

NORTHRIM BANCORP INC  
Form 10-Q  
August 06, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2012

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-33501

NORTHRIM BANCORP, INC.

(Exact name of registrant as specified in its charter)

Alaska

92-0175752

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

3111 C Street

Anchorage, Alaska 99503

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(Address of principal executive offices) (Zip Code)

(907) 562-0062

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer

Accelerated filer  Non-accelerated filer

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The number of shares of the issuer's Common Stock outstanding at August 6, 2012 was 6,470,518.

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## TABLE OF CONTENTS

|          |  |    |
|----------|--|----|
| PART I   | <u>FINANCIAL INFORMATION</u>                                       |    |
| Item 1.  | <u>Financial Statements (unaudited)</u>                            |    |
|          | <u>Consolidated Balance Sheets:</u>                                | 3  |
|          | <u>June 30, 2012, December 31, 2011 and June 30, 2011</u>          |    |
|          | <u>Consolidated Statements of Income:</u>                          | 4  |
|          | <u>Three and six months ended June 30, 2012 and 2011</u>           |    |
|          | <u>Consolidated Statements of Comprehensive Income:</u>            | 5  |
|          | <u>Three and six months ended June 30 2012 and 2011</u>            |    |
|          | <u>Consolidated Statements of Changes in Shareholders' Equity:</u> | 6  |
|          | <u>Six months ended June 30, 2012 and 2011</u>                     |    |
|          | <u>Consolidated Statements of Cash Flows:</u>                      | 7  |
|          | <u>Six months ended June 30, 2012 and 2011</u>                     |    |
|          | <u>Notes to the Consolidated Financial Statements</u>              | 8  |
|          | <u>Management's Discussion and Analysis of Financial</u>           | 24 |
| Item 2.  | <u>Condition and Results of Operations</u>                         |    |
| Item 3.  | <u>Quantitative and Qualitative Disclosures About Market Risk</u>  | 35 |
| Item 4.  | <u>Controls and Procedures</u>                                     | 35 |
| PART II  | <u>OTHER INFORMATION</u>   | 35 |
| Item 1.  | <u>Legal Proceedings</u>   | 35 |
| Item 1A. | <u>Risk Factors</u>  | 35 |
| Item 2.  | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 35 |
| Item 3.  | <u>Defaults Upon Senior Securities</u>                             | 36 |
| Item 4.  | <u>Mine Safety Disclosures</u>                                     | 36 |
| Item 5.  | <u>Other Information</u>   | 36 |
| Item 6.  | <u>Exhibits</u>  | 36 |
|          | <u>SIGNATURES</u>  | 36 |



## PART I. FINANCIAL INFORMATION

These consolidated financial statements should be read in conjunction with the financial statements, accompanying notes and other relevant information included in the Northrim Bancorp, Inc's Annual Report on Form 10-K for the year ended December 31, 2011.

## ITEM 1. FINANCIAL STATEMENTS

## CONSOLIDATED FINANCIAL STATEMENTS

## NORTHRIM BANCORP, INC.

## Consolidated Balance Sheets

June 30, 2012, December 31, 2011 and June 30, 2011

|  | June 30,<br>2012<br>(Unaudited)   | December<br>31,<br>2011 | June 30,<br>2011 |
|--|-----------------------------------|-------------------------|------------------|
|  | (In Thousands, Except Share Data) |                         |                  |
| <b>ASSETS</b>                              |                                   |                         |                  |
| Cash and due from banks                    | \$ 34,560                         | \$ 30,644               | \$ 33,101        |
| Interest bearing deposits in other banks   | 76,144                            | 60,886                  | 112,730          |
| Investment securities available for sale   | 189,247                           | 222,083                 | 182,878          |
| Investment securities held to maturity     | 3,601                             | 3,819                   | 5,142            |
| Total portfolio investments                | 192,848                           | 225,902                 | 188,020          |
| Investment in Federal Home Loan Bank stock | 2,003                             | 2,003                   | 2,003            |
| Loans held for sale                        | 22,629                            | 27,822                  | -                |
| Loans                                      | 656,850                           | 645,562                 | 634,130          |
| Allowance for loan losses                  | (16,490)                          | (16,503)                | (15,574)         |
| Net loans                                  | 662,989                           | 656,881                 | 618,556          |
| Purchased receivables, net                 | 23,650                            | 30,209                  | 14,743           |
| Accrued interest receivable                | 2,801                             | 2,898                   | 2,745            |
| Other real estate owned                    | 6,448                             | 5,183                   | 5,083            |
| Premises and equipment, net                | 27,797                            | 27,993                  | 28,774           |
| Goodwill and intangible assets             | 8,292                             | 8,421                   | 8,556            |
| Other assets                               | 34,545                            | 34,238                  | 35,026           |
| Total assets                               | \$ 1,072,077                      | \$ 1,085,258            | \$ 1,049,337     |
| <b>LIABILITIES</b>                         |                                   |                         |                  |
| Deposits:                                  |                                   |                         |                  |

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|  |            |            |            |
|--|------------|------------|------------|
| Demand   | \$ 298,953 | \$ 324,039 | \$ 296,508 |
| Interest-bearing demand                        | 139,220    | 141,572    | 130,736    |
| Savings  | 83,100     | 79,610     | 74,142     |
| Alaska CDs                                     | 102,481    | 102,384    | 101,945    |
| Money market                                   | 164,942    | 154,987    | 152,004    |
| Certificates of deposit less than \$100,000    | 42,634     | 45,468     | 49,458     |
| Certificates of deposit greater than \$100,000 | 63,443     | 63,188     | 79,377     |
| Total deposits                                 | 894,773    | 911,248    | 884,170    |
| Securities sold under repurchase agreements    | 15,265     | 16,348     | 11,616     |
| Borrowings                                     | 4,553      | 4,626      | 4,696      |
| Junior subordinated debentures                 | 18,558     | 18,558     | 18,558     |
| Other liabilities                              | 8,503      | 9,043      | 8,288      |
| Total liabilities                              | 941,652    | 959,823    | 927,328    |

SHAREHOLDERS' EQUITY

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

Common stock, \$1 par value, 10,000,000 shares authorized, 6,470,518; 6,466,763; and 6,433,438

|   |              |              |              |
|---|--------------|--------------|--------------|
| shares issued and outstanding at June 30, 2012, December 31, 2011 and June 30, 2011 | 6,471        | 6,467        | 6,433        |
| Additional paid-in capital  | 53,411       | 53,164       | 52,953       |
| Retained earnings   | 69,482       | 65,469       | 61,412       |
| Accumulated other comprehensive income  | 984          | 283          | 1,169        |
| Total Northrim BanCorp shareholders' equity   | 130,348      | 125,383      | 121,967      |
| Noncontrolling interest   | 77           | 52           | 42           |
| Total shareholders' equity  | 130,425      | 125,435      | 122,009      |
| Total liabilities and shareholders' equity  | \$ 1,072,077 | \$ 1,085,258 | \$ 1,049,337 |

See notes to the consolidated financial statements

## NORTHRIM BANCORP, INC.

## Consolidated Statements of Income

For the Three and Six Months Ended June 30, 2012 and 2011

|  | Three Months Ended<br>June 30,<br>2012 |           | Six Months Ended<br>June 30,<br>2012 |           |
|--|--|-----------|--------------------------------------|-----------|
|  | 2011                                   | 2011      | 2011                                 | 2011      |
|  | (Unaudited)                            |           |                                      |           |
|  | (In Thousands, Except Per Share Data)  |           |                                      |           |
| <b>Interest Income</b>   |  |           |                                      |           |
| Interest and fees on loans   | \$ 10,305                              | \$ 10,709 | \$ 20,530                            | \$ 21,396 |
| Interest on investment securities-available for sale                           | 718                                    | 663       | 1,467                                | 1,534     |
| Interest on investment securities-held to maturity                             | 37                                     | 59        | 75                                   | 120       |
| Interest on deposits in other banks  | 63                                     | 55        | 103                                  | 88        |
| Total Interest Income  | 11,123                                 | 11,486    | 22,175                               | 23,138    |
| <b>Interest Expense</b>  |  |           |                                      |           |
| Interest expense on deposits,<br>borrowings and junior subordinated debentures | 627                                    | 904       | 1,325                                | 1,881     |
| Net Interest Income  | 10,496                                 | 10,582    | 20,850                               | 21,257    |
| Provision for loan losses  | 89                                     | 550       | 178                                  | 1,099     |
| Net Interest Income After Provision<br>for Loan Losses                         | 10,407                                 | 10,032    | 20,672                               | 20,158    |
| <b>Other Operating Income</b>  |  |           |                                      |           |
| Purchased receivable income  | 712                                    | 565       | 1,424                                | 1,191     |
| Employee benefit plan income   | 616                                    | 593       | 1,156                                | 1,093     |
| Service charges on deposit accounts  | 569                                    | 594       | 1,137                                | 1,118     |
| Electronic banking income  | 493                                    | 467       | 976                                  | 916       |
| Equity in earnings from RML  | 405                                    | 270       | 706                                  | 218       |
| Rental income  | 204                                    | 191       | 402                                  | 387       |
| Gain on sale of securities   | 246                                    | -         | 273                                  | 263       |
| Other income   | 480                                    | 390       | 858                                  | 662       |
| Total Other Operating Income   | 3,725                                  | 3,070     | 6,932                                | 5,848     |
| <b>Other Operating Expense</b>   |  |           |                                      |           |
| Salaries and other personnel expense   | 5,154                                  | 5,200     | 10,860                               | 10,516    |
| Occupancy  | 920                                    | 997       | 1,916                                | 1,907     |
| Marketing expense  | 435                                    | 443       | 872                                  | 880       |
| Equipment expense  | 342                                    | 292       | 636                                  | 596       |
| Insurance expense  | 301                                    | 295       | 419                                  | 731       |
| Professional and outside services  | 287                                    | 304       | 676                                  | 617       |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Software expense  | 270       | 277       | 521       | 517       |
| Amortization of low income housing tax investments              | 234       | 235       | 462       | 451       |
| Internet banking expense  | 185       | 158       | 357       | 311       |
| OREO (income) expense, net rental income and gains<br>on sale   | 118       | (742)     | 215       | (881)     |
| Intangible asset amortization expense                           | 65        | 71        | 129       | 141       |
| Other operating expense   | 984       | 1,059     | 1,990     | 2,129     |
| Total Other Operating Expense                                   | 9,295     | 8,589     | 19,053    | 17,915    |
| Income Before Provision for Income Taxes                        | 4,837     | 4,513     | 8,551     | 8,091     |
| Provision for income taxes                                      | 1,551     | 1,198     | 2,577     | 2,232     |
| Net Income  | 3,286     | 3,315     | 5,974     | 5,859     |
| Less: Net income attributable to the<br>noncontrolling interest | 144       | 133       | 256       | 222       |
| Net Income Attributable to Northrim<br>BanCorp                  | \$ 3,142  | \$ 3,182  | \$ 5,718  | \$ 5,637  |
| Earnings Per Share, Basic                                       | \$ 0.49   | \$ 0.49   | \$ 0.88   | \$ 0.88   |
| Earnings Per Share, Diluted                                     | \$ 0.48   | \$ 0.49   | \$ 0.87   | \$ 0.86   |
| Weighted Average Shares Outstanding, Basic                      | 6,469,909 | 6,431,060 | 6,468,724 | 6,429,895 |
| Weighted Average Shares Outstanding, Diluted                    | 6,573,729 | 6,549,744 | 6,570,094 | 6,548,557 |

See notes to the consolidated financial statements



## NORTHRIM BANCORP, INC.

## Consolidated Statements of Comprehensive Income

For the Three and Six Months Ended June 30, 2012 and 2011

|  | Three Months<br>Ended June 30,<br>2011 | Six Months<br>Ended June 30,<br>2011 |
|--|--|--------------------------------------|
| Net income   | \$ 3,315                               | \$ 5,859                             |
| Other comprehensive income, net of tax:                                |  |                                      |
| Unrealized gains arising during the period                             | \$ 934                                 | \$ 784                               |
| Reclassification adjustment for net gain realized in earnings          | -                                      | (263)                                |
| Net change in unrealized gains   | \$ 934                                 | \$ 521                               |
| Other comprehensive income   | 934                                    | 521                                  |
| Comprehensive income   | 4,249                                  | 6,380                                |
| Less: comprehensive income attributable to the noncontrolling interest | (133)                                  | (222)                                |
| Comprehensive income attributable to Northrim BanCorp                  | \$ 4,116                               | \$ 6,158                             |
|  |  |                                      |
|  | Three Months<br>Ended June 30,<br>2012 | Six Months<br>Ended June<br>30, 2012 |
| Net income   | \$ 3,286                               | \$ 5,974                             |
| Other comprehensive income, net of tax:                                |  |                                      |
| Unrealized gains arising during the period                             | \$ 92                                  | \$ 974                               |
| Reclassification adjustment for net gain realized in earnings          | (246)                                  | (273)                                |
| Net change in unrealized gains   | \$ (154)                               | \$ 701                               |
| Other comprehensive income   | (154)                                  | 701                                  |
| Comprehensive income   | 3,132                                  | 6,675                                |
| Less: comprehensive income attributable to the noncontrolling interest | (144)                                  | (256)                                |
| Comprehensive income attributable to Northrim BanCorp                  | \$ 2,988                               | \$ 6,419                             |

See notes to the consolidated financial statements

## NORTHRIM BANCORP, INC.

## Consolidated Statements of Changes in Shareholders' Equity

For the Six Months Ended June 30, 2012 and 2011

|   | Common Stock<br>Number<br>of Shares<br>(Unaudited)<br>(In Thousands) | Par<br>Value    | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Non-<br>controlling<br>Interest | Total             |
|---|--|-----------------|----------------------------------|----------------------|---|---------------------------------|-------------------|
| <b>Six Months Ended June 30, 2011</b>   |  |                 |                                  |                      |   |                                 |                   |
| Balance as of January 1, 2011   | 6,427  | \$ 6,427        | \$ 52,658                        | \$ 57,339            | \$ 648  | \$ 50                           | \$ 117,122        |
| Cash dividend declared  | -  | -               | -                                | (1,564)              | -   | -                               | (1,564)           |
| Stock based compensation<br>expense   | -  | -               | 263                              | -                    | -   | -                               | 263               |
| Exercise of stock options   | 6  | 6               | (6)                              | -                    | -   | -                               | -                 |
| Excess tax benefits from<br>share-based payment<br>arrangements                         | -  | -               | 38                               | -                    | -   | -                               | 38                |
| Distributions to noncontrolling<br>interest   | -  | -               | -                                | -                    | -   | (230)                           | (230)             |
| Change in unrealized holding<br>gain<br>on available for sale<br>securities, net of tax | -  | -               | -                                | -                    | 521   | -                               | 521               |
| Net income attributable to the<br>noncontrolling interest                               | -  | -               | -                                | -                    | -   | 222                             | 222               |
| Net income attributable to<br>Northrim BanCorp  | -  | -               | -                                | 5,637                | -   | -                               | 5,637             |
| <b>Six Months Ended June 30, 2011</b>   | <b>6,433</b>   | <b>\$ 6,433</b> | <b>\$ 52,953</b>                 | <b>\$ 61,412</b>     | <b>\$ 1,169</b>                                 | <b>\$ 42</b>                    | <b>\$ 122,009</b> |
| <b>Six Months Ended June 30, 2012</b>   |  |                 |                                  |                      |   |                                 |                   |
| Balance as of January 1, 2012   | 6,467  | \$ 6,467        | \$ 53,164                        | \$ 65,469            | \$ 283  | \$ 52                           | \$ 125,435        |
| Cash dividend declared  | -  | -               | -                                | (1,705)              | -   | -                               | (1,705)           |
| Stock based compensation<br>expense   | -  | -               | 225                              | -                    | -   | -                               | 225               |
| Exercise of stock options   | 4  | 4               | (6)                              | -                    | -   | -                               | (2)               |
| Excess tax benefits from<br>share-based payment   | -  | -               | 28                               | -                    | -   | -                               | 28                |

|  |       |          |           |           |        |  |       |            |
|--|-------|----------|-----------|-----------|--------|--|-------|------------|
| arrangements   |       |          |           |           |        |  |       |            |
| Distributions to noncontrolling interest                                       | -     | -        | -         | -         | -      |  | (231) | (231)      |
| Change in unrealized holding gain on available for sale securities, net of tax | -     | -        | -         | -         | 701    |  | -     | 701        |
| Net income attributable to the noncontrolling interest                         | -     | -        | -         | -         | -      |  | 256   | 256        |
| Net income attributable to Northrim BanCorp                                    | -     | -        | -         | 5,718     | -      |  | -     | 5,718      |
| Six Months Ended June 30, 2012   | 6,471 | \$ 6,471 | \$ 53,411 | \$ 69,482 | \$ 984 |  | \$ 77 | \$ 130,425 |

