

SIERRA BANCORP  
Form 10-Q  
November 06, 2015

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES

EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2015

Commission file number: 000-33063

**Sierra Bancorp**

(Exact name of Registrant as specified in its charter)

California 33-0937517  
(State of Incorporation) (IRS Employer Identification No)

86 North Main Street, Porterville, California 93257

(Address of principal executive offices) (Zip Code)

(559) 782-4900

(Registrant's telephone number, including area code)

Not Applicable

Edgar Filing: SIERRA BANCORP - Form 10-Q

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

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  R                      No  £

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

Yes  R                      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.

Large accelerated filer  £    Accelerated filer  R  
Non-accelerated filer  £ (Do not check if a smaller reporting company)      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  R

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

Common stock, no par value, 13,248,048 shares outstanding as of October 30, 2015

**FORM 10-Q****Table of Contents**

|  | Page      |
|--|-----------|
| <b><u>Part I - Financial Information</u></b>   | <b>1</b>  |
| <u>Item 1. Financial Statements (Unaudited)</u>  | 1         |
| <u>Consolidated Balance Sheets</u>   | 1         |
| <u>Consolidated Statements of Income</u>   | 2         |
| <u>Consolidated Statements of Comprehensive Income</u>   | 3         |
| <u>Consolidated Statements of Cash Flows</u>   | 4         |
| <u>Notes to Unaudited Consolidated Financial Statements</u>  | 5         |
| <br>   |           |
| <u>Item 2. Management's Discussion &amp; Analysis of Financial Condition &amp; Results of Operations</u> | 34        |
| <u>Forward-Looking Statements</u>  | 34        |
| <u>Critical Accounting Policies</u>  | 34        |
| <u>Overview of the Results of Operations and Financial Condition</u>                                     | 35        |
| <u>Earnings Performance</u>  | 36        |
| <u>Net Interest Income and Net Interest Margin</u>   | 36        |
| <u>Provision for Loan and Lease Losses</u>   | 40        |
| <u>Non-interest Income and Non-Interest Expense</u>  | 41        |
| <u>Provision for Income Taxes</u>  | 44        |
| <u>Balance Sheet Analysis</u>  | 44        |
| <u>Earning Assets</u>  | 44        |
| <u>Investments</u>   | 44        |
| <u>Loan and Lease Portfolio</u>  | 45        |
| <u>Nonperforming Assets</u>  | 47        |
| <u>Allowance for Loan and Lease Losses</u>   | 48        |
| <u>Off-Balance Sheet Arrangements</u>  | 50        |
| <u>Other Assets</u>  | 50        |
| <u>Deposits and Interest-Bearing Liabilities</u>   | 51        |
| <u>Deposits</u>  | 51        |
| <u>Other Interest-Bearing Liabilities</u>  | 52        |
| <u>Non-Interest Bearing Liabilities</u>  | 52        |
| <u>Liquidity and Market Risk Management</u>  | 52        |
| <u>Capital Resources</u>   | 55        |
| <br>   |           |
| <u>Item 3. Qualitative &amp; Quantitative Disclosures about Market Risk</u>                              | 56        |
| <br>   |           |
| <u>Item 4. Controls and Procedures</u>   | 56        |
| <br>   |           |
| <b><u>Part II - Other Information</u></b>  | <b>57</b> |
| <u>Item 1. - Legal Proceedings</u>   | 57        |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|  |           |
|--|-----------|
| <u>Item 1A. - Risk Factors</u>   | 57        |
| <u>Item 2. - Unregistered Sales of Equity Securities and Use of Proceeds</u> | 57        |
| <u>Item 3. - Defaults upon Senior Securities</u>                             | 57        |
| <u>Item 4. - (Removed and Reserved)</u>                                      | 57        |
| <u>Item 5. - Other Information</u>   | 57        |
| <u>Item 6. - Exhibits</u>  | 58        |
| <b><u>Signatures</u></b>   | <b>59</b> |

**PART I - FINANCIAL INFORMATION****Item 1 – Financial Statements****SIERRA BANCORP****CONSOLIDATED BALANCE SHEETS**

(dollars in thousands)

|   | September 30,<br>2015<br>(unaudited) | December 31,<br>2014<br>(audited) |
|---|--------------------------------------|-----------------------------------|
| <b>ASSETS</b>                                     |                                      |                                   |
| Cash and due from banks                           | \$ 45,658                            | \$ 48,405                         |
| Interest-bearing deposits in banks                | 3,330                                | 1,690                             |
| Total cash & cash equivalents                     | 48,988                               | 50,095                            |
| Securities available for sale                     | 509,600                              | 511,883                           |
| Loans and leases:                                 |                                      |                                   |
| Gross loans and leases                            | 1,054,136                            | 970,653                           |
| Allowance for loan and lease losses               | (10,412                              | ) (11,248                         |
| Deferred loan and lease fees, net                 | 1,950                                | 1,651                             |
| Net loans and leases                              | 1,045,674                            | 961,056                           |
| Premises and equipment, net                       | 22,177                               | 21,853                            |
| Foreclosed assets                                 | 3,003                                | 3,991                             |
| Company owned life insurance                      | 43,675                               | 42,989                            |
| Goodwill  | 6,908                                | 6,908                             |
| Other intangible assets, net                      | 963                                  | 1,064                             |
| Other assets                                      | 36,146                               | 37,481                            |
|   | \$ 1,717,134                         | \$ 1,637,320                      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>       |                                      |                                   |
| Deposits:   |                                      |                                   |
| Non-interest bearing                              | \$ 423,449                           | \$ 390,897                        |
| Interest bearing                                  | 1,005,665                            | 975,798                           |
| Total deposits                                    | 1,429,114                            | 1,366,695                         |
| Federal funds purchased and repurchase agreements | 10,115                               | 7,251                             |
| Short-term borrowings                             | 41,500                               | 18,200                            |
| Long-term borrowings                              | 2,000                                | 6,000                             |
| Junior subordinated debentures                    | 30,928                               | 30,928                            |
| Other liabilities                                 | 16,425                               | 21,155                            |
| Total Liabilities                                 | 1,530,082                            | 1,450,229                         |

