offering, to a limited number of accredited investors (as defined in Regulation D under the Securities Act of 1933, as amended), of up to \$15.5 million of a new issue of Series A Convertible 10% Cumulative Preferred Stock (the Series A Shares ). Through May 7, 2010, we had sold a total of \$9.7 million of the Series A Shares in the private offering.

Cumulative dividends accrue on the Series A Shares at a rate of 10% per annum. Each outstanding Series A Share is convertible at the option of its holder, at a conversion price of \$7.65 per share, into approximately 13.07 shares of our common stock and, if not sooner converted, all of the Series A Shares will automatically convert into common stock at that same conversion price (as the same may be adjusted under certain anti-dilution provisions applicable to the Series A Shares) on the second anniversary of the original issue date of the Series A Shares (subject to a possible deferral of that automatic conversion date). A more detailed description of the rights, preferences and privileges of and restrictions of the Series A Shares is contained in that Current Report on Form 8-K and the foregoing summary is qualified by reference to that description.

We are using the net proceeds from the sale of the Series A Shares for general corporate purposes, which may include making a capital contribution to Bank in order to increase its equity capital and to provide it with cash to fund additional loans and other interest-earning assets and meet working capital requirements.

*Dividend Policy and Share Repurchase Programs.* Our Board of Directors has followed the policy of retaining earnings to maintain capital and, thereby, support the growth of the Company s banking franchise. On occasion, the Board also has considered paying cash dividends out of cash generated in excess of those capital requirements and, in February 2008, the Board of Directors declared a cash dividend, in the amount of \$0.10 per share of common stock, that was paid on March 14, 2008 to our shareholders.

The Board also has authorized share repurchase programs, in June 2005 and in October 2008, when the Board concluded that, at prevailing market prices, the Company s shares represented an attractive investment opportunity and, therefore, that share repurchases would be a good use of Company funds.

In the first quarter of 2009, the Board of Directors decided that the prudent course of action, in light of the economic recession, was to preserve cash and earnings to enhance the Bank s capital position and to be in a position to take advantage of improved economic and market conditions in the future. Moreover, the MOU entered into with the FRB and DFI in July 2009 prohibits the payment of cash dividends and share repurchases without the approval of those regulatory agencies. Accordingly, we do not expect to pay dividends or make share purchases at least for the foreseeable future.

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### **ITEM 3. MARKET RISK**

We are exposed to market risk as a consequence of the normal course of conducting our business activities. The primary market risk to which we are exposed is interest rate risk. Our interest rate risk arises from the instruments, positions and transactions entered into for purposes other than trading. They include loans, securities, deposit liabilities, and short-term borrowings. Interest rate risk occurs when assets and liabilities reprice at different times as market interest rates change. Interest rate risk is managed within an overall asset/liability framework for the Company.

### **ITEM 4T. CONTROLS AND PROCEDURES**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended (the Exchange Act ) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our CEO and CFO, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognized that any system of controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Management previously disclosed in Item 9A(T) Controls and Procedures in part II of our Annual Report on Form 10-K, filed on April 1, 2010 for the fiscal year ended December 31, 2009, a material weakness in internal control over financial reporting relating to our internal controls for assessing the adequacy of the Company's allowance for loan losses. That determination was made in January 2010, based on a report that we received from our federal and state bank regulators regarding their findings following a regulatory examination they had conducted of the Bank.

As required by Rules 13a-15 and 15d-15 under the Exchange Act, in connection with the filing of this Quarterly Report on Form 10-Q, an evaluation was performed under the supervision and with the participation of our management, including our CEO and CFO, of the effectiveness of the design and operation of our disclosure controls and procedures as of March 31, 2010. Based on the evaluation, our CEO and CFO have concluded that the previously identified deficiency in internal control over financial reporting could cause our disclosure controls and procedures to be not fully effective at the reasonable assurance level as of March, 2010.