See notes to the consolidated financial statements

## NORTHRIM BANCORP, INC.

## Consolidated Statements of Cash Flows

For the Six Months Ended June 30, 2012 and 2011

|   | Six Months Ended<br>June 30,<br>2012      2011<br>(Unaudited)<br>(In Thousands) |          |
|---|---|----------|
| Operating Activities:   |   |          |
| Net income  | \$ 5,974  | \$ 5,859 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |   |          |
| Gain on sale of securities, net   | (273)   | (263)    |
| Depreciation and amortization of premises and equipment                           | 821   | 868      |
| Amortization of software  | 98  | 102      |
| Intangible asset amortization   | 129   | 141      |
| Amortization of investment security premium, net of discount accretion            | 145   | 117      |
| Deferred tax (benefit) liability  | (240)   | (396)    |
| Stock-based compensation  | 225   | 263      |
| Excess tax benefits from share-based payment arrangements                         | (28)  | (38)     |
| Deferral of loan fees and costs, net  | 253   | (346)    |
| Provision for loan losses   | 178   | 1,099    |
| Purchases of loans held for sale  | (86,576)  | -        |
| Proceeds from the sale of loans held for sale                                     | 91,769  | 5,558    |
| Gain on sale of other real estate owned   | (26)  | (805)    |
| Impairment on other real estate owned   | 81  | -        |
| Equity in undistributed earnings from mortgage affiliate                          | 37  | 181      |
| Net changes in assets and liabilities:  |   |          |
| (Increase) decrease in accrued interest receivable                                | 97  | 656      |
| Decrease in other assets  | (784)   | (4)      |
| (Decrease) in other liabilities   | (535)   | (341)    |
| Net Cash Provided by Operating Activities   | 11,345  | 12,651   |
| Investing Activities:   |   |          |
| Investment in securities:   |   |          |
| Purchases of investment securities-available-for-sale                             | (39,603)  | (56,832) |
| Proceeds from sales/maturities of securities-available-for-sale                   | 73,760  | 88,987   |
| Proceeds from calls/maturities of securities-held-to-maturity                     | 215   | 992      |
| Purchases of domestic certificates of deposit                                     | (1,500)   | (2,000)  |
| Investment in purchased receivables, net of repayments                            | 6,559   | 1,786    |
| (Increase) decrease in loans, net   | (13,231)  | 37,115   |
| Proceeds from sale of other real estate owned                                     | 199   | 7,294    |
| Investment in other real estate owned   | (18)  | (28)     |
| Loan to Elliott Cove, net of repayments   | 93  | 110      |

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|   |           |            |
|---|-----------|------------|
| Purchases of premises and equipment                       | (625)     | (627)      |
| Net Cash (Used) Provided by Investing Activities          | 25,849    | 76,797     |
| Financing Activities:                                     |           |            |
| (Decrease) increase in deposits                           | (16,475)  | (7,966)    |
| (Decrease) in securities sold under repurchase agreements | (1,083)   | (1,258)    |
| (Decrease) increase in borrowings                         | (73)      | (690)      |
| Distributions to noncontrolling interest                  | (231)     | (230)      |
| Excess tax benefits from share-based payment arrangements | 28        | 38         |
| Cash dividends paid                                       | (1,686)   | (1,544)    |
| Net Cash (Used) Provided by Financing Activities          | (19,520)  | (11,650)   |
| Net Increase in Cash and Cash Equivalents                 | 17,674    | 77,798     |
| Cash and Cash Equivalents at Beginning of Period          | 79,530    | 66,033     |
| Cash and Cash Equivalents at End of Period                | \$ 97,204 | \$ 143,831 |
| Supplemental Information:                                 |           |            |
| Income taxes paid   | \$ 3,197  | \$ 2,844   |
| Interest paid   | \$ 1,327  | \$ 1,942   |
| Transfer of loans to other real estate owned              | \$ 1,499  | \$ 982     |
| Loans made to facilitate sales of other real estate owned | \$ 199    | \$ 780     |
| Cash dividends declared but not paid                      | \$ 19     | \$ 20      |

See notes to the consolidated financial statements

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

June 30, 2012 and 2011

### 1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by Northrim BanCorp, Inc. (the "Company") in accordance with accounting principles generally accepted in the United States of America ("GAAP") and with instructions to Form 10-Q under the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain reclassifications have been made to prior year amounts to maintain consistency with the current year with no impact on net income or total shareholders' equity. The Company determined that it operates as a single operating segment. Operating results for the interim period ended June 30, 2012, are not necessarily indicative of the results anticipated for the year ending December 31, 2012. These consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

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

The Company's significant accounting policies are discussed in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

In May 2011, the Financial Accounting Standard Board ("FASB") issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs ("ASU 2011-04"). Some of the amendments contained in ASU 2011-04 clarify the FASB's intent about the application of existing fair value measurement requirements, and other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. This ASU was effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2011, and has been applied prospectively. The adoption of this standard did not have a material impact on the Company's consolidated financial position or results of operations.

In June 2011, the FASB issued ASU 2011-05, Presentation of Comprehensive Income ("ASU 2011-05"). ASU 2011-05 amends Topic 220, "Comprehensive Income", to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor does it change the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects. In December 2011, the FASB issued ASU 2011-12, Deferral of the Effective Date for Amendments to Presentation of Reclassifications of Items Out

of Accumulated Other Comprehensive Income in Accounting Standards Update 2011-05 (“ASU 2011-12”). This ASU defers only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. ASU 2011-12 was issued in order to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, the Company will continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before the issuance of ASU 2011-05. ASU 2011-12 was effective for the Company’s financial statements for annual and interim periods beginning after December 31, 2011, and has been applied prospectively. The adoption of this standard did not have a material impact on the Company’s consolidated financial position or results of operations.

### 3. Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits with other banks, banker’s acceptances, commercial paper, securities purchased under agreement to resell, federal funds sold, and securities with maturities of less than 90 days at acquisition.

## 4. Investment Securities

The carrying values and approximate fair values of investment securities at the periods indicated are presented below:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------|
|   | (In Thousands)    |                              |                               |            |
| June 30, 2012                                   |                   |                              |                               |            |
| Securities available for sale                   |                   |                              |                               |            |
| U.S. Treasury and government sponsored entities | \$ 119,002        | \$ 504                       | \$ 3                          | \$ 119,503 |
| Municipal securities                            | 18,970            | 699                          | 1                             | 19,668     |
| U.S. Agency mortgage-backed securities          | 47                | 3                            | -                             | 50         |
| Corporate bonds                                 | 46,518            | 515                          | 186                           | 46,847     |
| Preferred stock                                 | 3,037             | 142                          | -                             | 3,179      |
| Total securities available for sale             | \$ 187,574        | \$ 1,863                     | \$ 190                        | \$ 189,247 |
| Securities held to maturity                     |                   |                              |                               |            |
| Municipal securities                            | \$ 3,601          | \$ 242                       | \$ -                          | \$ 3,843   |
| Total securities held to maturity               | \$ 3,601          | \$ 242                       | \$ -                          | \$ 3,843   |
| December 31, 2011                               |                   |                              |                               |            |
| Securities available for sale                   |                   |                              |                               |            |
| U.S. Treasury and government sponsored entities | \$ 160,529        | \$ 625                       | \$ 50                         | \$ 161,104 |
| Municipal securities                            | 16,260            | 675                          | -                             | 16,935     |
| U.S. Agency mortgage-backed securities          | 52                | 2                            | -                             | 54         |
| Corporate bonds                                 | 43,767            | 343                          | 1,119                         | 42,991     |
| Preferred stock                                 | 996               | 3                            | -                             | 999        |
| Total securities available for sale             | \$ 221,604        | \$ 1,648                     | \$ 1,169                      | \$ 222,083 |
| Securities held to maturity                     |                   |                              |                               |            |
| Municipal securities                            | \$ 3,819          | \$ 258                       | \$ -                          | \$ 4,077   |
| Total securities held to maturity               | \$ 3,819          | \$ 258                       | \$ -                          | \$ 4,077   |
| June 30, 2011                                   |                   |                              |                               |            |
| Securities available for sale                   |                   |                              |                               |            |
| U.S. Treasury and government sponsored entities | \$ 137,256        | \$ 874                       | \$ 4                          | \$ 138,126 |
| Municipal securities                            | 14,023            | 379                          | -                             | 14,402     |
| U.S. Agency mortgage-backed securities          | 58                | 2                            | -                             | 60         |
| Corporate bonds                                 | 29,553            | 785                          | 48                            | 30,290     |
| Total securities available for sale             | \$ 180,890        | \$ 2,040                     | \$ 52                         | \$ 182,878 |
| Securities held to maturity                     |                   |                              |                               |            |
| Municipal securities                            | \$ 5,142          | \$ 196                       | \$ -                          | \$ 5,338   |
| Total securities held to maturity               | \$ 5,142          | \$ 196                       | \$ -                          | \$ 5,338   |



The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. There were five securities with unrealized losses as of June 30, 2012 and 2011, respectively, that have been in a loss position for less than twelve months. There were no securities with unrealized losses as of June 30, 2012 and June 30, 2011 that have been in an unrealized loss position for more than twelve months. Because the Company does not intend to sell, nor is it required to sell these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

At June 30, 2012, \$33.2 million in securities, or 17%, of the investment portfolio was pledged, as compared to \$32.1 million, or 14%, at December 31, 2011, and \$24.2 million, or 13%, at June 30, 2011. We held no securities of any single issuer

9

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(other than government sponsored entities) that exceeded 10% of our shareholders' equity at June 30, 2012, December 31, 2011 or June 30, 2011.

The amortized cost and fair values of debt securities at June 30, 2012, are distributed by contractual maturity as shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Although preferred stock has no stated maturity, it is aggregated in the calculation of weighted average yields presented below in the category of investments that mature in ten years or more.

|   | Amortized<br>Cost | Fair Value | Weighted Average Yield |   |
|---|-------------------|------------|------------------------|---|
|   | (In Thousands)    |            |                        |   |
| US Treasury and government sponsored entities |                   |            |                        |   |
| Within 1 year                                 | \$ 29,996         | \$ 30,034  | 0.76                   | % |
| 1-5 years                                     | 89,006            | 89,469     | 0.73                   | % |
| Total   | \$ 119,002        | \$ 119,503 | 0.74                   | % |
| U.S. Agency mortgage-backed securities        |                   |            |                        |   |
| 5-10 years                                    | \$ 47             | \$ 50      | 4.45                   | % |
| Total   | \$ 47             | \$ 50      | 4.45                   | % |
| Corporate bonds                               |                   |            |                        |   |
| Within 1 year                                 | \$ 3,160          | \$ 3,195   | 2.88                   | % |
| 1-5 years                                     | 43,358            | 43,652     | 2.45                   | % |
| Total   | \$ 46,518         | \$ 46,847  | 2.48                   | % |
| Preferred stock                               |                   |            |                        |   |
| Over 10 years                                 | 3,037             | 3,179      | 5.88                   | % |
| Total   | \$ 3,037          | \$ 3,179   | 5.88                   | % |
| Municipal securities                          |                   |            |                        |   |
| Within 1 year                                 | \$ 2,414          | \$ 2,422   | 1.79                   | % |
| 1-5 years                                     | 9,897             | 10,137     | 2.01                   | % |
| 5-10 years                                    | 7,305             | 7,776      | 4.58                   | % |
| Over 10 years                                 | 2,955             | 3,176      | 4.79                   | % |
| Total   | \$ 22,511         | \$ 23,511  | 3.18                   | % |

The proceeds and resulting gains and losses, computed using specific identification, from sales of investment securities for the six months ending June 30, 2012 and 2011, respectively, are as follows:

Proceeds

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|                               |                | Gross<br>Gains | Gross<br>Losses |
|-------------------------------|----------------|----------------|-----------------|
|                               | (In Thousands) |                |                 |
| 2012                          |                |                |                 |
| Available for sale securities | \$ 30,424      | \$ 273         | \$ -            |
| 2011                          |                |                |                 |
| Available for sale securities | \$ 6,987       | \$ 263         | \$ -            |

A summary of interest income for the six months ending June 30, 2012 and 2011 on available for sale investment securities is as follows:

|   | 2012           | 2011     |
|---|----------------|----------|
|   | (In Thousands) |          |
| US Treasury and government sponsored entities | \$ 553         | \$ 816   |
| U.S. Agency mortgage-backed securities        | 1              | 1        |
| Other   | 630            | 482      |
| Total taxable interest income                 | \$ 1,184       | \$ 1,299 |
| Municipal securities                          | \$ 283         | \$ 235   |
| Total tax-exempt interest income              | 283            | 235      |
| Total   | \$ 1,467       | \$ 1,534 |

For the periods ending June 30, 2012, December 31, 2011 and June 30, 2011, we held Federal Home Loan Bank of Seattle (“FHLB”) stock with a book value approximately equal to its market value in the amount of \$2.0 million for each period. The Company evaluated its investment in FHLB stock for other-than-temporary impairment as of June 30, 2012, consistent with its accounting policy. Based on the Company’s evaluation of the underlying investment, including the long-term nature of the investment, the liquidity position of the FHLB of Seattle, the actions being taken by the FHLB of Seattle to address its regulatory capital situation, and the Company’s intent and ability to hold the investment for a period of time sufficient to recover the par value, the Company did not recognize an other-than-temporary impairment loss. Even though the Company did not recognize an other-than-temporary impairment loss during the six-month period ending June 30, 2012, continued deterioration in the FHLB of Seattle’s financial position may result in future impairment losses.

#### 5. Loans Held for Sale

The Company has purchased residential loans from our mortgage affiliate, Residential Mortgage Holding Company LLC (“RML”), from time to time since 1999. The Company then sells these loans in the secondary market. The Company purchased \$86.6 million and sold \$91.8 million in loans in the three-month period ending June 30, 2012. The Company sold \$5.6 million loans and did not purchase any loans in the three-month period ending June 30, 2011.

#### 6. Loans

The composition of the loan portfolio by segment, excluding loans held for resale, is presented below:

|  | June 30, 2012  |                  | December 31, 2011 |                  | June 30, 2011 |                  |  |   |
|--|----------------|------------------|-------------------|------------------|---------------|------------------|--|---|
|  | Dollar Amount  | Percent of Total | Dollar Amount     | Percent of Total | Dollar Amount | Percent of Total |  |   |
|  | (In Thousands) |                  |                   |                  |               |                  |  |   |
| Commercial   | \$ 240,395     | 36.6 %           | \$ 252,689        | 39.1 %           | \$ 232,765    | 36.7 %           |  | % |
| Real estate construction                                 | 40,922         | 6.2 %            | 40,182            | 6.2 %            | 47,639        | 7.5 %            |  | % |
| Real estate term   | 340,530        | 51.8 %           | 315,860           | 48.9 %           | 314,093       | 49.5 %           |  | % |
| Home equity lines and other consumer                     | 38,260         | 5.8 %            | 39,834            | 6.2 %            | 42,458        | 6.7 %            |  | % |
| Subtotal   | \$ 660,107     |                  | \$ 648,565        |                  | \$ 636,955    |                  |  |   |
| Less: Unearned origination fee, net of origination costs | (3,257)        | (0.5) %          | (3,003)           | (0.5) %          | (2,825)       | (0.4) %          |  | % |
| Total loans  | \$ 656,850     |                  | \$ 645,562        |                  | \$ 634,130    |                  |  |   |

At June 30, 2012, approximately 19% of the portfolio was scheduled to mature over the next 12 months, and 20% was scheduled to mature between July 1, 2013, and June 30, 2017.