Commitments and contingent liabilities (Note 8)

Shareholders' equity

|   |              |              |
|---|--------------|--------------|
| Common stock, no par value; 24,000,000 shares authorized; 13,248,048 and 13,689,181 shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively | 62,324       | 64,153       |
| Additional paid in capital  | 2,650        | 2,605        |
| Retained earnings   | 118,795      | 116,026      |
| Accumulated other comprehensive income  | 3,283        | 4,307        |
| Total shareholders' equity  | 187,052      | 187,091      |
|   | \$ 1,717,134 | \$ 1,637,320 |

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

**SIERRA BANCORP****CONSOLIDATED STATEMENTS OF INCOME**

(dollars in thousands, except per share data, unaudited)

|   | Three months ended September |           | Nine months ended September |           |
|---|------------------------------|-----------|-----------------------------|-----------|
|   | 30,                          | 2014      | 30,                         | 2014      |
|   | 2015                         |           | 2015                        | 2014      |
| Interest and dividend income                        |                              |           |                             |           |
| Loans and leases, including fees                    | \$ 12,924                    | \$ 11,237 | \$ 38,124                   | \$ 32,644 |
| Taxable securities                                  | 1,847                        | 2,008     | 6,191                       | 5,709     |
| Tax-exempt securities                               | 746                          | 729       | 2,202                       | 2,203     |
| Federal funds sold and other                        | 7                            | 4         | 26                          | 55        |
| Total interest income                               | 15,524                       | 13,978    | 46,543                      | 40,611    |
| Interest expense                                    |                              |           |                             |           |
| Deposits  | 452                          | 503       | 1,345                       | 1,614     |
| Short-term borrowings                               | 12                           | 6         | 43                          | 16        |
| Long-term borrowings                                | 2                            | -         | 9                           | -         |
| Subordinated debentures                             | 181                          | 177       | 533                         | 526       |
| Total interest expense                              | 647                          | 686       | 1,930                       | 2,156     |
| Net Interest Income                                 | 14,877                       | 13,292    | 44,613                      | 38,455    |
| Provision for loan losses                           | -                            | -         | -                           | 350       |
| Net interest income after provision for loan losses | 14,877                       | 13,292    | 44,613                      | 38,105    |
| Non-interest income                                 |                              |           |                             |           |
| Service charges on deposits                         | 2,611                        | 2,214     | 6,880                       | 6,139     |
| Net gains on sale of securities available-for-sale  | 108                          | -         | 431                         | 287       |
| Other income  | 1,542                        | 1,571     | 5,611                       | 5,084     |
| Total non-interest income                           | 4,261                        | 3,785     | 12,922                      | 11,510    |
| Other operating expense                             |                              |           |                             |           |
| Salaries and employee benefits                      | 5,904                        | 5,459     | 18,924                      | 16,772    |
| Occupancy and equipment                             | 1,834                        | 1,662     | 5,160                       | 4,700     |
| Other   | 4,547                        | 4,629     | 14,412                      | 12,014    |
| Total other operating expense                       | 12,285                       | 11,750    | 38,496                      | 33,486    |
| Income before taxes                                 | 6,853                        | 5,327     | 19,039                      | 16,129    |
| Provision for income taxes                          | 2,443                        | 1,776     | 6,335                       | 4,543     |
| Net income  | \$ 4,410                     | \$ 3,551  | \$ 12,704                   | \$ 11,586 |
| <b>PER SHARE DATA</b>                               |                              |           |                             |           |
| Book value  | \$ 14.12                     | \$ 13.46  | \$ 14.12                    | \$ 13.46  |
| Cash dividends                                      | \$ 0.11                      | \$ 0.09   | \$ 0.31                     | \$ 0.25   |
| Earnings per share basic                            | \$ 0.33                      | \$ 0.25   | \$ 0.94                     | \$ 0.82   |
| Earnings per share diluted                          | \$ 0.33                      | \$ 0.25   | \$ 0.93                     | \$ 0.81   |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|   |              |              |              |              |
|---|--------------|--------------|--------------|--------------|
| Average shares outstanding, basic       | 13,358,895   | 13,939,152   | 13,531,370   | 14,083,649   |
| Average shares outstanding, diluted     | 13,482,364   | 14,072,783   | 13,656,747   | 14,218,194   |
| Total shareholder equity (in thousands) | \$ 187,052   | \$ 186,240   | \$ 187,052   | \$ 186,240   |
| Shares outstanding                      | 13,248,048   | 13,841,342   | 13,248,048   | 13,841,342   |
| Dividends Paid                          | \$ 1,474,639 | \$ 1,260,823 | \$ 4,205,218 | \$ 3,528,478 |