#### ***Remediation***

As previously reported in an amendment that we filed on Form 10-Q/A with the SEC on March 18, 2010, to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009, in order to address the material weakness, described above, in our internal control over financial reporting, management has modified its policies and procedures for assessing the adequacy of the Company's allowance for loan losses to give greater weight to the impact that qualitative factors can reasonably be expected to have on the performance and collectability of loans in the loan portfolio. Those qualitative factors include:

The effects of changes that we may make in our loan policies or underwriting standards on the quality of the loans and the risks in our loan portfolios;

Trends and changes in local, regional and national economic conditions, as well as changes in industry specific conditions, and any other reasonably foreseeable events that could affect the performance or the collectibility of the loans in our loan portfolios;

Material changes that may occur in the mix or in the volume of the loans in our loan portfolios that could alter, whether positively or negatively, the risk profile of those portfolios;

Changes in management or loan personnel or other circumstances that could, either positively or negatively, impact the application of our loan underwriting standards, the monitoring of nonperforming loans or our loan collection efforts;

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Changes in the concentration of risk in the loan portfolio; and

External factors that, in addition to economic conditions, can affect the ability of borrowers to meet their loan obligations, such as fires, earthquakes and terrorist attacks.

We also continue to perform quarterly analyses of our allowance for loan losses. In addition, the allowance for loan losses continues to be reviewed at all levels of senior and executive management, as well as by the Board of Directors.



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Management believes the additional control procedures, when implemented and validated, will remediate this material weakness. However, the effectiveness of any system of internal controls is subject to inherent limitations and there can be no assurance that the Company's internal control over financial reporting will prevent or detect all errors. The Company intends to continue to evaluate and strengthen its internal control over financial reporting system.

***Changes in Internal Control over Financial Reporting***

There were no changes in our internal control over financial reporting during the first quarter of 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting, except for the process to remediate the material weakness described above.

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**PART II**

**ITEM 1 LEGAL PROCEEDINGS**

James Laliberte, et al. vs. Pacific Mercantile Bank, filed in May 2003 in the California Superior Court for the County of Orange (Case No. 030007092). Information regarding this law suit is contained in Item 3 of Part I of our Annual Report on Form 10-K for our fiscal year ended December 31, 2009, and there have been no subsequent developments in that case since we filed that Annual Report with the SEC on April 1, 2010.

We also are subject to legal actions that arise from time to time in the ordinary course of our business. Currently there are no such pending legal proceedings that we believe will become material to our financial condition or results of operations.

**ITEM 1A. RISK FACTORS**

There have been no material changes from the risk factors that were disclosed under the caption "Risk Factors" in Item 1A of Part I of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 (the "2009 10-K"), except as follows:

*It may become necessary for us to raise additional capital which could dilute the ownership of our existing shareholders and adversely affect the market price of our common stock*

Due primarily to concerns of bank regulatory agencies that banking institutions may incur additional losses before there is a sustained economic recovery, bank holding companies and banks are coming under increasing pressure from bank regulatory agencies to raise additional capital, even in cases of banking institutions that are categorized as adequately capitalized or well-capitalized under bank regulatory guidelines. There is no assurance that we will not be required, by our bank regulatory agencies, to sell shares to the public or in private transactions in order to raise additional capital during 2010 at a time when the prevailing prices of our shares are at historic lows. As a result, any such sales of shares could dilute the ownership of our existing shareholders and the tangible book value of our existing shares and, thereby, adversely affect the market prices of our common stock.

Moreover, our ability to raise additional capital will depend on market and economic conditions over which we do not have control. As a result, there is no assurance that, if required, we will be able to raise additional capital in amounts sufficient to meet regulatory requirements. If we are unable to do so, additional regulatory restrictions may be imposed on us which could increase our costs of doing business and adversely affect our results of operations and the market price of our shares.

**ITEM 6. EXHIBITS**

The following documents are filed as Exhibits to the Quarterly Report on Form 10-Q:

| <b>Exhibit No.</b> | <b>Description of Exhibits</b>   |
|--------------------|--|
| Exhibit 31.1       | Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 31.2       | Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 32.1       | Certification of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 32.2       | Certification of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 |

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**SIGNATURES**

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

**PACIFIC MERCANTILE BANCORP**

Date: May 11, 2010

By: */s/ NANCY A. GRAY*  
Nancy A. Gray, Chief Financial Officer

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**EXHIBIT INDEX**

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