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including trends in past due and nonaccrual loans, gross and net charge offs, and movement in loan balances within the risk classifications. The Company utilizes a risk grading matrix to assign a risk classification to each of its loans. Loans are graded on a scale of 1 to 8. A description of the general characteristics of the eight risk classifications are as follows:

11

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- Risk Code 1 - Excellent: Loans in this grade are those where the borrower has substantial financial capacity, above average profit margins, and excellent liquidity. Cash flow has been consistent and is well in excess of debt servicing requirements. Loans in this grade may be secured by cash and/or negotiable securities having a readily ascertainable market value and may also be fully guaranteed by the U.S. Government, and other approved government and financial institutions. Loans in this grade have borrowers with exceptional credit ratings and would compare to AA ratings as established by Standard & Poor's.
- Risk Code 2 – Good: Loans in this grade are those to borrowers who have demonstrated satisfactory asset quality, earnings history, liquidity and other adequate margins of creditor protection. Borrowers exhibit positive fundamentals in terms of working capital, cash flow sufficient to service the debt, and debt to worth ratios. Borrowers for loans in this grade are capable of absorbing normal economic or other setbacks without difficulty. The borrower may exhibit some weaknesses or varying historical profitability. Management is considered adequate in all cases. Borrowing facilities may be unsecured or secured by customary acceptable collateral with well-defined market values. Additional support for the loan is available from secondary repayment sources and/or adequate guarantors.
- Risk Code 3 – Satisfactory: Loans in this grade represent moderate credit risk due to some instability in borrower capacity and financial condition. These loans generally require average loan officer attention. Characteristics of assets in this classification may include: marginal debt service coverage, newly established ventures, limited or unstable earnings history, some difficulty in absorbing normal setbacks, and atypical maturities, collateral or other exceptions to established loan policies. In all cases, such weaknesses are offset by well secured collateral positions and/or acceptable guarantors.
- Risk Code 4 - Watch List: Loans in this grade are acceptable, but additional attention is needed. This is an interim classification reserved for loans that are intrinsically creditworthy but which require specific attention. Loans may have documentation deficiencies that are deemed correctable, may be contrary to current lending policies, or may have insufficient credit or financial information. Loans in this grade may also be characterized by borrower failure to comply with loan covenants or to provide other required information. If such conditions are not resolved within 90 days from the date of the assignment of Risk Code 4, the loan may warrant further downgrade.
- Risk Code 5 - Special Mention: Loans in this grade have had a deterioration of financial condition or collateral value, but are still reasonably secured by collateral or net worth of the borrower. Although the Company is presently protected from loss, potential weaknesses are apparent which, if not corrected, could cause future problems. Loans in this classification warrant more than the ordinary amount of attention but have not yet reached the point of concern for loss. Loans in this category have deteriorated sufficiently that they would have difficulty in refinancing. Loans in this classification may show one or more of the following characteristics: inadequate loan documentation, deteriorating financial condition or control over collateral, economic or market conditions which may adversely impact the borrower in the future, unreliable or insufficient credit or collateral information, adverse trends in operations that are not yet jeopardizing repayment, or adverse trends in secondary repayment sources.
- Risk Code 6 – Substandard: Loans in this grade are no longer adequately protected due to declining net worth of the borrower, lack of earning capacity, or insufficient collateral. The possibility for loss of some portion of the loan principal cannot be ruled out. Loans in this grade exhibit well-defined weaknesses that bring normal repayment into doubt. Some of these weaknesses may include: unprofitable or poor earnings trends of the borrower or property, declining liquidity, excessive debt, significant unfavorable industry comparisons, secondary repayment sources are not available, or there is a possibility of a protracted work-out.
- Risk Code 7 – Doubtful: Loans in this grade exhibit the same weaknesses as those classified Substandard, but the traits are more pronounced. Collection in full is improbable, however the extent of the loss may be indeterminable due to pending factors which may yet occur that could salvage the loan, such as possible pledge of additional collateral, sale of assets, merger, acquisition or refinancing. Borrowers in this grade may be on the verge of insolvency or bankruptcy, and stringent action is required on the part of the loan officer.
- Risk Code 8 – Loss: Loans in this grade are those that are largely non-collectible or those in which ultimate recovery is too distant in the future to warrant continuance as a bankable asset. This classification does not mean that the asset has



absolutely no recovery or salvage value, but rather it is not practical or desirable to defer charging the loan off even though recovery may be affected in the future.

A risk rating is assigned for each loan at origination. The risk ratings for commercial, real estate construction, and real estate term loans may change throughout the life of the loan as a multitude of risk factors change. The risk rating for consumer loans may change as loans become delinquent. Delinquent loans are those that are thirty days or more past due.

The loan portfolio, segmented by risk class for the periods indicated, is shown below:

|   | Commercial     | Real estate construction | Real estate term | Home equity lines and other consumer | Total      |
|---|----------------|--------------------------|------------------|--------------------------------------|------------|
|   | (In Thousands) |                          |                  |                                      |            |
| June 30, 2012   |                |                          |                  |                                      |            |
| Risk Code 1 - Excellent                                   | \$ 968         | \$ -                     | \$ -             | \$ 426                               | \$ 1,394   |
| Risk Code 2 - Good  | 61,999         | 289                      | 62,521           | 818                                  | 125,627    |
| Risk Code 3 - Satisfactory                                | 159,236        | 36,769                   | 264,425          | 34,274                               | 494,704    |
| Risk Code 4 - Watch                                       | 6,837          | 451                      | 1,370            | 1,909                                | 10,567     |
| Risk Code 5 - Special Mention                             | 8,717          | 370                      | 3,910            | 167                                  | 13,164     |
| Risk Code 6 - Substandard                                 | 2,215          | 3,043                    | 8,132            | 666                                  | 14,056     |
| Risk Code 7 - Doubtful                                    | 423            | -                        | 172              | -                                    | 595        |
| Subtotal  | \$ 240,395     | \$ 40,922                | \$ 340,530       | \$ 38,260                            | \$ 660,107 |
| Less: Unearned origination fees, net of origination costs |                |                          |                  |                                      | (3,257)    |
|   |                |                          |                  |                                      | \$ 656,850 |
| December 31, 2011   |                |                          |                  |                                      |            |
| Risk Code 1 - Excellent                                   | \$ 540         | \$ -                     | \$ -             | \$ 575                               | \$ 1,115   |
| Risk Code 2 - Good  | 65,315         | -                        | 55,617           | 849                                  | 121,781    |
| Risk Code 3 - Satisfactory                                | 164,767        | 29,063                   | 247,330          | 35,914                               | 477,074    |
| Risk Code 4 - Watch                                       | 8,033          | 3,579                    | 1,102            | 1,497                                | 14,211     |
| Risk Code 5 - Special Mention                             | 9,671          | -                        | 3,339            | 364                                  | 13,374     |
| Risk Code 6 - Substandard                                 | 3,694          | 7,540                    | 8,026            | 635                                  | 19,895     |
| Risk Code 7 - Doubtful                                    | 669            | -                        | 446              | -                                    | 1,115      |
| Subtotal  | \$ 252,689     | \$ 40,182                | \$ 315,860       | \$ 39,834                            | \$ 648,565 |
| Less: Unearned origination fees, net of origination costs |                |                          |                  |                                      | (3,003)    |
|   |                |                          |                  |                                      | \$ 645,562 |
| June 30, 2011   |                |                          |                  |                                      |            |
| Risk Code 1 - Excellent                                   | \$ 725         | \$ -                     | \$ -             | \$ 704                               | \$ 1,429   |
| Risk Code 2 - Good  | 75,285         | -                        | 58,182           | 908                                  | 134,375    |
| Risk Code 3 - Satisfactory                                | 131,788        | 33,918                   | 240,814          | 37,698                               | 444,218    |
| Risk Code 4 - Watch                                       | 8,842          | 3,431                    | 1,285            | 2,193                                | 15,751     |



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|   |            |           |            |           |            |
|---|------------|-----------|------------|-----------|------------|
| Risk Code 5 - Special Mention                             | 10,834     | -         | 3,260      | 496       | 14,590     |
| Risk Code 6 - Substandard                                 | 4,822      | 10,290    | 10,552     | 459       | 26,123     |
| Risk Code 7 - Doubtful                                    | 469        | -         | -          | -         | 469        |
| Subtotal  | \$ 232,765 | \$ 47,639 | \$ 314,093 | \$ 42,458 | \$ 636,955 |
| Less: Unearned origination fees, net of origination costs |            |           |            |           | (2,825)    |
|   |            |           |            |           | \$ 634,130 |

Loans are carried at their principal amount outstanding, net of charge-offs, unamortized fees and direct loan origination costs. Loan balances are charged to the Allowance for Loan Losses (“Allowance”) when management believes that collection of principal is unlikely. Interest income on loans is accrued and recognized on the principal amount outstanding except for loans in a nonaccrual status. All classes of loans are placed on nonaccrual and considered impaired when management believes doubt exists

13

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as to the collectability of the interest or principal. Cash payments received on nonaccrual loans are directly applied to the principal balance. Generally, a loan may be returned to accrual status when the delinquent principal and interest are brought current in accordance with the terms of the loan agreement. Additionally, certain ongoing performance criteria, which generally includes a performance period of six months, must be met in order for a loan to be returned to accrual status. Loans are reported as past due when installment payments, interest payments, or maturity payments are past due based on contractual terms.

Nonaccrual loans totaled \$5.9 million, \$7.4 million and \$9.6 million at June 30, 2012, December 31, 2011, and June 30, 2011, respectively. Nonaccrual loans at the periods indicated, by segment are presented below:

|                                      | June 30,<br>2012 | December<br>31, 2011 | June 30,<br>2011 |
|--------------------------------------|------------------|----------------------|------------------|
|                                      | (In Thousands)   |                      |                  |
| Commercial                           | \$ 2,169         | \$ 3,360             | \$ 4,218         |
| Real estate construction             | 843              | 2,355                | 2,033            |
| Real estate term                     | 2,602            | 1,477                | 3,094            |
| Home equity lines and other consumer | 308              | 169                  | 286              |
| Total                                | \$ 5,922         | \$ 7,361             | \$ 9,631         |

Past due loans and nonaccrual loans at the periods indicated are presented below by loan class:

|   | 30-59<br>Days Past<br>Due Still<br>Accruing | 60-89<br>Days Past<br>Due Still<br>Accruing | Greater<br>Than 90<br>Days Still<br>Accruing | Nonaccrual | Total<br>Past Due | Current    | Total<br>Financing<br>Receivables |
|---|---|---|--|------------|-------------------|------------|-----------------------------------|
|   | (In Thousands)                              |   |  |            |                   |            |                                   |
| June 30, 2012   |   |   |  |            |                   |            |                                   |
| Risk Code 1 - Excellent                                   | \$ -  | \$ -  | \$ -   | \$ -       | \$ -              | \$ 1,394   | \$ 1,394                          |
| Risk Code 2 - Good  | -   | -   | -  | -          | -                 | 125,627    | 125,627                           |
| Risk Code 3 - Satisfactory                                | 111   | -   | -  | -          | 111               | 494,593    | 494,704                           |
| Risk Code 4 - Watch                                       | 3,037                                       | -   | -  | -          | 3,037             | 7,530      | 10,567                            |
| Risk Code 5 - Special Mention                             | -   | -   | -  | 148        | 148               | 13,016     | 13,164                            |
| Risk Code 6 - Substandard                                 | 54  | -   | 91   | 5,179      | 5,324             | 8,732      | 14,056                            |
| Risk Code 7 - Doubtful                                    | -   | -   | -  | 595        | 595               | -          | 595                               |
| Subtotal  | \$ 3,202                                    | \$ -  | \$ 91  | \$ 5,922   | \$ 9,215          | \$ 650,892 | \$ 660,107                        |
| Less: Unearned origination fees, net of origination costs |   |   |  |            |                   |            | (3,257)                           |
|   |   |   |  |            |                   |            | \$ 656,850                        |

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December 31, 2011

|   |        |        |      |          |          |            |            |
|---|--------|--------|------|----------|----------|------------|------------|
| Risk Code 1 - Excellent                                   | \$ -   | \$ -   | \$ - | \$ -     | \$ -     | \$ 1,115   | \$ 1,115   |
| Risk Code 2 - Good  | -      | -      | -    | -        | -        | 121,781    | 121,781    |
| Risk Code 3 - Satisfactory                                | -      | -      | -    | -        | -        | 477,074    | 477,074    |
| Risk Code 4 - Watch                                       | 387    | 170    | -    | -        | 557      | 13,654     | 14,211     |
| Risk Code 5 - Special Mention                             | 86     | -      | -    | 170      | 256      | 13,118     | 13,374     |
| Risk Code 6 - Substandard                                 | -      | 21     | -    | 6,076    | 6,097    | 13,798     | 19,895     |
| Risk Code 7 - Doubtful                                    | 2      | -      | -    | 1,115    | 1,117    | (2)        | 1,115      |
| Subtotal  | \$ 475 | \$ 191 | \$ - | \$ 7,361 | \$ 8,027 | \$ 640,538 | \$ 648,565 |
| Less: Unearned origination fees, net of origination costs |        |        |      |          |          |            | (3,003)    |
|   |        |        |      |          |          |            | \$ 645,562 |

June 30, 2011

|   |          |        |        |          |           |            |            |
|---|----------|--------|--------|----------|-----------|------------|------------|
| Risk Code 1 - Excellent                                   | \$ -     | \$ -   | \$ -   | \$ -     | \$ -      | \$ 1,429   | \$ 1,429   |
| Risk Code 2 - Good  | -        | -      | -      | -        | -         | 134,375    | 134,375    |
| Risk Code 3 - Satisfactory                                | -        | -      | -      | -        | -         | 444,218    | 444,218    |
| Risk Code 4 - Watch                                       | 99       | 22     | -      | -        | 121       | 15,630     | 15,751     |
| Risk Code 5 - Special Mention                             | 240      | 443    | 225    | -        | 908       | 13,682     | 14,590     |
| Risk Code 6 - Substandard                                 | 1,247    | -      | -      | 9,163    | 10,410    | 15,713     | 26,123     |
| Risk Code 7 - Doubtful                                    | -        | -      | -      | 468      | 468       | 1          | 469        |
| Subtotal  | \$ 1,586 | \$ 465 | \$ 225 | \$ 9,631 | \$ 11,907 | \$ 625,048 | \$ 636,955 |
| Less: Unearned origination fees, net of origination costs |          |        |        |          |           |            | (2,825)    |
|   |          |        |        |          |           |            | \$ 634,130 |

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The Company considers a loan to be impaired when it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement. Once a loan is determined to be impaired, the impairment is measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate, except that if the loan is collateral dependent, the impairment is measured by using the fair value of the loan's collateral. Nonperforming loans greater than \$50,000 are individually evaluated for impairment based upon the borrower's overall financial condition, resources, and payment record, and the prospects for support from any financially responsible guarantors.