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



**SIERRA BANCORP****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(dollars in thousands, unaudited)

|   | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |           |
|---|-------------------------------------|----------|------------------------------------|-----------|
|   | 2015                                | 2014     | 2015                               | 2014      |
| Net Income  | \$ 4,410                            | \$ 3,551 | \$ 12,704                          | \$ 11,586 |
| Other comprehensive income, before tax:   |                                     |          |                                    |           |
| Unrealized gains on securities:   |                                     |          |                                    |           |
| Unrealized holding (losses) gains arising during period   | 1,284                               | (237 )   | (1,225 )                           | 5,256     |
| Less: reclassification adjustment for gains <sup>(1)</sup>  | (108 )                              | -        | (431 )                             | (287 )    |
| Other comprehensive (loss) income, before tax   | 1,176                               | (237 )   | (1,656 )                           | 4,969     |
| Income tax expense (benefit) related to items of other<br>comprehensive income (loss), net of tax | (494 )                              | 97       | 632                                | (2,045 )  |
| Other comprehensive income (loss) gain  | 682                                 | (140 )   | (1,024 )                           | 2,924     |
| Comprehensive Income  | \$ 5,092                            | \$ 3,411 | \$ 11,680                          | \$ 14,510 |

<sup>(1)</sup> Amounts are included in net gains on investment securities available-for-sale on the Consolidated Statements of Income in non-interest revenue. Income tax expense associated with the reclassification adjustment for the three months ended September 30, 2015 and 2014 was \$45 thousand and zero respectively. Income tax expense associated with the reclassification adjustment for the nine months ended September 30, 2015 and 2014 was \$181 thousand and \$118 thousand respectively.

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

**SIERRA BANCORP****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in thousands, unaudited)

|   | Nine months ended September 30,<br>2015 | 2014      |
|---|---|-----------|
| Cash flows from operating activities:   |   |           |
| Net income  | \$ 12,704                               | \$ 11,586 |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |           |
| Gain on sales of securities   | (431 )                                  | (287 )    |
| Gain on sales of loans  | (6 )                                    | (3 )      |
| Loss on disposal of fixed assets  | 62                                      | 1         |
| Gain on sale on foreclosed assets   | (166 )                                  | (531 )    |
| Writedowns on foreclosed assets   | 193                                     | 286       |
| Share-based compensation expense  | 33                                      | 57        |
| Provision for loan losses   | -                                       | 350       |
| Depreciation  | 1,694                                   | 1,569     |
| Net accretion on purchased loans  | (634 )                                  | -         |
| Net amortization on securities premiums and discounts                             | 5,217                                   | 4,925     |
| Decrease (increase) in unearned net loan fees                                     | 299                                     | (16 )     |
| Increase in cash surrender value of life insurance policies                       | (686 )                                  | (1,001 )  |
|   | 323                                     | 108       |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|  |         |   |          |
|--|---------|---|----------|
| Proceeds from sale of loans                                |         |   |          |
| Increase in loans held-for-sale                            | (317    | ) | -        |
| Decrease in interest receivable and other assets           | 3,845   |   | 1,923    |
| (Decrease) increase in other liabilities                   | (4,730  | ) | 1,756    |
| Deferred Income Tax (Benefit) provision                    | (1,182  | ) | 864      |
| Excess tax benefit from equity based compensation          | 92      |   | -        |
| Net cash provided by operating activities                  | 16,310  |   | 21,587   |
| Cash flows from investing activities:                      |         |   |          |
| Maturities of securities available for sale                | 580     |   | 995      |
| Proceeds from sales/calls of securities available for sale | 24,408  |   | 11,055   |
| Purchases of securities available for sale                 | (97,899 | ) | (111,425 |
| Principal pay downs on securities available for sale       | 68,753  |   | 57,062   |
| Purchases of FHLB stock                                    | (504    | ) | (190     |
| Net increase in loans receivable, net                      | (84,776 | ) | (82,126  |
| Purchases of premises and equipment, net                   | (2,136  | ) | (2,159   |
| Proceeds from sale premises and equipment                  | 56      |   | -        |
| Proceeds from sales of foreclosed assets                   | 1,454   |   | 4,421    |
| Net cash used in investing activities                      | (90,064 | ) | (122,367 |
| Cash flows from financing activities:                      |         |   |          |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|   |           |   |           |   |
|---|-----------|---|-----------|---|
| Increase in deposits                              | 62,419    |   | 48,867    |   |
| Increase in borrowed funds                        | 19,300    |   | 22,390    |   |
| Increase in repurchase agreements                 | 2,864     |   | 1,196     |   |
| Cash dividends paid                               | (4,205    | ) | (3,528    | ) |
| Repurchases of common stock                       | (7,956    | ) | (7,284    | ) |
| Stock options exercised                           | 317       |   | 811       |   |
| Excess tax benefit from equity based compensation | (92       | ) | -         |   |
| Net cash provided by financing activities         | 72,647    |   | 62,452    |   |
| Decrease in cash and due from banks               | (1,107    | ) | (38,328   | ) |
| Cash and cash equivalents                         |           |   |           |   |
| Beginning of period                               | 50,095    |   | 78,006    |   |
| End of period                                     | \$ 48,988 |   | \$ 39,678 |   |