At June 30, 2012, December 31, 2011 and June 30, 2011, the recorded investment in loans that are considered to be impaired was \$14.2 million, \$9.5 million, and \$12.7 million, respectively. The following table presents information about impaired loans by class as of the periods indicated:

|  | Recorded<br>Investment<br>(In Thousands) | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|--|--|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| June 30, 2012  |  |                                |                      |                                   |                                  |
| With no related allowance recorded                             |  |                                |                      |                                   |                                  |
| Commercial - risk code 4 watch                                 | \$ 192                                   | \$ 192                         | \$ -                 | \$ 260                            | \$ 7                             |
| Commercial - risk code 5 special mention                       | 294                                      | 294                            | -                    | 285                               | 11                               |
| Commercial - risk code 6 substandard                           | 1,559                                    | 2,203                          | -                    | 1,822                             | 6                                |
| Commercial - risk code 8 loss                                  | -  | 224                            | -                    | 112                               | -                                |
| Real estate construction - risk code 3 satisfactory            | 2,827                                    | 2,827                          | -                    | 2,900                             | 134                              |
| Real estate term - risk code 5 special mention                 | 1,074                                    | 1,152                          | -                    | 1,068                             | 32                               |
| Real estate term - risk code 6 substandard                     | 4,035                                    | 4,035                          | -                    | 4,071                             | 163                              |
| Home equity lines and other consumer - risk code 4 watch       | 94                                       | 94                             | -                    | 96                                | 3                                |
| Home equity lines and other consumer - risk code 6 substandard | 113                                      | 113                            | -                    | 118                               | 4                                |
|  | \$ 10,188                                | \$ 11,134                      | \$ -                 | \$ 10,732                         | \$ 360                           |
| With an allowance recorded                                     |  |                                |                      |                                   |                                  |
| Commercial - risk code 6 substandard                           | \$ 265                                   | \$ 265                         | \$ 141               | \$ 280                            | \$ -                             |
| Commercial - risk code 7 doubtful                              | 423                                      | 423                            | 401                  | 434                               | -                                |
| Real estate construction - risk code 6 substandard             | 843                                      | 843                            | 263                  | 924                               | -                                |
| Real estate term - risk code 6 substandard                     | 2,078                                    | 2,358                          | 61                   | 2,398                             | -                                |
| Real estate term - risk code 7 doubtful                        | 172                                      | 446                            | 6                    | 309                               | -                                |
| Home equity lines and other consumer - risk code 6 substandard | 227                                      | 227                            | 49                   | 228                               | -                                |
|  | \$ 4,008                                 | \$ 4,562                       | \$ 921               | \$ 4,573                          | \$ -                             |
| Total  |  |                                |                      |                                   |                                  |
| Commercial - risk code 4 watch                                 | \$ 192                                   | \$ 192                         | \$ -                 | \$ 260                            | \$ 7                             |
| Commercial - risk code 5 special mention                       | 294                                      | 294                            | -                    | 285                               | 11                               |
| Commercial - risk code 6 substandard                           | 1,824                                    | 2,468                          | 141                  | 2,102                             | 6                                |

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|  |           |           |        |           |        |
|--|-----------|-----------|--------|-----------|--------|
| Commercial - risk code 7 doubtful                              | 423       | 423       | 401    | 434       | -      |
| Commercial - risk code 8 loss                                  | -         | 224       | -      | 112       | -      |
| Real estate construction - risk code 3 satisfactory            | 2,827     | 2,827     | -      | 2,900     | 134    |
| Real estate construction - risk code 6 substandard             | 843       | 843       | 263    | 924       | -      |
| Real estate term - risk code 5 special mention                 | 1,074     | 1,152     | -      | 1,068     | 32     |
| Real estate term - risk code 6 substandard                     | 6,113     | 6,393     | 61     | 6,469     | 163    |
| Real estate term - risk code 7 doubtful                        | 172       | 446       | 6      | 309       | -      |
| Home equity lines and other consumer - risk code 4 watch       | 94        | 94        | -      | 96        | 3      |
| Home equity lines and other consumer - risk code 6 substandard | 340       | 340       | 49     | 346       | 4      |
|  | \$ 14,196 | \$ 15,696 | \$ 921 | \$ 15,305 | \$ 360 |

December 31, 2011

With no related allowance recorded

|  |          |          |      |          |        |
|--|----------|----------|------|----------|--------|
| Commercial - risk code 5 special mention                           | \$ 327   | \$ 327   | \$ - | \$ 430   | \$ 23  |
| Commercial - risk code 6 substandard                               | 2,166    | 2,810    | -    | 2,380    | 5      |
| Real estate construction - risk code 6 substandard                 | 1,349    | 1,527    | -    | 1,463    | -      |
| Real estate term - risk code 5 special mention                     | 170      | 248      | -    | 193      | -      |
| Real estate term - risk code 6 substandard                         | 2,455    | 2,545    | -    | 2,371    | 102    |
| Home equity lines and other consumer - risk code 5 special mention | 97       | 97       | -    | 49       | 5      |
| Home equity lines and other consumer - risk code 6 substandard     | 52       | 52       | -    | 53       | -      |
|  | \$ 6,616 | \$ 7,606 | \$ - | \$ 6,939 | \$ 135 |

With an allowance recorded

|  |          |          |          |          |      |
|--|----------|----------|----------|----------|------|
| Commercial - risk code 6 substandard               | \$ 511   | \$ 511   | \$ 44    | \$ 687   | \$ - |
| Commercial - risk code 7 doubtful                  | 669      | 669      | 576      | 707      | -    |
| Real estate construction - risk code 6 substandard | 1,006    | 1,006    | 494      | 1,024    | -    |
| Real estate term - risk code 6 substandard         | 204      | 204      | 5        | 215      | -    |
| Real estate term - risk code 7 doubtful            | 446      | 446      | 62       | 447      | -    |
|  | \$ 2,836 | \$ 2,836 | \$ 1,181 | \$ 3,080 | \$ - |

Total

|  |          |           |          |           |        |
|--|----------|-----------|----------|-----------|--------|
| Commercial - risk code 5 special mention                           | \$ 327   | \$ 327    | \$ -     | \$ 430    | \$ 23  |
| Commercial - risk code 6 substandard                               | 2,677    | 3,321     | 44       | 3,067     | 5      |
| Commercial - risk code 7 doubtful                                  | 669      | 669       | 576      | 707       | -      |
| Real estate construction - risk code 6 substandard                 | 2,355    | 2,533     | 494      | 2,487     | -      |
| Real estate term - risk code 5 special mention                     | 170      | 248       | -        | 193       | -      |
| Real estate term - risk code 6 substandard                         | 2,659    | 2,749     | 5        | 2,586     | 102    |
| Real estate term - risk code 7 doubtful                            | 446      | 446       | 62       | 447       | -      |
| Home equity lines and other consumer - risk code 5 special mention | 97       | 97        | -        | 49        | 5      |
| Home equity lines and other consumer - risk code 6 substandard     | 52       | 52        | -        | 53        | -      |
|  | \$ 9,452 | \$ 10,442 | \$ 1,181 | \$ 10,019 | \$ 135 |

June 30, 2011

With no related allowance recorded

|  |          |          |      |          |       |
|--|----------|----------|------|----------|-------|
| Commercial - risk code 5 special mention           | \$ 3,327 | \$ 3,925 | \$ - | \$ 3,423 | \$ 17 |
| Commercial - risk code 6 substandard               | 552      | 552      | -    | 596      | 19    |
| Real estate construction - risk code 6 substandard | 1,381    | 1,460    | -    | 1,407    | 9     |

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|  |           |           |        |           |       |
|--|-----------|-----------|--------|-----------|-------|
| Real estate term - risk code 6 substandard                     | 4,688     | 4,778     | -      | 4,718     | 42    |
| Home equity lines and other consumer - risk code 6 substandard | 209       | 209       | -      | 163       | 2     |
|  | \$ 10,157 | \$ 10,924 | \$ -   | \$ 10,307 | \$ 89 |
| With an allowance recorded                                     |           |           |        |           |       |
| Commercial - risk code 6 Substandard                           | \$ 499    | \$ 499    | \$ 183 | \$ 678    | \$ -  |
| Commercial - risk code 7 doubtful                              | 465       | 465       | 456    | 475       | -     |
| Real estate construction - risk code 6 substandard             | 1,568     | 1,613     | 57     | 1,573     | -     |
| Real estate term - risk code 6 Substandard                     | -         | -         | -      | -         | -     |
| Home equity lines and other consumer - risk code 6 Substandard | -         | -         | -      | -         | -     |
|  | \$ 2,532  | \$ 2,577  | \$ 696 | \$ 2,726  | \$ -  |
| Total  |           |           |        |           |       |
| Commercial - risk code 5 special mention                       | \$ 3,327  | \$ 3,925  | \$ -   | \$ 3,423  | \$ 17 |
| Commercial - risk code 6 substandard                           | 1,051     | 1,051     | 183    | 1,274     | 19    |
| Commercial - risk code 7 doubtful                              | 465       | - 465     | - 456  | - 475     | - -   |
| Real estate construction - risk code 6 substandard             | 2,949     | 3,073     | 57     | 2,980     | 9     |
| Real estate term - risk code 6 substandard                     | 4,688     | 4,778     | -      | 4,718     | 42    |
| Home equity lines and other consumer - risk code 6 substandard | 209       | 209       | -      | 163       | 2     |
|  | \$ 12,689 | \$ 13,501 | \$ 696 | \$ 13,033 | \$ 89 |

The unpaid principal balance included in the table above represents the recorded investment at the dates indicated, plus amounts charged off for book purposes.

Loans classified as troubled debt restructurings totaled \$12.1 million, \$4.5 million, and \$3.7 million at June 30, 2012, December 31, 2011, and June 30, 2011, respectively. A troubled debt restructuring is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Company is granting the borrower a concession of some kind. The Company has granted a variety of concessions to borrowers in the form of loan modifications. The modifications granted can generally be described in the following categories:

**Rate Modification:** A modification in which the interest rate is changed.

**Term Modification:** A modification in which the maturity date, timing of payments, or frequency of payments is changed.

**Payment Modification:** A modification in which the dollar amount of the payment is changed, or in which a loan is converted to interest only payments for a period of time are included in this category.

**Combination Modification:** Any other type of modification, including the use of multiple categories above.

The following table presents newly restructured loans that occurred during the six months ended June 30, 2012:

|   | June 30, 2012     |                      | Total<br>Modifications |
|---|-------------------|----------------------|------------------------|
|   | Accrual<br>Status | Nonaccrual<br>Status |                        |
| New Troubled Debt Restructurings                    | (In Thousands)    |                      |                        |
| Commercial risk code 5 - special mention            | \$ 107            | \$ -                 | \$ 107                 |
| Commercial risk code 6 - substandard                | 85                | -                    | 85                     |
| Real estate construction risk code 3 - satisfactory | 2,827             | -                    | 2,827                  |
| Real estate construction risk code 6 - substandard  |                   | 843                  | 843                    |
| Real estate term risk code 5 - special mention      | 397               | -                    | 397                    |
| Real estate term risk code 6 - substandard          | 1,886             | 2,077                | 3,963                  |
| Subtotal  | \$ 5,302          | \$ 2,920             | \$ 8,222               |
| Existing Troubled Debt Restructurings               | 2,840             | 1,067                | 3,907                  |
| Total   | \$ 8,142          | \$ 3,987             | \$ 12,129              |

The following table presents newly restructured loans that occurred during the six months ended June 30, 2012 by concession (terms modified):

|   | Number<br>of Contracts | June 30, 2012        |                      | Payment<br>Modification | Combination<br>Modification | Total<br>Modifications |
|---|------------------------|----------------------|----------------------|-------------------------|-----------------------------|------------------------|
|   |                        | Rate<br>Modification | Term<br>Modification |                         |                             |                        |
| Pre-Modification Outstanding Recorded Investment:   |                        |                      |                      |                         |                             |                        |
| (In Thousands)                                      |                        |                      |                      |                         |                             |                        |
| Commercial risk code 5 - special mention            | 1                      | \$ -                 | \$ 108               | \$ -                    | \$ -                        | \$ 108                 |
| Commercial risk code 6 - substandard                | 1                      | -                    | 86                   | -                       | -                           | 86                     |
| Real estate construction risk code 3 - satisfactory | 1                      | -                    | -                    | -                       | 2,827                       | 2,827                  |
| Real estate construction risk code 6 - substandard  | 1                      | -                    | 1,015                | -                       | -                           | 1,015                  |
| Real estate term risk code 5 - special mention      | 1                      | -                    | -                    | -                       | 403                         | 403                    |
| Real estate term risk code 6 - substandard          | 3                      | -                    | -                    | 2,589                   | 1,886                       | 4,475                  |
| Total   | 8                      | \$ -                 | \$ 1,209             | \$ 2,589                | \$ 5,116                    | \$ 8,914               |
| Post-Modification Outstanding Recorded Investment:  |                        |                      |                      |                         |                             |                        |
| Commercial risk code 5 - special mention            | 1                      | \$ -                 | \$ 107               | \$ -                    | \$ -                        | \$ 107                 |
| Commercial risk code 6 - substandard                | 1                      | -                    | 85                   | -                       | -                           | 85                     |
| Real estate construction risk code 3 - satisfactory | 1                      | -                    | -                    | -                       | 2,827                       | 2,827                  |
| Real estate construction risk code 6 - substandard  | 1                      | -                    | 843                  | -                       | -                           | 843                    |
| Real estate term risk code 5 - special mention      | 1                      | -                    | -                    | -                       | 397                         | 397                    |
| Real estate term risk code 6 - substandard          | 3                      | -                    | -                    | 2,077                   | 1,886                       | 3,963                  |
| Total   | 8                      | \$ -                 | \$ 1,035             | \$ 2,077                | \$ 5,110                    | \$ 8,222               |



The following table presents TDRs that occurred during the last twelve months that have defaulted in 2012. These loans are past due, and they are nonaccrual loans:

|  | Number<br>of Contracts<br>(In Thousands) | June 30,<br>2012<br>Recorded<br>Investment | June 30,<br>2011<br>Recorded<br>Investment |
|--|--|--|--|
| Troubled Debt Restructurings that Subsequently Defaulted:          |  |  |  |
| Commercial risk code 5 - special mention                           | 1  | \$ 192                                     | \$ -                                       |
| Commercial risk code 6 - substandard                               | 2  | 478  | -  |
| Commercial risk code 7 - doubtful                                  | 1  | 216  | -  |
| Real estate construction risk code 6 - substandard                 | 1  | 842  | -  |
| Real estate term risk code 6 - substandard                         | 1  | 881  | -  |
| Home equity lines and other consumer risk code 5 - special mention | 1  | 94   | -  |
| Total  | 7  | \$ 2,703                                   | \$ -                                       |

The Company had no commitments to extend additional credit to borrowers owing receivables whose terms have been modified in troubled debt restructurings. All troubled debt restructurings are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the Allowance. There were two charge offs totaling \$280,000 in the six months ended June 30, 2012 on loans that were later classified as troubled debt restructurings in the real estate term category. Six troubled debt restructurings with a total recorded investment of \$3.5 million had a specific impairment amount totaling \$815,000 at June 30, 2012.

#### 7. Allowance for Loan Losses

The following tables detail activity in the Allowance for the periods indicated:

| Three Months Ended June 30,  | Commercial<br>(In Thousands) | Real estate<br>construction | Real<br>estate<br>term | Home<br>equity<br>lines and<br>other<br>consumer | Unallocated | Total     |
|------------------------------|------------------------------|-----------------------------|------------------------|--|-------------|-----------|
| 2012                         |                              |                             |                        |  |             |           |
| Balance, beginning of period | \$ 6,083                     | \$ 1,218                    | \$ 5,197               | \$ 599   | \$ 3,191    | \$ 16,288 |
| Charge-Offs                  | -                            | -                           | (127)                  | -  | -           | (127)     |
| Recoveries                   | 223                          | 12                          | -                      | 5  | -           | 240       |
| Provision                    | 880                          | 22                          | 323                    | 270  | (1,406)     | 89        |
| Balance, end of period       | \$ 7,186                     | \$ 1,252                    | \$ 5,393               | \$ 874   | \$ 1,785    | \$ 16,490 |

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|  |                |                          |                  |                             |             |           |
|--|----------------|--------------------------|------------------|-----------------------------|-------------|-----------|
| Balance, end of period: Individually evaluated |                |                          |                  |                             |             |           |
| for impairment                                 | \$ 542         | \$ 263                   | \$ 67            | \$ 49                       | \$ -        | \$ 921    |
| Balance, end of period: Collectively evaluated |                |                          |                  |                             |             |           |
| for impairment                                 | \$ 6,644       | \$ 989                   | \$ 5,326         | \$ 825                      | \$ 1,785    | \$ 15,569 |
| 2011   |                |                          |                  |                             |             |           |
| Balance, beginning of period                   | \$ 6,138       | \$ 1,876                 | \$ 4,305         | \$ 601                      | \$ 2,219    | \$ 15,139 |
| Charge-Offs                                    | (91)           | -                        | (90)             | (65)                        | -           | (246)     |
| Recoveries                                     | 109            | 12                       | -                | 10                          | -           | 131       |
| Provision                                      | 547            | (256)                    | 755              | 373                         | (869)       | 550       |
| Balance, end of period                         | \$ 6,703       | \$ 1,632                 | \$ 4,970         | \$ 919                      | \$ 1,350    | \$ 15,574 |
| Balance, end of period: Individually evaluated |                |                          |                  |                             |             |           |
| for impairment                                 | \$ 513         | \$ 183                   | \$ 0             | \$ 0                        | \$ -        | \$ 696    |
| Balance, end of period: Collectively evaluated |                |                          |                  |                             |             |           |
| for impairment                                 | \$ 6,190       | \$ 1,449                 | \$ 4,970         | \$ 919                      | \$ 1,350    | \$ 14,878 |
|  |                |                          |                  |                             |             |           |
|  |                |                          |                  | Home equity lines and other |             |           |
| Six Months Ended June 30,                      | Commercial     | Real estate construction | Real estate term | consumer                    | Unallocated | Total     |
|  | (In Thousands) |                          |                  |                             |             |           |
| 2012   |                |                          |                  |                             |             |           |
| Balance, beginning of period                   | \$ 6,783       | \$ 1,143                 | \$ 5,529         | \$ 792                      | \$ 2,256    | \$ 16,503 |
| Charge-Offs                                    | (231)          | -                        | (553)            | -                           | -           | (784)     |
| Recoveries                                     | 572            | 12                       | -                | 9                           | -           | 593       |
| Provision                                      | 62             | 97                       | 417              | 73                          | (471)       | 178       |
| Balance, end of period                         | \$ 7,186       | \$ 1,252                 | \$ 5,393         | \$ 874                      | \$ 1,785    | \$ 16,490 |
| Balance, end of period: Individually evaluated |                |                          |                  |                             |             |           |
| for impairment                                 | \$ 542         | \$ 263                   | \$ 67            | \$ 49                       | \$ -        | \$ 921    |
| Balance, end of period: Collectively evaluated |                |                          |                  |                             |             |           |
| for impairment                                 | \$ 6,644       | \$ 989                   | \$ 5,326         | \$ 825                      | \$ 1,785    | \$ 15,569 |
| 2011   |                |                          |                  |                             |             |           |
| Balance, beginning of period                   | \$ 6,374       | \$ 1,035                 | \$ 4,270         | \$ 741                      | \$ 1,986    | \$ 14,406 |
| Charge-Offs                                    | (564)          | -                        | (90)             | (65)                        | -           | (719)     |
| Recoveries                                     | 699            | 13                       | 53               | 23                          | -           | 788       |
| Provision                                      | 194            | 584                      | 737              | 220                         | (636)       | 1,099     |
| Balance, end of period                         | \$ 6,703       | \$ 1,632                 | \$ 4,970         | \$ 919                      | \$ 1,350    | \$ 15,574 |

Balance, end of period: Individually  
evaluated

|                |        |        |      |      |      |        |
|----------------|--------|--------|------|------|------|--------|
| for impairment | \$ 513 | \$ 183 | \$ 0 | \$ 0 | \$ - | \$ 696 |
|----------------|--------|--------|------|------|------|--------|

Balance, end of period: Collectively  
evaluated

|                |          |          |          |        |          |           |
|----------------|----------|----------|----------|--------|----------|-----------|
| for impairment | \$ 6,190 | \$ 1,449 | \$ 4,970 | \$ 919 | \$ 1,350 | \$ 14,878 |
|----------------|----------|----------|----------|--------|----------|-----------|

17

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The following is a detail of the recorded investment in the loan portfolio, segregated by amounts evaluated individually or collectively in the Allowance at the periods indicated:

|   | Commercial     | Real estate construction | Real estate term | Home equity lines and other consumer | Total      |
|---|----------------|--------------------------|------------------|--------------------------------------|------------|
|   | (In Thousands) |                          |                  |                                      |            |
| June 30, 2012   |                |                          |                  |                                      |            |
| Balance, end of period  | \$ 240,395     | \$ 40,922                | \$ 340,530       | \$ 38,260                            | \$ 660,107 |
| Balance, end of period: Individually evaluated for impairment | \$ 2,733       | \$ 3,670                 | \$ 7,359         | \$ 434                               | \$ 14,196  |
| Balance, end of period: Collectively evaluated for impairment | \$ 237,662     | \$ 37,252                | \$ 333,171       | \$ 37,826                            | \$ 645,911 |
| June 30, 2011   |                |                          |                  |                                      |            |
| Balance, end of period  | \$ 232,765     | \$ 47,639                | \$ 314,093       | \$ 42,458                            | \$ 636,955 |
| Balance, end of period: Individually evaluated for impairment | \$ 4,843       | \$ 2,949                 | \$ 4,688         | \$ 209                               | \$ 12,689  |
| Balance, end of period: Collectively evaluated for impairment | \$ 227,922     | \$ 44,690                | \$ 309,405       | \$ 42,249                            | \$ 624,266 |

The following represents the balance of the Allowance for the periods indicated segregated by segment and class:

|  | Total          | Commercial | Real estate construction | Real estate term | Home equity lines and other consumer | Unallocated |
|--|----------------|------------|--------------------------|------------------|--------------------------------------|-------------|
|  | (In Thousands) |            |                          |                  |                                      |             |
| June 30, 2012                          |                |            |                          |                  |                                      |             |
| Individually evaluated for impairment: |                |            |                          |                  |                                      |             |
| Risk Code 6 - Substandard              | \$ 515         | \$ 141     | \$ -                     | \$ 325           | \$ 49                                | \$ -        |
| Risk Code 7 - Doubtful                 | 406            | 400        | -                        | 6                | -                                    | -           |

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Collectively evaluated for impairment:

|                               |           |          |          |          |        |          |
|-------------------------------|-----------|----------|----------|----------|--------|----------|
| Risk Code 2 - Good            | 14        | 8        | -        | 6        |        |          |
| Risk Code 3 - Satisfactory    | 11,364    | 4,888    | 1,065    | 4,845    | 566    | -        |
| Risk Code 4 - Watch           | 413       | 139      | 10       | 16       | 248    | -        |
| Risk Code 5 - Special Mention | 1,630     | 1,584    | 6        | 32       | 8      | -        |
| Risk Code 6 - Substandard     | 363       | 26       | 171      | 163      | 3      | -        |
| Risk Code 7 - Doubtful        | -         | -        | -        | -        | -      | -        |
| Unallocated                   | 1,785     | -        | -        | -        | -      | 1,785    |
|                               | \$ 16,490 | \$ 7,186 | \$ 1,252 | \$ 5,393 | \$ 874 | \$ 1,785 |

June 30, 2011

Individually evaluated for impairment:

|                           |        |       |        |      |      |      |
|---------------------------|--------|-------|--------|------|------|------|
| Risk Code 6 - Substandard | \$ 240 | \$ 57 | \$ 183 | \$ - | \$ - | \$ - |
| Risk Code 7 - Doubtful    | 456    | 456   | -      | -    | -    | -    |

Collectively evaluated for impairment:

|                               |           |          |          |          |        |          |
|-------------------------------|-----------|----------|----------|----------|--------|----------|
| Risk Code 3 - Satisfactory    | 9,512     | 3,809    | 1,041    | 4,094    | 568    | -        |
| Risk Code 4 - Watch           | 513       | 143      | 68       | 13       | 289    | -        |
| Risk Code 5 - Special Mention | 2,271     | 2,180    | -        | 31       | 60     | -        |
| Risk Code 6 - Substandard     | 1,232     | 58       | 340      | 832      | 2      | -        |
| Risk Code 7 - Doubtful        | -         | -        | -        | -        | -      | -        |
| Unallocated                   | 1,350     | -        | -        | -        | -      | 1,350    |
|                               | \$ 15,574 | \$ 6,703 | \$ 1,632 | \$ 4,970 | \$ 919 | \$ 1,350 |

At June 30, 2012, the Company's ratio of nonperforming loans compared to portfolio loans was 0.92%. The Company's ratio of Allowance compared to portfolio loans at June 30, 2012 was 2.51%.

#### 8. Goodwill and Other Intangibles

The Company performs goodwill impairment testing annually in accordance with the policy described in Note 1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2011. There was no indication of impairment as of June 30, 2012. The Company continues to monitor the Company's goodwill for potential impairment on an ongoing basis. No assurance can be given that there will not be an impairment charge to earnings during 2012 for goodwill impairment, if, for example, our stock price declines and trades at a significant discount to its book value, although there are many qualitative and quantitative factors that we analyze in determining the impairment of goodwill.

#### 9. Deposit Activities

Total deposits at June 30, 2012, December 31, 2011 and June 30, 2011 were \$894.8 million, \$911.2 million and \$884.2 million, respectively. The only deposit category with stated maturity dates is certificates of deposit. At June 30, 2012, the Company had \$106.1 million in certificates of deposit as compared to certificates of deposit of \$108.7 million and \$128.8 million, for the periods ending December 31, 2011 and June 30, 2011, respectively. At June 30, 2012, \$73.9 million, or 70%, of the Company's certificates of deposits are scheduled to mature over the next 12 months as compared to \$75.1 million, or 69%, of total certificates of deposit at December 31, 2011, and \$89.2 million, or 69%, of total certificates of deposit at June 30, 2011.

#### 10. Stock Incentive Plan

The Company adopted the 2010 Stock Option Plan ("2010 Plan") following shareholder approval of the 2010 Plan at the 2010 Annual Meeting. Subsequent to the adoption of the 2010 Plan, no additional grants may be issued under the prior plans. The 2010 Plan provides for grants of up to 348,232 shares, which includes any shares subject to stock awards under the previous stock option plans.

**Stock Options:** Under the 2010 Plan and previous plans, certain key employees have been granted the option to purchase set amounts of common stock at the market price on the day the option was granted. Optionees, at their own discretion, may cover the cost of exercise through the exchange at the then fair value of already owned shares of the

Company's stock. Options are granted for a 10-year period and vest on a pro rata basis over the initial three years from grant.

19

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The Company measures the fair value of each stock option at the date of grant using the Black-Scholes option pricing model. For the quarters ended June 30, 2012 and 2011, the Company recognized \$15,000 and \$17,000, respectively, in stock option compensation expense as a component of salaries and other personnel expense. For the six months ended June 30, 2012 and 2011, the Company recognized \$30,000 and \$34,000, respectively, in stock option compensation expense as a component of salaries and other personnel expense.

Proceeds from the exercise of stock options in the three months ended June 30, 2012 and 2011, were \$94,000 and \$103,000, respectively. The Company withheld \$98,000 and \$103,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options in the three months ended June 30, 2012 and 2011, respectively. Proceeds from the exercise of stock options in the six months ended June 30, 2012 and 2011, were \$158,000 and \$179,000, respectively. The Company withheld \$161,000, and \$179,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options in the six months ended June 30, 2012 and 2011, respectively.

**Restricted Stock Units:** The Company grants restricted stock units to certain key employees periodically. Recipients of restricted stock units do not pay any cash consideration to the Company for the shares and receive all dividends with respect to such shares when the shares vest. Restricted stock units cliff vest at the end of a three-year time period. For the three months ended June 30, 2012 and 2011, the Company recognized \$98,000 and \$112,000, respectively, in restricted stock unit compensation expense as a component of salaries and other personnel expense. For the six months ended June 30, 2012 and 2011, the Company recognized \$196,000 and \$229,000, respectively, in restricted stock unit compensation expense as a component of salaries and other personnel expense.

## 11. Fair Value of Assets and Liabilities

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

**Level 1:** Valuation is based upon quoted prices for identical instruments traded in active exchange markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

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



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

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

Cash and cash equivalents: Due to the short term nature of these instruments, the carrying amounts reported in the balance sheet represent their fair values.

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

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

Loans: Fair value adjustments for loans are mainly related to credit risk, interest rate risk, required equity return, and liquidity risk. Credit risk is primarily addressed in the financial statements through the Allowance (see Note 7). Loans are valued using a discounted cash flow methodology and are pooled based on type of interest rate (fixed or adjustable) and maturity. A discount rate was developed based on the relative risk of the cash flows, taking into account the maturity of the loans and liquidity risk. Impaired loans are carried at fair value. Specific valuation allowances are included in the Allowance.

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

Accrued interest receivable: Due to the short term nature of these instruments, the carrying amounts reported in the balance sheet represent their fair values.

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

Accrued interest payable: Due to the short term nature of these instruments, the carrying amounts reported in the balance sheet represent their fair values.

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

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

Junior subordinated debentures: Fair value adjustments for junior subordinated debentures are based on discounted cash flows to maturity using current interest rates for similar financial instruments. Management utilized a market approach to determine the appropriate discount rate for junior subordinated debentures.

Assets subject to nonrecurring adjustment to fair value: The Company is also required to measure certain assets such as equity method investments, goodwill, intangible assets, impaired loans, and other real estate owned (“OREO”) at fair value on a nonrecurring basis in accordance with GAAP. Any nonrecurring adjustments to fair value usually result from the write down of individual assets.

The Company uses either in-house evaluations or external appraisals to estimate the fair value of OREO and impaired loans as of each reporting date. In-house appraisals are considered Level 3 inputs and external appraisals are considered Level 2 inputs. The Company’s determination of which method to use is based upon several factors. The Company takes into account compliance with legal and regulatory guidelines, the amount of the loan, the size of the assets, the location and type of property to be valued and how critical the timing of completion of the analysis is to the assessment of value. Those factors are balanced with the level of internal expertise, internal experience and market information available, versus external expertise available such as qualified appraisers, brokers, auctioneers and equipment specialists.

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

reallocated based on revised estimates. The Company adjusts the carrying value of other real estate owned in accordance with this guidance for increases in estimated cost to complete that exceed the fair value of the real estate at the end of each reporting period.

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

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

Estimated fair values as of the periods indicated are as follows:

|  | June 30, 2012      |            | December 31, 2011  |            | June 30, 2011      |            |
|--|--------------------|------------|--------------------|------------|--------------------|------------|
|  | Carrying<br>Amount | Fair Value | Carrying<br>Amount | Fair Value | Carrying<br>Amount | Fair Value |
|  | (In Thousands)     |            |                    |            |                    |            |
| Financial assets:                                |                    |            |                    |            |                    |            |
| Level 1 inputs:                                  |                    |            |                    |            |                    |            |
| Cash, due from banks and deposits in other banks | \$ 110,704         | \$ 110,704 | \$ 91,530          | \$ 91,530  | \$ 143,831         | \$ 143,831 |
| Level 2 inputs:                                  |                    |            |                    |            |                    |            |
| Investment securities                            | 194,851            | 195,093    | 227,905            | 228,163    | 188,020            | 188,216    |
| Accrued interest receivable                      | 2,801              | 2,801      | 2,898              | 2,898      | 2,745              | 2,745      |
| Level 3 inputs:                                  |                    |            |                    |            |                    |            |
| Loans and loans held for sale, net               | 662,989            | 655,950    | 656,881            | 649,907    | 618,556            | 615,464    |
| Purchased receivables                            | 23,650             | 23,650     | 30,209             | 30,209     | 14,743             | 14,743     |

Financial liabilities:

Level 2 inputs:

|   |            |            |            |            |            |            |
|---|------------|------------|------------|------------|------------|------------|
| Deposits                                    | \$ 894,773 | \$ 894,358 | \$ 911,248 | \$ 910,927 | \$ 884,170 | \$ 883,317 |
| Securities sold under repurchase agreements | 15,265     | 15,265     | 16,348     | 16,348     | 11,616     | 11,616     |
| Borrowings                                  | 4,553      | 4,193      | 4,626      | 4,066      | 4,696      | 3,993      |
| Junior subordinated debentures              | 18,558     | 17,620     | 18,558     | 17,356     | 18,558     | 15,106     |
| Accrued interest payable                    | 50         | 50         | 52         | 52         | 239        | 239        |

Unrecognized financial instruments:

|   |            |          |            |          |            |          |
|---|------------|----------|------------|----------|------------|----------|
| Commitments to extend credit <sup>(1)</sup> | \$ 223,832 | \$ 2,238 | \$ 173,834 | \$ 1,738 | \$ 204,899 | \$ 2,049 |
| Standby letters of credit <sup>(1)</sup>    | 21,484     | 215      | 16,172     | 162      | 18,240     | 182      |

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

The following table sets forth the balances as of the periods indicated of assets measured at fair value on a recurring basis:

|   | Total      | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
|---|------------|---|---|--|
| June 30, 2012                                   |            |   |   |  |
| (In Thousands)                                  |            |   |   |  |
| Available for sale securities                   |            |   |   |  |
| U.S. Treasury and government sponsored entities | \$ 119,503 | \$ -  | \$ 119,503  | \$ -   |
| Municipal securities                            | 19,668     | -   | 19,668  | -  |
| U.S. Agency mortgage-backed securities          | 50         | -   | 50  | -  |
| Corporate bonds                                 | 46,847     | -   | 46,847  | -  |
| Preferred stock                                 | 3,179      | -   | 3,179   | -  |
| Total   | \$ 189,247 | \$ -  | \$ 189,247  | \$ -   |
| December 31, 2011                               |            |   |   |  |
| Available for sale securities                   |            |   |   |  |
| U.S. Treasury and government sponsored entities | \$ 161,104 | \$ -  | \$ 161,104  | \$ -   |
| Municipal securities                            | 16,935     | -   | 16,935  | -  |
| U.S. Agency mortgage-backed securities          | 54         | -   | 54  | -  |
| Corporate bonds                                 | 42,991     | -   | 42,991  | -  |
| Preferred stock                                 | 999        | -   | 999   | -  |
| Total   | \$ 222,083 | \$ -  | \$ 222,083  | \$ -   |
| June 30, 2011                                   |            |   |   |  |
| Available for sale securities                   |            |   |   |  |
| U.S. Treasury and government sponsored entities | \$ 138,126 | -   | \$ 138,126  | \$ -   |
| Municipal securities                            | 14,402     | -   | 14,402  | -  |
| U.S. Agency mortgage-backed securities          | 60         | -   | 60  | -  |
| Corporate bonds                                 | 30,290     | -   | 30,290  | -  |
| Total   | \$ 182,878 | \$ -  | \$ 182,878  | \$ -   |