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

Sierra Bancorp

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

September 30, 2015

**Note 1 – The Business of Sierra Bancorp**

Sierra Bancorp (the “Company”) is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the “Bank”), and has been the Bank’s sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company’s only other subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities (“TRUPS”). Pursuant to the Financial Accounting Standards Board (“FASB”) standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the Company’s financial statements. References herein to the “Company” include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California. We offer a full range of retail and commercial banking services primarily in Tulare, Kern, Fresno, and Kings Counties in Central California, and in select markets in Southern California including Ventura County, the Santa Clarita Valley, and the San Fernando Valley. Bank of the Sierra was incorporated in September 1977, and opened for business in January 1978 as a one-branch bank with \$1.5 million in capital and eleven employees. Our growth in the ensuing years has primarily been organic, but includes two acquisitions: Sierra National Bank in the year 2000, and Santa Clara Valley Bank (“SCVB”) in 2014 (see Note 13 to the financial statements, Recent Developments, for details on the SCVB acquisition). We are now the largest bank headquartered in the South San Joaquin Valley with more than 400 employees, 28 full-service branches, a loan production office and \$1.7 billion in assets at September 30, 2015. We have received regulatory approval for another branch in Bakersfield, California which is expected to commence operations in mid-2016, and more recently obtained consent for a branch in Sanger, California which could open in the first quarter of 2016 if approved. In addition to our stand-alone offices the Bank has specialized lending units which include a real estate industries center, an agricultural credit center, and an SBA lending unit. We also operate offsite ATMs at six different non-branch locations. The Bank’s deposit accounts are insured by the Federal Deposit Insurance Corporation (“FDIC”) up to maximum insurable amounts.

**Note 2 – Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by U.S. generally accepted accounting principles (“GAAP”) for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of Management, necessary for a fair statement of the results for such period. Such adjustments can generally be considered as normal and recurring unless otherwise disclosed in this Form 10-Q. In preparing the accompanying financial statements, Management has taken subsequent events into consideration and recognized them where appropriate. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2014 have been reclassified to be consistent with the reporting for 2015. The interim financial information should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2014, as filed with the Securities and Exchange Commission.

### **Note 3 – Current Accounting Developments**

In January 2014, the FASB issued Accounting Standards Update (“ASU”) 2014-01, *Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*, to provide additional flexibility with regard to accounting for investments in qualified affordable housing projects. ASU 2014-01 modifies the conditions that must be met to present the pretax impact and related tax benefits of such investments as a component of income taxes (“net” within income tax expense), to enable more investors to elect to use a net presentation for those investments. Investors that do not qualify for net presentation under the new guidance will continue to account for such investments under the equity method or cost method, which results in losses recognized in pretax income and tax benefits recognized in income taxes (“gross” presentation of investment results). For investments that qualify for the net presentation of investment performance, ASU 2014-01 introduces a “proportional amortization method” that can be elected to amortize the investment basis. If elected, the method is required for all eligible investments in qualified affordable housing projects. ASU 2014-01 also requires enhanced recurring disclosures for all investments in qualified affordable housing projects, regardless of the accounting method used for those investments. It is effective for interim and annual periods beginning after December 15, 2014. The Company adopted the enhanced disclosure requirements of ASU 2014-01 as of the first quarter of 2015, as reflected in Note 10 to the consolidated financial statements, but we continue to account for our low-income housing tax credit investments using the equity method so there has been no impact on our income statement or balance sheet.

In January 2014, the FASB issued ASU 2014-04, *Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*, to resolve diversity in practice with respect to a creditor's reclassification of a collateralized consumer mortgage loan to other real estate owned (OREO). Current US GAAP requires a loan to be reclassified to OREO upon a troubled debt restructuring that is "in substance a repossession or foreclosure", where the creditor receives "physical possession" of the debtor's assets regardless of whether formal foreclosure proceedings take place. The terms "in substance a repossession or foreclosure" and "physical possession" are not defined in US GAAP; therefore, questions have arisen about when a creditor should reclassify a collateralized mortgage loan to OREO. ASU 2014-04 requires a creditor to reclassify a collateralized consumer mortgage loan to real estate property upon obtaining legal title to the real estate collateral, or when the borrower voluntarily conveys all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. ASU 2014-04 is effective for public business entities for interim and annual periods beginning after December 15, 2014. It was adopted by the Company for the first quarter of 2015, without any impact on our financial statements or operations.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU is the result of a joint project initiated by the FASB and the International Accounting Standards Board (IASB) to clarify the principles for recognizing revenue, and to develop a common revenue standard and disclosures for U.S. and international accounting standards that would: (1) remove inconsistencies and weaknesses in revenue requirements; (2) provide a more robust framework for addressing revenue issues; (3) improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; (4) provide more useful information to users of financial statements through improved disclosure requirements; and (5) simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. The guidance affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets. The core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required with regard to contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. This ASU was originally scheduled to become effective for reporting periods beginning after December 15, 2016. However, subsequent guidance from the FASB issued in August 2015 delayed the effective date by a year, to annual reporting periods beginning after December 15, 2017, including interim periods therein, with early adoption permitted for reporting periods beginning after December 15, 2016. The Company does not expect to adopt this guidance early and is currently evaluating the potential effects of the guidance on its financial statements and disclosures.

In June 2014, the FASB issued ASU 2014-11, *Transfers and Servicing (Topic 860), Repurchase-to-Maturity Transactions,*

*Repurchase Financings, and Disclosures*. This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as repurchase financings with the accounting for other more typical repurchase agreements, by requiring that all of these transactions be accounted for as secured borrowings. The guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer

of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement, which has resulted in off-balance-sheet accounting. ASU 2014-11 requires a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. It also requires expanded disclosures about the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. ASU 2014-11 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company has not entered into any repurchase transactions in recent periods, and any such transactions executed by the Company in the future will likely be typical in nature (i.e., not repurchase-to-maturity transactions or repurchase agreements executed as a repurchase financing) and will thus be accounted for as secured borrowings. As such, ASU 2014-11 did not have an impact on the Company's consolidated financial statements upon adoption, and is not expected to have any impact in future periods.



In June 2014 the FASB issued ASU 2014-12, *Compensation—Stock Compensation (Topic 718)*, which amended existing guidance related to the accounting for share-based payments when the terms of an award provide that a performance target can be achieved after the requisite service period. These amendments require that a performance target be treated as a “performance condition” if it affects vesting and can be achieved after the requisite service period. To account for such awards, a reporting entity should apply existing guidance in Topic 718 as it relates to awards with performance conditions that affect vesting. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest, and should be adjusted to reflect those awards that ultimately vest. The requisite period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. It will be adopted by the Company for the first quarter of 2016, and we do not expect any impact upon our financial statements or operations upon adoption.

In August 2014 the FASB issued ASU 2014-14, *Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40), Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*, which amended existing guidance related to the classification of certain government-guaranteed mortgage loans, including those guaranteed by the FHA and the VA, upon foreclosure. It requires that a mortgage loan be derecognized and a separate “other receivable” be recognized upon foreclosure if the following conditions are met: 1) the loan has a government guarantee that is not separable from the loan before foreclosure; 2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and 3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. ASU 2014-14 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. It was adopted by the Company for the first quarter of 2015 with no impact on our financial statements or operations.

In April 2015 the FASB issued ASU 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*, to simplify the presentation of debt issuance costs related to a recognized debt liability by reflecting those costs as a direct deduction from the carrying amount of debt liability, consistent with debt discounts. ASU 2015-15 was subsequently issued in August 2015 to clarify the SEC staff’s position on presenting and measuring debt issuance costs incurred in connection with line-of-credit arrangements. ASU 2015-03, as modified by ASU 2015-15, is effective for interim and annual periods beginning after December 15, 2015. Early adoption is permitted if the guidance is applied as of the beginning of the annual period of adoption. We do not expect the adoption of this guidance to have a material effect on our consolidated financial statements.

**Note 4 – Supplemental Disclosure of Cash Flow Information**

During the nine months ended September 30, 2015 and 2014, cash paid for interest due on interest-bearing liabilities was \$1.957 million and \$2.219 million, respectively. There was \$6.390 million in cash paid for income taxes during the nine months ended September 30, 2015, and \$160,000 in cash paid for income taxes for the nine months ended September 30, 2014. Assets totaling \$1.004 million and \$184,000 were acquired in settlement of loans for the nine months ended September 30, 2015 and September 30, 2014, respectively. We received \$1.454 million in cash from the sale of foreclosed assets during the first nine months of 2015 relative to \$4.421 million during the first nine months of 2014, which represents sales proceeds less loans (if any) extended to finance such sales.

**Note 5 – Share Based Compensation**

The 2007 Stock Incentive Plan (the “2007 Plan”) was adopted by the Company in 2007. Our 1998 Stock Option Plan (the “1998 Plan”) was concurrently terminated, although options to purchase 50,200 shares that were granted under the 1998 Plan were still outstanding as of September 30, 2015 and remain unaffected by that plan’s termination. The 2007 Plan provides for the issuance of both “incentive” and “nonqualified” stock options to officers and employees, and of “nonqualified” stock options to non-employee directors of the Company. The 2007 Plan also provides for the potential issuance of restricted stock awards to these same classes of eligible participants, on such terms and conditions as are established at the discretion of the Board of Directors or the Compensation Committee. The total number of shares of the Company’s authorized but unissued stock reserved for issuance pursuant to awards under the 2007 Plan was initially 1,500,000 shares, although the number remaining available for grant had declined to 785,300 at September 30, 2015. The dilutive impact of stock options outstanding is discussed below in Note 6, Earnings per Share. No restricted stock awards have been issued by the Company.

Pursuant to FASB's standards on stock compensation, the value of each option granted is reflected in our income statement as employee compensation or directors' expense by amortizing the value over the vesting period of such option or by expensing it as of the grant date for immediately vested options. The Company is utilizing the Black-Scholes model to value stock options, and the "multiple option" approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach an employee's options for each vesting period are separately valued and amortized, which appears to be the preferred method for option grants with graded vesting. A pre-tax charge of \$14,000 was reflected in the Company's income statement during the third quarter of 2015 and \$24,000 was charged during the third quarter of 2014, as expense related to stock options. For the first nine months, the charges totaled \$33,000 in 2015 and \$57,000 in 2014.

**Note 6 – Earnings per Share**

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 13,358,895 weighted average shares outstanding during the third quarter of 2015, and 13,939,152 during the third quarter of 2014. There were 13,531,370 weighted average shares outstanding during the first nine months of 2015, and 14,083,649 during the first nine months of 2014.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of "in-the-money" stock options. The dilutive effect of options outstanding was calculated using the treasury stock method, excluding anti-dilutive shares and adjusting for unamortized expense and windfall tax benefits. For the third quarter and first nine months of 2015 the dilutive effect of options outstanding calculated under the treasury stock method totaled 123,469 and 125,377, respectively, which were added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the third quarter and first nine months of 2014 shares totaling 133,631 and 134,545, respectively, were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

**Note 7 – Comprehensive Income**

As presented in the Consolidated Statements of Comprehensive Income, comprehensive income includes net income and other comprehensive income. The Company's only source of other comprehensive income is unrealized gains and losses on available-for-sale investment securities. Gains or losses on investment securities that were realized and reflected in net income of the current period, which had previously been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are considered to be reclassification adjustments that are excluded from other comprehensive income in the current period.