As of and for the three months ending June 30, 2012 and 2011, no impairment or valuation adjustment was recognized for assets recognized at fair value on a nonrecurring basis, except for certain assets as shown in the following table. For loans measured for impairment, the Company classifies fair value measurements using observable inputs, such as external appraisals, as level 2 valuations in the fair value hierarchy, and unobservable inputs, such as in-house evaluations, as level 3 valuations in the fair value hierarchy.

|  | Total          | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs (Level<br>3) | Total<br>(gains)<br>losses |
|--|----------------|---|---|--|----------------------------|
| June 30, 2012                              | (In Thousands) |   |   |  |                            |
| Loans measured for impairment <sup>1</sup> | \$ 4,008       | \$ -  | \$ 2,920  | \$ 1,088   | \$ (259)                   |
| Other real estate owned <sup>2</sup>       | 639            | -   | -   | 639  | 81                         |
| Total                                      | \$ 4,647       | \$ -  | \$ 2,920  | \$ 1,727   | \$ (178)                   |
| December 31, 2011                          |                |   |   |  |                            |
| Loans measured for impairment <sup>1</sup> | \$ 2,836       | \$ -  | \$ 204  | \$ 2,632   | \$ 797                     |
| Other real estate owned <sup>2</sup>       | \$ 1,432       | \$ -  | \$ -  | \$ 1,432   | \$ 92                      |
| Total                                      | \$ 4,268       | \$ -  | \$ 204  | \$ 4,064   | \$ 889                     |
| June 30, 2011                              |                |   |   |  |                            |
| Loans measured for impairment <sup>1</sup> | \$ 2,532       | \$ -  | \$ 1,636  | \$ 896   | \$ 313                     |
| Total                                      | \$ 2,532       | \$ -  | \$ 1,636  | \$ 896   | \$ 313                     |

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

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

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

This discussion should be read in conjunction with the unaudited consolidated financial statements of Northrim BanCorp, Inc. (the "Company") and the notes thereto presented elsewhere in this report and with the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

### Note Regarding Forward Looking-Statements

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

### Critical Accounting Policies

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

The accounting policies that involve significant estimates and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities, are considered critical accounting policies. The Company's critical accounting policies include those that address the accounting for the Allowance, the valuation of goodwill and other intangible assets, and the valuation of other real estate owned. These critical accounting policies



are further described in Item 7, Management's Discussion and Analysis, and in Note 1, Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements in the Company's Form 10-K for the year ended December 31, 2011. Management has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements.

See Note 2 of the Notes to Consolidated Financial Statements in this Form 10-Q for a summary of the pronouncements that became effective in 2012 and discussion of the impact of their adoption on the Company's consolidated financial statements.

#### Update on Economic Conditions

The Company continues to see progress on a number of resource development projects including a significant project located offshore of Alaska's north coast in the Chukchi and Beaufort Seas.

The Company's business activities are currently focused primarily in the state of Alaska. Consequently, our results of operations and financial condition are dependent upon the general trends in the Alaska economy, which is significantly affected by the development of natural resources. Bloomberg recently reported on Interior Secretary Ken Salazar's comments on June 26, 2012 as follows: "Royal Dutch Shell Plc (RDSA) will begin drilling off Alaska's north coast in the third quarter," Interior Secretary Ken Salazar said as he outlined U.S. plans to advance Arctic energy production. "We anticipate that there will be exploration with the initial wells going in by Shell this summer," Salazar said in an interview at a meeting of energy ministers in Trondheim, Norway. "We have now pending exploration plans that have been submitted by other companies as well." Shell is awaiting U.S. approval of the final permits to develop leases bought in 2005 and 2008. ConocoPhillips (COP) and Statoil ASA (STL) also won rights in the region and plan to join The Hague-based Shell in the area last explored in the early 1990s.

#### Recent Developments

**New Proposed Capital Rules:** On June 12, 2012, the three federal banking regulators (including the Federal Reserve and the FDIC) jointly announced that they were seeking comment on three sets of proposed regulations relating to capital (the "Proposed Rules"). The Proposed Rules would apply to both depository institutions and (subject to certain exceptions not applicable to the Company) their holding companies. Although parts of the Proposed Rules would apply only to large, complex financial institutions, substantial portions of the Proposed Rules would apply to the Bank and the Company. The Proposed Rules include requirements contemplated by Dodd-Frank Act as well as certain standards initially adopted by the Basel Committee on Banking Supervision in December 2010, which standards are commonly referred to as "Basel III".

The Proposed Rules include new risk-based and leverage capital ratio requirements, which would be phased in beginning in 2013 and be fully implemented January 1, 2015, and would refine the definition of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to the Company and the Bank under the Proposed Rules would be: (i) a new common equity Tier 1 risk-based capital ratio of 4.5%; (ii) a Tier 1 risk-based capital ratio of 6% (increased from 4%); (iii) a total risk-based capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. Common equity Tier 1

capital would consist of retained earnings and common stock instruments, subject to certain adjustments.

The Proposed Rules would also establish a “capital conservation buffer” of 2.5% above the new regulatory minimum risk-based capital requirements. The conservation buffer would consist entirely of common equity Tier 1 capital and, when added to the capital requirements, would result in the following minimum ratios: (i) a common equity Tier 1 risk-based capital ratio of 7.0%, (ii) a Tier 1 risk-based capital ratio of 8.5%, and (iii) a total risk-based capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on certain activities including payment of dividends, share repurchases and discretionary bonuses to executive officers if its capital level is below the buffer amount.

The Proposed Rules would also revise the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Bank, if their capital levels do not meet certain thresholds. These revisions would be phased in beginning in 2013 and be fully implemented January 1, 2015. The prompt correction action rules would be modified to include a common equity Tier 1 capital component and to increase certain other capital requirements for the various thresholds. For example, under the proposed prompt corrective action rules, insured depository institutions would be required to meet the following capital levels in order to qualify as “well capitalized”: (i) a new common equity Tier 1 risk-based capital ratio of 6.5%; (ii) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (iii) a total risk-based capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (unchanged from current rules).

The Proposed Rules set forth certain changes in the methods of calculating certain risk-weighted assets, which in turn would affect the calculation of risk based ratios. These new calculations would take effect beginning January 1, 2015. Under the Proposed Rules, higher or more sensitive risk weights would be assigned to various categories of assets, including residential mortgages, certain credit facilities that finance the acquisition, development or construction of real property, certain exposures or credits that are 90 days past due or on accrual, foreign exposures and certain corporate exposures. In addition, the Proposal Rules include (i) alternative standards of creditworthiness consistent with the Dodd-Frank Act; (ii) greater recognition of collateral and guarantees; and (iii) revised capital treatment for derivatives and repo-style transactions.

The deadline for comments on the Proposed Rules is September 7, 2012. We cannot predict at this time when or in what form final rules will be adopted.

#### Highlights and Summary of Performance – Second Quarter of 2012

- § Diluted earnings per share in the second quarter of 2012 were \$0.48, compared to \$0.49 per diluted share in the quarter ended June 30, 2011.
- § Northrim paid a quarterly cash dividend of \$0.13 per share in the second quarter of 2012, compared to a quarterly cash dividend of \$0.12 per share in the second quarter of 2011, which provides a yield of approximately 2.4% at current market share prices.
- § At quarter end, tangible book value was \$18.86 per share, up from \$18.09 at December 31, 2011 and \$17.63 per share at June 30, 2011. Tangible book value is a non-GAAP ratio that represents total shareholders' equity less goodwill and intangible assets divided by the number of common shares outstanding. The GAAP measure of book value is total shareholders' equity divided by the number of common shares outstanding. Book value was \$20.14 at June 30, 2012 as compared to \$19.39 at December 31, 2011 and \$18.96 at June 30, 2011.
- § Other operating income, which includes revenues from financial services affiliates, service charges, and electronic banking, contributed 26.2% to second quarter 2012 total revenues, compared to 22.5% of second quarter 2011 total revenues.
- § Northrim remains well-capitalized with Tier 1 Capital to Risk Adjusted Assets at June 30, 2012 of 15.44%, compared to 15.20% at December 31, 2011 and 15.59% at June 30, 2011. Tangible common equity to tangible assets was 11.47% at June 30, 2012, up from 10.86% at December 31, 2011 and 10.90% a year ago. Tangible common equity to tangible assets is a non-GAAP ratio that represents total equity less goodwill and intangible assets divided by total assets less goodwill and intangible assets. The GAAP measure of equity to assets is total equity divided by total assets. Total equity to total assets was 12.17% at June 30, 2012 as compared to 11.56% at December 31, 2011 and 11.63% at June 30, 2011.
- § At June 30, 2012, nonperforming assets were \$12.5 million, or 1.16% of total assets, compared to \$12.5 million, or 1.16% of total assets at the end of December 2011, and \$16.9 million, or 1.61% of total assets a year ago.
- § The allowance for loan losses totaled 2.51% of gross loans at June 30, 2012, down from 2.56% at December 31, 2011 and up from 2.46% a year ago. The allowance for loan losses to nonperforming loans also increased to 274% at June 30, 2012, from 224% at December 31, 2011 and 133% a year ago.
- § Second quarter 2012, net interest margin was 4.51%, down 14 basis points from the second quarter a year ago.

The Company reported net income and diluted earnings per share of \$3.1 million and \$0.48, respectively, for the second quarter of 2012 compared to net income and diluted earnings per share of \$3.2 million and \$0.49, respectively, for the second quarter of 2011. The slight decrease in net income from the prior year was the result of a number of factors. The largest change in net income for the second quarter of 2012 as compared to the same period in 2011 is attributable to an increase in other operating expense due to decreased rental income and gains on the sale of other real estate owned ("OREO"). The increase in other operating expense was nearly entirely offset by an increase in other operating income primarily due to increased gains on the sale of securities, purchased receivable income, and earnings from Residential Mortgage Holding Company LLC ("RML"), the Company's mortgage affiliate. Lastly, the provision for loan losses also decreased significantly in the second quarter of 2012 as compared to the same period in 2011, and the provision for income taxes increased primarily due to increased taxable income.

Northrim's total assets increased by 2% at June 30, 2012 as compared to June 30, 2011, with increases in loans, portfolio investments, and purchased receivables partially offset by a decrease in interest bearing deposits in other banks. Total assets at June 30, 2012 decreased 1% as compared to December 31, 2011 primarily due to decreases in portfolio investments and purchased

receivables, which were partially offset with increases in interest bearing deposits in other banks and loan growth. Net loans increased to \$663.0 million at June 30, 2012 as compared to \$656.9 million at December 31, 2011 and \$618.6 million a year ago. This increase in the loan portfolio in the first six months of 2012 was primarily due to increases in real estate term loans.

### Credit Quality

Nonperforming assets: Nonperforming assets at June 30, 2012 were consistent with December 31, 2011 and decreased by \$2.5 million, or 17%, as compared June 30, 2011. Nonaccrual loans at June 30, 2012 decreased \$3.7 million, or 39%, year-over-year. Other real estate owned increased \$1.4 million, or 27%, as compared to and June 30, 2011, as a result of the addition of a property in Fairbanks which includes thirty seven lots that are ready for building and some unrestricted acreage.

The following table summarizes total OREO activity for the three and six month periods ending June 30, 2012 and 2011:

|   | Three Months<br>Ended June 30, |           | Six Months<br>Ended June 30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
|   | 2012                           | 2011      | 2012                         | 2011      |
|   | (In Thousands)                 |           |                              |           |
| Balance, beginning of the period                  | \$ 6,657                       | \$ 10,343 | \$ 5,183                     | \$ 10,355 |
| Transfers from loans, net                         | -                              | 8         | 1,499                        | 982       |
| Investment in other real estate owned             | 1                              | 14        | 18                           | 28        |
| Proceeds from the sale of other real estate owned | (149)                          | (6,154)   | (199)                        | (7,294)   |
| Gain on sale of other real estate owned, net      | 7                              | 733       | 26                           | 805       |
| Deferred gain on sale of other real estate owned  | 13                             | 139       | 2                            | 207       |
| Impairment on other real estate owned             | (81)                           | -         | (81)                         | -         |
| Balance at end of period                          | \$ 6,448                       | \$ 5,083  | \$ 6,448                     | \$ 5,083  |

Potential problem loans: Potential problem loans are loans which are currently performing and are not included in nonaccrual loans, accruing loans 90 days or more past due, or impaired loans that have developed negative indications that the borrower may not be able to comply with present payment terms and which may later be included in nonaccrual, past due, or impaired loans. At June 30, 2012, management had identified potential problem loans of \$2.4 million as compared to potential problem loans of \$4.6 million at December 31, 2011 and \$8.6 million at June 30, 2011. The decrease in potential problem loans at June 30, 2012 from December 31, 2011 is primarily due to the movement of two real estate term loans to the same borrower totaling \$2.7 million from potential problem loans to nonaccrual status. The decrease at June 30, 2012 as compared to June 30, 2011 is due to the movement of \$4.8 million in loans to nonaccrual or OREO status, as well as pay downs and upgrades on several loans.

Troubled debt restructurings (“TDRs”): TDRs are those loans for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower, have been granted due to the borrower’s weakened financial condition. Interest on TDRs will be accrued at the restructured rates when it is anticipated that no loss of original principal will occur, and the interest can be collected, which is generally after a period of six months. The Company had \$8.1 million in loans classified as TDRs that were performing as of June 30, 2012. Additionally, there were \$4.0 million in TDRs included in nonaccrual loans at June 30, 2012 for a total of \$12.1 million. At December 31, 2011 and June 30, 2011 there were \$2.3 million and \$1.9 million, respectively, in loans classified as TDRs that were performing and \$2.2 million and \$1.8 million, respectively, in TDRs included in nonaccrual loans. See Note 6 of the Notes to Consolidated Financial Statements included in Item 1 of this report for further discussion of TDRs.

## RESULTS OF OPERATIONS

### Income Statement

#### Net Income

Net income attributable to Northrim BanCorp for the second quarter of 2012 decreased \$40,000, or 1%, to \$3.1 million as compared to \$3.2 million for the same period in 2011. This decrease was due to increases in other operating expense and the

provision for income taxes and a slight decrease in net interest income. These changes were partially offset by an increase in other operating income and a decrease in the provision for loan losses.

Net income attributable to Northrim BanCorp for the six-month period ending June 30, 2012 increased \$81,000, or 1%, to \$5.7 million compared to \$5.6 million for the same period in 2011. This increase was due to an increase in other operating income and a decrease in the provision for loan losses. These changes were partially offset by increases in other operating expense and the provision for income taxes and a slight decrease in net interest income.

#### Net Interest Income / Net Interest Margin

Net interest income for the second quarter of 2012 decreased \$85,000, or 1%, as compared to the second quarter in 2011. Net interest income for the six month period ending June 30, 2012 decreased \$407,000, or 2%, as compared to the same period in 2011. The decreases in both periods arose from reductions in interest income due to decreased yields on interest-earning assets, accompanied by a smaller decrease in the costs of the Company's interest-bearing liabilities. The Company's net interest income as a percentage of average interest-earning assets on a tax equivalent basis decreased by 14 and 16 basis points to 4.51% and 4.52%, respectively, for the three and six-month periods ending June 30, 2012 as compared to the same periods in 2011.

Average loans, the largest category of interest-earning assets, increased by \$25.0 million and \$16.2 million, or 4% and 2%, to \$677.2 million and \$673.2 million in the three and six-month periods ending June 30, 2012, respectively, as compared to the same periods in 2011. Average commercial loans, real estate term loans, and loans held for sale increased while real estate construction and home equity lines and other consumer loans decreased in the both periods as compared to the same periods in 2011. Total interest income from loans decreased \$404,000 and \$866,000 for the three and six-month periods ending June 30, 2012, respectively, as compared to the same periods in 2011, due to decreased yields.