Note 8 – Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business. Those financial instruments currently consist of unused commitments to extend credit and standby letters of credit. They involve, to varying degrees, elements of risk in excess of the amount recognized in the balance sheet. The Company's exposure to credit loss in the event of nonperformance by counterparties for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and issuing letters of credit as it does for originating loans included on the balance sheet. The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

|                              | September 30, 2015 | December 31, 2014 |
|------------------------------|--------------------|-------------------|
| Commitments to extend credit | \$ 370,787         | \$ 366,909        |
| Standby letters of credit    | \$ 16,881          | \$ 14,389         |

Commitments to extend credit consist primarily of the unused or unfunded portions of the following: home equity lines of credit; commercial real estate construction loans, where disbursements are made over the course of construction; commercial revolving lines of credit; mortgage warehouse lines of credit; unsecured personal lines of credit; and formalized (disclosed) deposit account overdraft lines. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many commitments are expected to expire without being drawn upon, the unused portions of committed amounts do not necessarily represent future cash requirements. Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party, and the credit risk involved in issuing letters of credit is essentially the same as the risk involved in extending loans to customers.

The Company is also utilizing a letter of credit in the amount of \$107 million issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits. That letter of credit is backed by loans which are pledged to the FHLB by the Company.

Note 9 – Fair Value Disclosures and Reporting, the Fair Value Option and Fair Value Measurements

FASB's standards on financial instruments, and on fair value measurements and disclosures, require all entities to disclose in their financial statement footnotes the estimated fair values of financial instruments for which it is practicable to estimate fair values. In addition to disclosure requirements, FASB's standard on investments requires that our debt securities which are classified as available for sale and our equity securities that have readily determinable fair values be measured and reported at fair value in our statement of financial position. Certain impaired loans are also reported at fair value, as explained in greater detail below, and foreclosed assets are carried at the lower of cost or fair value. FASB's standard on financial instruments permits companies to report certain other financial assets and liabilities at fair value, but we have not elected the fair value option for any of those financial instruments.

Fair value measurement and disclosure standards also establish a framework for measuring fair values. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability, in an orderly transaction between market participants on the measurement date. Further, the standards establish a fair value hierarchy that encourages an entity to maximize the use of observable inputs and limit the use of unobservable inputs when measuring fair values. The standards describe three levels of inputs that may be used to measure fair values:

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

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

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the factors that market participants would likely consider in pricing an asset or liability.

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. The estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to realized

gains and losses could have a significant effect on fair value estimates but have not been considered in any estimates. Because no active market exists for a significant portion of our financial instruments, fair value disclosures are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. The estimates are subjective and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly alter the fair values presented. The following methods and assumptions were used by the Company to estimate the fair value of its financial instruments disclosed at September 30, 2015 and December 31, 2014:

· Cash and cash equivalents and fed funds sold: The carrying amount is estimated to be fair value.

Investment securities: Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities when quoted prices for specific securities are not readily available.

Loans and leases: For variable-rate loans and leases that re-price frequently with no significant change in credit risk or interest rate spread, fair values are based on carrying values. Fair values for other loans and leases are estimated by discounting projected cash flows at interest rates being offered at each reporting date for loans and leases with similar terms, to borrowers of comparable creditworthiness. The carrying amount of accrued interest receivable approximates its fair value.

Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are not relevant for reporting purposes. If available-for-sale loans are on our books for an extended period of time, the fair value of those loans is determined using quoted secondary-market prices.

Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.

Cash surrender value of life insurance policies: Fair values are based on net cash surrender values at each reporting date.

Investments in, and capital commitments to, limited partnerships: The fair values of our limited partner investments in low-income housing tax credit funds and other limited partnership investments are estimated using quarterly indications of value provided by the general partners. The fair values of undisbursed capital commitments are assumed to be the same as their book values.

Other investments: Certain investments for which no secondary market exists are carried at cost and the carrying amount for those investments typically approximates their estimated fair value, unless an impairment analysis indicates the need for adjustments.

Deposits: Fair values for non-maturity deposits are equal to the amount payable on demand at the reporting date, which is the carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a cash flow analysis, discounted at interest rates being offered at each reporting date by the Bank for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

Short-term borrowings: Current carrying amounts are used as an approximation of fair values for federal funds purchased, overnight advances from the Federal Home Loan Bank (“FHLB”), borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days of the reporting dates. Fair values of other short-term borrowings are estimated by discounting projected cash flows at the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

Long-term borrowings: Fair values are estimated using projected cash flows discounted at the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

Subordinated debentures: Fair values are determined based on the current market value for like instruments of a similar maturity and structure.

Commitments to extend credit and letters of credit: If funded, the carrying amounts for currently unused commitments would provide an equivalent measure of fair values for the newly created financial assets at the funding date. However, because of the high degree of uncertainty with regard to whether or not those commitments will ultimately be funded, fair values for loan commitments and letters of credit in their current undisbursed state cannot reasonably be estimated, and only notional values are disclosed in the table below.



Estimated fair values for the Company's financial instruments are as follows, as of the dates noted:

**Fair Value of Financial Instruments**

(dollars in thousands, unaudited)

|   | September 30, 2015   |           |             |              |           |
|---|----------------------|-----------|-------------|--------------|-----------|
|   | Estimated Fair Value |           |             |              |           |
|   |                      | Quoted    |             |              |           |
|   |                      | Prices in |             |              |           |
|   |                      | Active    | Significant | Significant  |           |
|   | Carrying             | Markets   | Observable  | Unobservable | Total     |
|   | Amount               | for       | Inputs      | Inputs       |           |
|   |                      | Identical | (Level 2)   | (Level 3)    |           |
|   |                      | Assets    |             |              |           |
|   |                      | (Level 1) |             |              |           |
| Financial assets:                               |                      |           |             |              |           |
| Cash and cash equivalents                       | \$48,988             | \$48,988  | \$-         | \$-          | \$48,988  |
| Investment securities available for sale        | 509,600              | 1,296     | 508,304     | -            | 509,600   |
| Loans and leases, net held for investment       | 1,035,731            | -         | 1,056,516   | -            | 1,056,516 |
| Collateral dependent impaired loans             | 9,943                | -         | 9,943       | -            | 9,943     |
| Cash surrender value of life insurance policies | 43,675               | -         | 43,675      | -            | 43,675    |
| Other investments                               | 7,546                | -         | 7,546       | -            | 7,546     |
| Investment in limited partnership               | 6,432                | -         | 6,432       | -            | 6,432     |
| Accrued interest receivable                     | 5,662                | -         | 5,662       | -            | 5,662     |
| Financial liabilities:                          |                      |           |             |              |           |
| Deposits:                                       |                      |           |             |              |           |
| Noninterest-bearing                             | \$423,449            | \$423,449 | \$-         | \$-          | \$423,449 |
| Interest-bearing                                | 1,005,665            | -         | 1,005,827   | -            | 1,005,827 |
| Fed funds purchased and repurchase agreements   | 10,115               | -         | 10,115      | -            | 10,115    |
| Short-term borrowings                           | 41,500               | -         | 41,500      | -            | 41,500    |
| Long-term borrowings                            | 2,000                | -         | 2,004       | -            | 2,004     |
| Subordinated debentures                         | 30,928               | -         | 12,008      | -            | 12,008    |
| Limited partnership capital commitment          | 795                  | -         | 795         | -            | 795       |
| Accrued interest payable                        | 115                  | -         | 115         | -            | 115       |

**Notional Amount**

**Off-balance-sheet financial instruments:**

|                              |           |
|------------------------------|-----------|
| Commitments to extend credit | \$370,787 |
| Standby letters of credit    | 16,881    |

December 31, 2014

|  | Estimated Fair Value |           |             |              |       |
|--|----------------------|-----------|-------------|--------------|-------|
|  | Carrying             | Quoted    | Significant | Significant  | Total |
|  | Amount               | Prices in | Observable  | Unobservable |       |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|   |           | Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Inputs<br>(Level 2) | Inputs<br>(Level 3) |           |
|---|-----------|--|---------------------|---------------------|-----------|
| <b>Financial assets:</b>                        |           |  |                     |                     |           |
| Cash and cash equivalents                       | \$50,095  | \$50,095   | \$ -                | \$ -                | \$50,095  |
| Investment securities available for sale        | 511,883   | 2,222  | 509,661             | -                   | 511,883   |
| Loans and leases, net held for investment       | 956,265   | -  | 966,599             | -                   | 966,599   |
| Collateral dependent impaired loans             | 4,791     | -  | 4,791               | -                   | 4,791     |
| Cash surrender value of life insurance policies | 42,989    | -  | 42,989              | -                   | 42,989    |
| Other Investments                               | 7,042     | -  | 7,042               | -                   | 7,042     |
| Investment in limited partnership               | 7,276     | -  | 7,276               | -                   | 7,276     |
| Accrued interest receivable                     | 5,852     | -  | 5,852               | -                   | 5,852     |
| <b>Financial liabilities:</b>                   |           |  |                     |                     |           |
| <b>Deposits:</b>                                |           |  |                     |                     |           |
| Noninterest-bearing                             | \$390,897 | \$390,897  | \$ -                | \$ -                | \$390,897 |
| Interest-bearing                                | 975,798   | -  | 976,002             | -                   | 976,002   |
| Fed funds purchased and repurchase agreements   | 7,251     | -  | 7,251               | -                   | 7,251     |
| Short-term borrowings                           | 18,200    | -  | 18,200              | -                   | 18,200    |
| Long-term borrowings                            | 6,000     | -  | 6,000               | -                   | 6,000     |
| Subordinated debentures                         | 30,928    | -  | 11,428              | -                   | 11,428    |
| Limited partnership capital commitment          | 914       | -  | 914                 | -                   | 914       |
| Accrued interest payable                        | 137       | -  | 137                 | -                   | 137       |

**Notional Amount**

|   |           |
|---|-----------|
| <b>Off-balance-sheet financial instruments:</b> |           |
| Commitments to extend credit                    | \$366,909 |
| Standby letters of credit                       | 14,389    |

For financial asset categories that were actually reported at fair value as of September 30, 2015 and December 31, 2014, the Company used the following methods and significant assumptions:

Investment securities: Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities.

Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.

Foreclosed assets: Repossessed real estate (known as other real estate owned, or “OREO”) and other foreclosed assets are carried at the lower of cost or fair value. Fair value is the appraised value less expected selling costs for OREO and some other assets such as mobile homes, and fair values for any other foreclosed assets are represented by estimated sales proceeds as determined using reasonably available sources. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Fair values for other foreclosed assets are adjusted as necessary, subsequent to a periodic re-evaluation of expected cash flows and the timing of resolution. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

Assets reported at fair value on a recurring basis are summarized below:

**Fair Value Measurements - Recurring**

(dollars in thousands, unaudited)

|                                     | Fair Value Measurements at September 30, 2015, using                             |  |  |            |                         |
|-------------------------------------|--|--|--|------------|-------------------------|
|                                     | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total      | Realized<br>Gain/(Loss) |
| Investment securities               |  |  |  |            |                         |
| US Government agencies              | \$ -   | \$ 29,741  | \$ -   | \$ 29,741  | \$ -                    |
| Mortgage-backed securities          | -  | 377,308  | -  | 377,308    | -                       |
| State and political subdivisions    | -  | 101,255  | -  | 101,255    | -                       |
| Other securities                    | 1,296  | -  | -  | 1,296      | -                       |
| Total available-for-sale securities | \$ 1,296   | \$ 508,304                                       | \$ -   | \$ 509,600 | \$ -                    |

|                                     | Fair Value Measurements at December 31, 2014, using                              |  |  |            |                         |
|-------------------------------------|--|--|--|------------|-------------------------|
|                                     | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total      | Realized<br>Gain/(Loss) |
| Investment securities               |  |  |  |            |                         |
| US Government agencies              | \$ -   | \$ 27,270  | \$ -   | \$ 27,270  | \$ -                    |
| Mortgage-backed securities          | -  | 381,442  | -  | 381,442    | -                       |
| State and political subdivisions    | -  | 100,949  | -  | 100,949    | -                       |
| Other securities                    | 2,222  | -  | -  | 2,222      | -                       |
| Total available-for-sale securities | \$ 2,222   | \$ 509,661                                       | \$ -   | \$ 511,883 | \$ -                    |