Average investments changed less than 1% for both the three and six month periods ending June 30, 2012 as compared to the same periods in 2011.

The average yield on interest-earning assets, which includes loans and investments, decreased 27 basis points to 4.77% for the second quarter of 2012 from 5.04% in the same period in 2011. The average yield on interest-earning assets decreased 29 basis points to 4.80% for the six months ended June 30, 2012 from 5.09% in the same period in 2011. The decrease in average yields in both periods arose from decreasing interest rates in both the loan and investment portfolios as new volume replaces old volume at lower current rates.



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Average interest-bearing liabilities increased \$13.7 million, or 2%, to \$634.9 million during the second quarter of 2012 as compared to \$621.2 million for the same period in 2011. Average interest-bearing liabilities increased \$4.2 million, or 1%, to \$630.1 million during the six months ended June 30, 2012 as compared to \$625.9 million for the same period in 2011. These increases were the result of increased average interest-bearing deposit balances and increased balances in securities sold under repurchase agreements, which are classified as borrowings.

The average cost of interest-bearing liabilities decreased \$277,000, or 19 basis points, and \$556,000, or 18 basis points, for the three and six month periods ending June 30, 2012, respectively, as compared to the same periods in 2011 due to declining market rates across all deposit types and borrowings.

Components of Net Interest Margin

The following tables compares average balances and rates as well as net tax equivalent margin on earning assets for the three and six months ending June 30, 2012 and 2011:

|   | Three Months Ended June 30, |              |           |        |          | Interest income/<br>expense |          |        |      |      | Average Y<br>Tax Equiv |      |      |      |    |
|---|-----------------------------|--------------|-----------|--------|----------|-----------------------------|----------|--------|------|------|------------------------|------|------|------|----|
|   | Average Balances            |              | Change    |        | 2012     | 2011                        | Change   |        | 2012 | 2011 | 2012                   | 2011 | 2012 | 2011 |    |
|   | 2012                        | 2011         | \$        | %      |          |                             | \$       | %      |      |      |                        |      |      |      | \$ |
|   | (In Thousands)              |              |           |        |          |                             |          |        |      |      |                        |      |      |      |    |
| Commercial  | \$ 248,884                  | \$ 244,273   | \$ 4,611  | 2 %    | \$ 4,114 | \$ 4,161                    | \$ (47)  | (1) %  | 6.65 | %    | 6.65                   | %    | 6.65 | %    |    |
| Real estate construction                                  | 37,235                      | 58,953       | (21,718)  | (37) % | 766      | 1,077                       | (311)    | (29) % | 8.27 | %    | 8.27                   | %    | 8.27 | %    |    |
| Real estate term  | 341,786                     | 309,216      | 32,570    | 11 %   | 4,721    | 4,785                       | (64)     | (1) %  | 5.56 | %    | 5.56                   | %    | 5.56 | %    |    |
| Home equity lines and<br>other consumer                   | 38,312                      | 42,350       | (4,038)   | (10) % | 590      | 686                         | (96)     | (14) % | 6.20 | %    | 6.20                   | %    | 6.20 | %    |    |
| Loans held for sale                                       | 12,768                      | -            | 12,768    | NM     | 114      | -                           | 114      | NM     | 3.59 | %    | 3.59                   | %    | 3.59 | %    |    |
| Unearned origination<br>fees, net of<br>origination costs | (1,782)                     | (2,641)      | 859       | (33) % |          |                             |          |        |      |      |                        |      |      |      |    |
| Total loans <sup>1,2</sup>                                | 677,203                     | 652,151      | 25,052    | 4 %    | 10,305   | 10,709                      | (404)    | (4) %  | 6.15 | %    | 6.15                   | %    | 6.15 | %    |    |
| Short-term investments                                    | 75,075                      | 84,310       | (9,235)   | (11) % | 63       | 55                          | 8        | 15 %   | 0.33 | %    | 0.33                   | %    | 0.33 | %    |    |
| Long-term investments                                     | 197,700                     | 188,168      | 9,532     | 5 %    | 755      | 722                         | 33       | 5 %    | 1.72 | %    | 1.72                   | %    | 1.72 | %    |    |
| Total investments   | 272,775                     | 272,478      | 297       | 0 %    | 818      | 777                         | 41       | 5 %    | 1.35 | %    | 1.35                   | %    | 1.35 | %    |    |
| Interest-earning assets                                   | 949,978                     | 924,629      | 25,349    | 3 %    | 11,123   | 11,486                      | (363)    | (3) %  | 4.77 | %    | 4.77                   | %    | 4.77 | %    |    |
| Nonearning assets   | 114,569                     | 109,562      | 5,007     | 5 %    |          |                             |          |        |      |      |                        |      |      |      |    |
| Total   | \$ 1,064,547                | \$ 1,034,191 | \$ 30,356 | 3 %    |          |                             |          |        |      |      |                        |      |      |      |    |
| Interest-bearing deposits                                 | \$ 597,878                  | \$ 586,003   | \$ 11,875 | 2 %    | \$ 422   | \$ 704                      | \$ (282) | (40) % | 0.28 | %    | 0.28                   | %    | 0.28 | %    |    |
| Borrowings  | 37,066                      | 35,219       | 1,847     | 5 %    | 205      | 200                         | 5        | 3 %    | 2.18 | %    | 2.18                   | %    | 2.18 | %    |    |
| Total interest-bearing<br>liabilities                     | 634,944                     | 621,222      | 13,722    | 2 %    | 627      | 904                         | (277)    | (31) % | 0.39 | %    | 0.39                   | %    | 0.39 | %    |    |

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|                                 |              |              |           |   |   |           |           |         |     |   |
|---------------------------------|--------------|--------------|-----------|---|---|-----------|-----------|---------|-----|---|
| Demand deposits and other       |              |              |           |   |   |           |           |         |     |   |
| noninterest-bearing liabilities | 299,819      | 291,912      | 7,907     | 3 | % |           |           |         |     |   |
| Equity                          | 129,784      | 121,057      | 8,727     | 7 | % |           |           |         |     |   |
| Total                           | \$ 1,064,547 | \$ 1,034,191 | \$ 30,356 | 3 | % |           |           |         |     |   |
| Net interest income             |              |              |           |   |   | \$ 10,496 | \$ 10,582 | \$ (86) | (1) | % |

Net tax equivalent margin on earning assets<sup>3</sup> 4.51 % 4

<sup>1</sup> Loan fees recognized during the period and included in the yield calculation totaled \$663,000 and \$680,000 in the second quarter of 2011, respectively.

<sup>2</sup> Average nonaccrual loans included in the computation of the average loans were \$6.3 million and \$10.1 million in the second quarter of 2011 and 2010, respectively.

<sup>3</sup> Tax-equivalent net interest margin is a non-GAAP performance measurement in which interest income on non-taxable investments is presented on a tax-equivalent basis using a combined federal and state statutory rate of 41.11% in both 2011 and 2010.

|   | Six Months Ended June 30, |              |           |      |      | Interest income/expense |          | Change   |      | Average Yield Tax Equivalent |      |     |
|---|---------------------------|--------------|-----------|------|------|-------------------------|----------|----------|------|------------------------------|------|-----|
|   | Average Balances          |              | Change    |      | 2012 | 2011                    | \$       | %        | 2012 | 2011                         |      |     |
|   | 2012                      | 2011         | \$        | %    |      |                         |          |          |      |                              |      |     |
|   | (In Thousands)            |              |           |      |      |                         |          |          |      |                              |      |     |
| Commercial  | \$ 250,355                | \$ 243,707   | \$ 6,648  | 3    | %    | \$ 8,191                | \$ 8,229 | \$ (38)  | 0    | %                            | 6.58 | % 6 |
| Real estate construction                            | 38,431                    | 61,338       | (22,907)  | (37) | %    | 1,544                   | 2,243    | (699)    | (31) | %                            | 8.08 | % 7 |
| Real estate term                                    | 333,477                   | 311,286      | 22,191    | 7    | %    | 9,332                   | 9,530    | (198)    | (2)  | %                            | 5.63 | % 6 |
| Home equity lines and other consumer                | 38,769                    | 42,718       | (3,949)   | (9)  | %    | 1,205                   | 1,381    | (176)    | (13) | %                            | 6.25 | % 6 |
| Loans held for sale                                 | 14,015                    | 616          | 13,399    | NM   |      | 258                     | 13       | 245      | NM   | %                            | 3.69 | % 4 |
| Unearned origination fees, net of origination costs | (1,848)                   | (2,650)      | 802       | 30   | %    |                         |          |          |      |                              |      |     |
| Total loans <sup>1, 2</sup>                         | 673,199                   | 657,015      | 16,184    | 2    | %    | 20,530                  | 21,396   | (866)    | (4)  | %                            | 6.17 | % 6 |
| Short-term investments                              | 59,059                    | 68,474       | (9,415)   | (14) | %    | 103                     | 88       | 15       | 17   | %                            | 0.34 | % 0 |
| Long-term investments                               | 209,796                   | 201,445      | 8,351     | 4    | %    | 1,542                   | 1,654    | (112)    | (7)  | %                            | 1.65 | % 1 |
| Total investments                                   | 268,855                   | 269,919      | (1,064)   | 0    | %    | 1,645                   | 1,742    | (97)     | (6)  | %                            | 1.37 | % 1 |
| Interest-earning assets                             | 942,054                   | 926,934      | 15,120    | 2    | %    | 22,175                  | 23,138   | (963)    | (4)  | %                            | 4.80 | % 5 |
| Nonearning assets                                   | 113,655                   | 110,180      | 3,475     | 3    | %    |                         |          |          |      |                              |      |     |
| Total   | \$ 1,055,709              | \$ 1,037,114 | \$ 18,595 | 2    | %    |                         |          |          |      |                              |      |     |
| Interest-bearing deposits                           | \$ 592,271                | \$ 590,103   | \$ 2,168  | 0    | %    | \$ 907                  | \$ 1,487 | \$ (580) | (39) | %                            | 0.31 | % 0 |
| Borrowings  | 37,798                    | 35,776       | 2,022     | 6    | %    | 418                     | 394      | 24       | 6    | %                            | 2.18 | % 2 |
| Total interest-bearing liabilities                  | 630,069                   | 625,879      | 4,190     | 1    | %    | 1,325                   | 1,881    | (556)    | (30) | %                            | 0.42 | % 0 |
| Demand deposits and other                           |                           |              |           |      |      |                         |          |          |      |                              |      |     |
| noninterest-bearing liabilities                     | 297,078                   | 291,396      | 5,682     | 2    | %    |                         |          |          |      |                              |      |     |
| Equity  | 128,562                   | 119,839      | 8,723     | 7    | %    |                         |          |          |      |                              |      |     |
| Total   | \$ 1,055,709              | \$ 1,037,114 | \$ 18,595 | 2    | %    |                         |          |          |      |                              |      |     |

|  |           |           |             |          |
|--|-----------|-----------|-------------|----------|
| Net interest income                                      | \$ 20,850 | \$ 21,257 | \$ (407)(2) | %        |
| Net tax equivalent margin on earning assets <sup>3</sup> |           |           |             | 4.52 % 4 |

<sup>1</sup> Loan fees recognized during the period and included in the yield calculation totaled \$1.3 million in the six months ending June 30, 2012 and 2011, respectively.

<sup>2</sup> Average nonaccrual loans included in the computation of the average loans were \$6.5 million and \$10.5 million in the six months ending June 30, 2012 and 2011, respectively.

<sup>3</sup> Tax-equivalent net interest margin is a non-GAAP performance measurement in which interest income on non-taxable investments is presented on a tax-equivalent basis using a combined federal and state statutory rate of 41.11% in both 2011 and 2010.

## Analysis of Changes in Interest Income and Expense

The following tables set forth the changes in consolidated net interest income attributable to changes in volume and to changes in interest rates for the three month and six month periods ending June 30, 2012 as compared to the same period in 2011. Changes attributable to the combined effect of volume and interest rate have been allocated proportionately to the changes due to volume and the changes due to interest rates.

|                           | Quarter ended June 30,<br>2012 vs. 2011 |          |          |
|---------------------------|---|----------|----------|
|                           | Increase<br>(decrease) due<br>to        |          |          |
|                           | Volume                                  | Rate     | Total    |
| Interest Income:          |   |          |          |
| Loans                     | \$ 126                                  | \$ (530) | \$ (404) |
| Long-term investments     | 25                                      | 8        | 33       |
| Short-term investments    | (6)                                     | 15       | 9        |
| Total interest income     | \$ 145                                  | \$ (507) | \$ (362) |
| Interest Expense:         |   |          |          |
| Interest-bearing deposits | \$ 14                                   | \$ (296) | \$ (282) |
| Borrowings                | 10                                      | (5)      | 5        |
| Total interest expense    | \$ 24                                   | \$ (301) | \$ (277) |

|                           | Six months ended June<br>30, 2012 vs. 2011 |            |          |
|---------------------------|--|------------|----------|
|                           | Increase (decrease) due to                 |            |          |
|                           | Volume                                     | Rate       | Total    |
| Interest Income:          |  |            |          |
| Loans                     | \$ 265                                     | \$ (1,131) | \$ (866) |
| Long-term investments     | 145  | (257)      | (112)    |
| Short-term investments    | (10)                                       | 25         | 15       |
| Total interest income     | \$ 400                                     | \$ (1,363) | \$ (963) |
| Interest Expense:         |  |            |          |
| Interest-bearing deposits | \$ 6                                       | \$ (581)   | \$ (581) |
| Borrowings                | 28   | (9)        | 25       |

Total interest expense \$ 34 \$ (590) \$ (556)

#### Provision for Loan Losses

The provision for loan losses was \$89,000 and \$178,000 for the three and six-month periods ending June 30, 2012 and \$550,000 and \$1.1 million for the same periods in 2011, respectively. The decrease in the provision for loan losses in both periods is primarily the result of an increase in the credit quality of the loan portfolio. At June 30, the Allowance was \$16.5 million, or 2.51% of total loans as compared to \$15.6 million, or 2.46% of total loans a year ago. See additional analysis of the Allowance in the Balance Sheet Overview section.

#### Other Operating Income

Other operating income for the second quarter of 2012 increased \$655,000, or 21%, to \$3.7 million as compared to \$3.1 million for the second quarter of 2011. This increase is primarily due to increases of \$246,000, \$147,000, \$135,000 and \$91,000, respectively, in gains on the sale of securities, purchased receivable income, equity in earnings from RML, and other income. The increase in other income is primarily the result of increases in miscellaneous loan fees, merchant fees, and in the Company's share of income from its affiliate Elliot Cove Insurance Agency, LLC, ("ECIA") which is accounted for using the equity method. The Company purchased a 41% interest in ECIA in the fourth quarter of 2011. The increase in purchased receivable income resulted from higher average balances.

Changes in other operating income for the year-to-date as of June, 30 2012 are similar to those that occurred in the second quarter of 2012 as compared to 2011 discussed above. Other operating income increased \$1.1 million as compared to the same period in 2011. This increase is primarily due to increases in equity in earnings from RML of \$488,000, purchased receivable income of \$233,000, and other income of \$196,000. Employee benefit plan income and electronic banking income also increased by \$63,000 and \$60,000, respectively, year-to-date as of June, 30 2012 as compared to the same period in 2011.

### Other Operating Expense

Other operating expense for the second quarter of 2012 increased \$706,000, or 8%, to \$9.3 million as compared to \$8.6 million for the second quarter of 2011. This increase was primarily due to an increase of \$860,000 in OREO expense, net of rental income and gains on the sale of OREO properties, which primarily resulted from decreased gains on the sale and rental income attributable to OREO properties. This increase was partially offset by decreases of \$77,000 and \$75,000 in occupancy expense and other operating expense, respectively, as compared to the same period in 2011. Occupancy expense decreased due to decreased costs for repairs and maintenance related to the Company's main office building. Other operating expense decreased primarily due to decreases in operational charge offs, expenses associated with loan collection costs, and shareholder costs. These decreases were only partially offset by an increase in employee education expense.

Other operating expense for the six-months ended June 30, 2012 increased \$1.1 million, or 6%, to \$19.1 million as compared to \$17.9 million for the same period in 2011. This increase was primarily due to an increase of \$1.1 million in OREO expense, net of rental income and gains on the sale of OREO properties, which primarily resulted from decreased gains on the sale and rental income attributable to OREO properties. Additionally, salaries and other personnel expense increased by \$344,000 year-to-date as of June 30, 2012 as compared to the same period in 2011 due to higher salaries and related incentives and group medical expenses. These increases were partially offset by a decrease in insurance expense of \$312,000, primarily due to lower FDIC insurance premiums.

### Income Taxes

The provision for income taxes for the three and six-month periods ending June 30, 2012 increased \$353,000, or 29%, and \$345,000, or 15%, respectively, as compared to the same periods in 2011 primarily due to an increase in net income before the provision for income taxes. The tax rate for the second quarter of 2012 increased to 32% from 27% in the second quarter of 2011 due to a decrease in tax exempt income on investments as well as a decrease in tax exempt gains on the cash surrender value of assets held under the Company's keyman policies relative to the level of taxable income. The tax rate for the six-month period ending June 30, 2012 increased to 30% from 28% for the same period in 2011.

### Financial Condition

## Balance Sheet Overview

### Investment Securities

Investment securities at June 30, 2012 decreased \$33.1 million, or 15%, to \$192.8 million from \$225.9 million at December 31, 2011, and increased \$4.8 million, or 3%, from \$188.0 million at June 30, 2011. The decrease at June 30, 2012 as compared to December 31, 2011 is partially due to a decrease in total deposits of \$16.5 million and also due to the fact that proceeds from the sale and maturity of investment securities were used to fund loan growth and placed in interest bearing deposits in other banks. The increase from June 30, 2011 is due to the purchase of available for sale securities with funds from interest bearing deposits at other banks.

### Loans and Lending Activities

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

Loans are the highest yielding component of our earning assets. Loans comprised 71% of total average earning assets for the three and six-month periods ending June 30, 2012 and June 30, 2011, respectively. The yield on loans averaged 6.15% and 6.17% for the three and six-month periods ending June 30, 2012 as compared to 6.62% and 6.60%, respectively, for the same periods in 2011. See the “Net Interest Income/Net Interest Margin” and “Components of Net Interest Margin” sections for further discussion of average balances and yields for the three and six-month periods ending June 30, 2012 and 2011.

The loan portfolio increased by \$11.2 million, or 2%, to \$656.9 million at June 30, 2012 from \$645.6 million at December 31, 2011. The loan portfolio increased by \$22.7 million, or 4%, at June 30, 2012 from \$634.1 million at June 30, 2011. The increases for both periods are primarily due to a higher level of real estate term loans. The following table details the changes in loan balances by loan type:

|  | June 30, 2012  |                  | December 31, 2011 |                  | June 30, 2011 |                  |            |       |   |
|--|----------------|------------------|-------------------|------------------|---------------|------------------|------------|-------|---|
|  | Dollar Amount  | Percent of Total | Dollar Amount     | Percent of Total | Dollar Amount | Percent of Total |            |       |   |
|  | (In Thousands) |                  |                   |                  |               |                  |            |       |   |
| Commercial   | \$ 240,395     | 36.6             | %                 | \$ 252,689       | 39.1          | %                | \$ 232,765 | 36.7  | % |
| Real estate construction                                 | 40,922         | 6.2              | %                 | 40,182           | 6.2           | %                | 47,639     | 7.5   | % |
| Real estate term   | 340,530        | 51.8             | %                 | 315,860          | 48.9          | %                | 314,093    | 49.5  | % |
| Home equity lines and other consumer                     | 38,260         | 5.8              | %                 | 39,834           | 6.2           | %                | 42,458     | 6.7   | % |
| Subtotal   | \$ 660,107     |                  |                   | \$ 648,565       |               |                  | \$ 636,955 |       |   |
| Less: Unearned origination fee, net of origination costs | (3,257)        | (0.5)            | %                 | (3,003)          | (0.5)         | %                | (2,825)    | (0.4) | % |
| Total loans  | \$ 656,850     |                  |                   | \$ 645,562       |               |                  | \$ 634,130 |       |   |

Due to its efforts to capitalize on market opportunities, the Company expects its loan portfolio to increase during the remainder of 2012 mainly in the commercial and real estate term areas.

#### Analysis of Allowance for Loan Losses

The Company maintains an Allowance to reflect losses inherent in the loan portfolio. The Allowance is increased by provisions for loan losses and loan recoveries and decreased by loan charge-offs. The size of the Allowance is determined through quarterly assessments of probable estimated losses in the loan portfolio. Our methodology for making such assessments and determining the adequacy of the Allowance includes the following key elements:

§ A specific allocation for impaired loans. Management determined the fair value of the majority of these loans based on the underlying collateral values. This analysis is based upon a specific analysis for each impaired loan, including



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

When the Company determines that a loss has occurred on an impaired loan, a charge-off equal to the difference between carrying value and fair value is recorded. If a specific allowance is deemed necessary for a loan, and then that loan is partially charged off, the loan remains classified as a nonperforming loan after the charge-off is recognized. Loans measured for impairment based on collateral value and all other loans measured for impairment are accounted for in the same way. The total charge-off rate for nonperforming loans as of June 30, 2012 and 2011 was 39% and 19%, respectively.

§ A general allocation. The Company has identified segments and classes of loans not considered impaired for purposes of establishing the general allocation allowance. The Company determined the disaggregation of the loan portfolio into segments and classes based on its assessment of how different pools of loans with like characteristics in the portfolio behave over time. This determination is based on historical experience and management's assessment of how current facts and circumstances are expected to affect the loan portfolio.

The Company first disaggregates the loan portfolio into the following segments: commercial, real estate construction, real estate term, and home equity lines and other consumer loans. Then the Company further disaggregates each of these segments into the following classes, which are also known as risk classifications: excellent, good, satisfactory, watch, special mention, substandard, doubtful, and loss.

After the portfolio has been disaggregated into segments and classes, the Company calculates a general reserve for each segment and class based on the average year loss history for each segment and class. In 2012, the Company increased the look-back period used in the calculation of average historical loss rates from four years to five years. Management made this change because we believe that continuing to include the elevated loss experience from 2007 that occurred as a result of the economic downturn from that time is appropriate.

After the Company calculates a general allocation using its loss history, the general reserve is then adjusted for qualitative factors by segment and class. Qualitative factors are based on management's assessment of current trends that may cause losses inherent in the current loan portfolio to differ significantly from historical losses. Some factors that management considers in determining the qualitative adjustment to the general reserve include national and local economic trends, business conditions, underwriting policies and standards, trends in local real estate markets, effects of various political activities, peer group data, and internal factors such as underwriting policies and expertise of the Company's employees.

§ An unallocated reserve. The unallocated portion of the Allowance provides for other credit losses inherent in the Company's loan portfolio that may not have been contemplated in the specific and general components of the Allowance, and it acknowledges the inherent imprecision of all loss prediction models. The unallocated component is reviewed periodically based on trends in credit losses and overall economic conditions.

At June 30, 2012, the unallocated portion of the Allowance as a percentage of the total Allowance was 11%. The unallocated portion of the Allowance as a percentage of the total Allowance was 14% at December 31, 2011 and 9% at June 30, 2011.

Further discussion of the enhancement to the Company's Allowance methodology can be found in Item 7 in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The following table sets forth information regarding changes in the Allowance for the periods indicated:

|   | Three Months<br>Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---|-----------------------------------|-----------|------------------------------|-----------|
|   | 2012                              | 2011      | 2012                         | 2011      |
|   | (In Thousands)                    |           |                              |           |
| Balance at beginning of period          | \$ 16,288                         | \$ 15,139 | \$ 16,503                    | \$ 14,406 |
| Charge-offs:                            |                                   |           |                              |           |
| Commercial                              | -                                 | 91        | 231                          | 564       |
| Real estate construction                | -                                 | -         | -                            | -         |
| Real estate term                        | 127                               | 90        | 553                          | 90        |
| Home equity lines and<br>other consumer | -                                 | 65        | -                            | 65        |
| Total charge-offs                       | 127                               | 246       | 784                          | 719       |
| Recoveries:                             |                                   |           |                              |           |
| Commercial                              | 223                               | 109       | 572                          | 699       |
| Real estate construction                | 12                                | 12        | 12                           | 13        |
| Real estate term                        | -                                 | -         | -                            | 53        |
| Home equity lines and<br>other consumer | 5                                 | 10        | 9                            | 23        |
| Total recoveries                        | 240                               | 131       | 593                          | 788       |
| Net, (recoveries) charge-offs           | (113)                             | 115       | 191                          | (69)      |
| Provision for loan losses               | 89                                | 550       | 178                          | 1,099     |
| Balance at end of period                | \$ 16,490                         | \$ 15,574 | \$ 16,490                    | \$ 15,574 |

Additional disclosure regarding activity in the Allowance can be found in Note 7 of the Notes to Consolidated Financial Statements in this Form 10-Q.

While management believes that it uses the best information available to determine the Allowance, unforeseen market conditions and other events could result in adjustment to the Allowance, and net income could be significantly affected if circumstances differed substantially from the assumptions used in making the final determination of the Allowance. Moreover, bank regulators frequently monitor banks' loan loss allowances, and if regulators were to determine that the Company's Allowance is inadequate, they may require the Company to increase the Allowance, which may adversely impact the Company's net income and financial condition.

## Deposits

Deposits are the Company's primary source of funds. Total deposits decreased \$16.5 million to \$894.8 million at June 30, 2012, from \$911.2 million at December 31, 2011, and increased \$10.6 million from \$844.2 million at June 30, 2011. The Company's deposits generally are expected to fluctuate according to the level of the Company's market share, economic conditions, and normal seasonal trends. Total average deposits increased \$19.8 million to \$897.7 million for the second quarter of 2012 from the second quarter of 2011 and increased \$7.9 million for the six-month period ending June 30, 2012 as compared to the same period in 2011. In April 2012 Northrim launched a new marketing campaign titled "100% 907" (based on the Alaska area code 907) to broaden and deepen the Company's relationship with our local communities and expects that this campaign will increase total deposits. There were no depositors with deposits representing 10% or more of total deposits at June 30, 2012, December 31, 2011, or June 30, 2011.

## Borrowings

At June 30, 2012, the Company's maximum borrowing line from the FHLB was \$130.3 million, approximately 12% of the Company's assets. FHLB advances are dependent on the availability of acceptable collateral such as marketable securities or real estate loans, although all FHLB advances are secured by a blanket pledge of the Company's assets. At June 30, 2012, December 31, 2011, and June 30, 2011, the Company had no outstanding balances on the borrowing line.

The Company purchased its main office facility for \$12.9 million on July 1, 2008. In this transaction, the Company, through Northrim Building LLC, assumed an existing loan secured by the building in an amount of \$5.1 million. At June 30, 2012, December 31, 2011, and June 30, 2011, the outstanding balance on this loan was \$4.6 million, \$4.6 million, and \$4.7 million, respectively. This loan has a maturity date of April 1, 2014 and a fixed interest rate of 5.95%.

At June 30, 2012, December 31, 2011, and June 30, 2011, the Company had no short-term (original maturity of one year or less) borrowings that exceeded 30% of shareholders' equity.

Liquidity and Capital Resources

33

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The Company manages its liquidity through its Asset and Liability Committee. In addition to the \$110.7 million of cash and due from banks and interest bearing deposits in other banks and \$156.0 million in unpledged available for sale securities held at June 30, 2012, the Company had additional funding sources which include fed fund borrowing lines and advances available at the FHLB of Seattle and the Federal Reserve Bank of approximately \$134.2 million as of June 30, 2012.

At June 30, 2012, \$33.2 million in securities, or 17%, of the investment portfolio was pledged, as compared to \$32.1 million, or 14%, at December 31, 2011, and \$24.2 million, or 13%, at June 30, 2011. As shown in the Consolidated Statements of Cash Flows, net cash provided by operating activities was \$11.3 million for the first six months of 2012. Net cash provided by investing activities was \$25.8 million for the same period, mostly due to proceeds from the sale and maturity of available-for-sale securities, net of securities purchases and loan paydowns in excess of fundings. The \$19.5 million of cash used by financing activities for the period primarily consisted of a \$16.5 million decrease in deposits.

The Company issued 1,828 shares of its common stock through the exercise of stock options in the second quarter of 2012 and did not repurchase any shares of its common stock under the Company's publicly announced repurchase program. At June 30, 2012, the Company had 6,470,518 million shares of its common stock outstanding.

#### Capital Requirements and Ratios

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

The requirements address both risk-based capital and leverage capital. At June 30, 2012, all capital ratios of the Company and the Bank exceeded the ratios required for a "well-capitalized" institution.

The following table illustrates the actual capital ratios for the Company and the Bank as calculated under regulatory guidelines, compared to the regulatory minimum capital ratios and the regulatory minimum capital ratios needed to be eligible to qualify as a "well-capitalized" institution as of June 30, 2012.

|                           | Adequately-<br>Capitalized | Well-<br>Capitalized | Actual Ratio<br>BHC | Actual Ratio<br>Bank |   |
|---------------------------|----------------------------|----------------------|---------------------|----------------------|---|
| Tier 1 risk-based capital | 4.00                       | % 6.00               | % 15.44             | % 14.04              | % |
| Total risk-based capital  | 8.00                       | % 10.00              | % 16.70             | % 15.30              | % |
| Leverage ratio            | 4.00                       | % 5.00               | % 13.33             | % 12.12              | % |

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

#### Off-Balance Sheet Items

The Company is a party to financial instruments with off-balance sheet risk. Among the off-balance sheet items entered into in the ordinary course of business are commitments to extend credit and the issuance of letters of credit. These instruments

involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized on the balance sheet. Certain commitments are collateralized. As of June 30, 2012, December 31, 2011 and June 30, 2011, the Company's commitments to extend credit and to provide letters of credit which are not reflected on its balance sheet amounted to \$245.3 million, \$190 million, and \$223 million, respectively. Since many of the commitments are expected to expire without being drawn upon, these total commitment amounts do not necessarily represent future cash requirements.

#### Capital Expenditures and Commitments

The company has no capital commitments as of June 30, 2012. June 30, 2012

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

Our assessment of market risk as of June 30, 2012 indicates that there are no material changes in the quantitative and qualitative disclosures from those in our Annual Report on Form 10-K for the year ended December 31, 2011.

### ITEM 4. CONTROLS AND PROCEDURES

#### Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, we evaluated the effectiveness (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934) of our disclosure controls and procedures. Our principal executive and financial officers supervised and participated in this evaluation. Based on this evaluation, our principal executive and financial officers each concluded that as of June 30, 2012, the disclosure controls and procedures are effective in timely alerting them to material information required to be included in the periodic reports to the Securities and Exchange Commission. The design of any system of controls is based in part upon various assumptions about the likelihood of future events, and there can be no assurance that any of our plans, products, services or procedures will succeed in achieving their intended goals under future conditions.

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

There was no change in our internal control over financial reporting that occurred during the quarterly period ended June 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

During the normal course of its business, the Company is a party to various debtor-creditor legal actions, disputes, claims, and litigation related to the conduct of its banking business. These include cases filed as a plaintiff in collection and foreclosure cases, and the enforcement of creditors' rights in bankruptcy proceedings. Management does not expect that the resolution of these matters will have a material effect on the Company's business, financial position, results of operations, or cash flows.

ITEM 1A. RISK FACTORS

For information regarding risk factors, please refer to Item 1A in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. These risk factors have not materially changed as of June 30, 2012.

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

(a)-(b) Not applicable

(c) There were no stock repurchases by the Company during the three months ending June 30, 2012.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

ITEM 5. OTHER INFORMATION

(a) Not applicable.

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

ITEM 6. EXHIBITS

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

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

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

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

101.INSXBRL Instance Document

101.SCHXBRL Schema Document

101.CALXBRL Calculation Linkbase Document

101.LABXBRL Labels Linkbase Document

101.PREXBRL Presentation Linkbase Document

101.DEF XBRL Definition Linkbase Document

Notes to Exhibits List:

Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheet at June 30, 2012, December 31, 2011 and June 30, 2011, (ii) Consolidated Statements of Income for the three and six months ended June 30, 2012 and 2011, (iii) Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income for the three and six months ended June 30, 2012 and 2011, (iv) Consolidated Statements of Cash Flows for the six months ended June 30, 2012 and 2011, and (v) Notes to the Consolidated Financial Statements. In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

SIGNATURES

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

NORTHRIM BANCORP, INC.

August 6, 2012

By /s/ R. Marc Langland

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

August 6, 2012

By /s/ Joseph M. Schierhorn

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

37

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