Assets reported at fair value on a nonrecurring basis are summarized below:

**Fair Value Measurements - Nonrecurring**

(dollars in thousands, unaudited)

|                                     | Fair Value Measurements at September 30, 2015, using                                      |   |   |          |
|-------------------------------------|---|---|---|----------|
|                                     | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) | Total    |
| Collateral dependent impaired loans | \$ -  | \$ 9,943                                      | \$ -  | \$ 9,943 |
| Foreclosed assets                   | \$ -  | \$ 3,003                                      | \$ -  | \$ 3,003 |

|                                     | Fair Value Measurements at December 31, 2014, using                        |   |   |          |
|-------------------------------------|--|---|---|----------|
|                                     | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) | Total    |
| Collateral dependent impaired loans | \$ -   | \$ 4,791                                      | \$ -  | \$ 4,791 |
| Foreclosed assets                   | \$ -   | \$ 3,991                                      | \$ -  | \$ 3,991 |

The table above includes collateral-dependent impaired loan balances for which a specific reserve has been established or on which a write-down has been taken. Information on the Company's total impaired loan balances and specific loss reserves associated with those balances is included in Note 11 below, and in Management's Discussion and Analysis of Financial Condition and Results of Operation in the "Nonperforming Assets" and "Allowance for Loan and Lease Losses" sections.

The unobservable inputs are based on Management's best estimates of appropriate discounts in arriving at fair market value. Increases or decreases in any of those inputs could result in a significantly lower or higher fair value measurement. For example, an increase or decrease in actual loss rates would have a directionally opposite change in the calculation of the fair value of unsecured impaired loans.

**Note 10 – Investments**

## **Investment Securities**

Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as “available for sale” to allow maximum flexibility with regard to interest rate risk and liquidity management. Pursuant to FASB’s guidance on accounting for debt and equity securities, available for sale securities are carried on the Company’s financial statements at their estimated fair market values, with monthly tax-effected “mark-to-market” adjustments made vis-à-vis accumulated other comprehensive income in shareholders’ equity.

**Amortized Cost And Estimated Fair Value**

The amortized cost and estimated fair value of investment securities available-for-sale are as follows

(dollars in thousands, unaudited):

|                                  | September 30, 2015 |                              |                               |                         |
|----------------------------------|--------------------|------------------------------|-------------------------------|-------------------------|
|                                  | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated Fair<br>Value |
| US Government agencies           | \$29,360           | \$ 389                       | \$ (8                         | ) \$ 29,741             |
| Mortgage-backed securities       | 374,966            | 3,425                        | (1,083                        | ) 377,308               |
| State and political subdivisions | 98,951             | 2,574                        | (270                          | ) 101,255               |
| Other securities                 | 659                | 637                          | -                             | 1,296                   |
| Total investment securities      | \$503,936          | \$ 7,025                     | \$ (1,361                     | ) \$ 509,600            |

|                                  | December 31, 2014 |                              |                               |                         |
|----------------------------------|-------------------|------------------------------|-------------------------------|-------------------------|
|                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated Fair<br>Value |
| US Government agencies           | \$26,959          | \$ 334                       | \$ (23                        | ) \$ 27,270             |
| Mortgage-backed securities       | 378,339           | 4,299                        | (1,196                        | ) 381,442               |
| State and political subdivisions | 98,056            | 3,093                        | (200                          | ) 100,949               |
| Other securities                 | 1,210             | 1,012                        | -                             | 2,222                   |
| Total investment securities      | \$504,564         | \$ 8,738                     | \$ (1,419                     | ) \$ 511,883            |

At September 30, 2015 and December 31, 2014, the Company had 167 securities and 134 securities, respectively, with unrealized losses. Management has evaluated those securities as of the respective dates, and does not believe that any of the associated unrealized losses are other than temporary. Gross unrealized losses on our investment securities as of the indicated dates are disclosed in the table below, categorized by investment type and by the duration of time that loss positions on individual securities have continuously existed (over or under twelve months).

**Investment Portfolio - Unrealized Losses**

(dollars in thousands, unaudited)

September 30, 2015

|                                  | Less than twelve months |            | Twelve months or more |            |
|----------------------------------|-------------------------|------------|-----------------------|------------|
|                                  | Gross                   | Fair Value | Gross                 | Fair Value |
|                                  | Unrealized              | Losses     | Unrealized            | Losses     |
| US Government agencies           | \$(8 )                  | \$ 1,719   | \$ -                  | \$ -       |
| Mortgage-backed securities       | (735)                   | 121,574    | (348 )                | 36,331     |
| State and political subdivisions | (162)                   | 18,004     | (108 )                | 5,081      |
| Total                            | \$(905)                 | \$ 141,297 | \$ (456 )             | \$ 41,412  |

December 31, 2014

|                                  | Less than twelve months |            | Twelve months or more |            |
|----------------------------------|-------------------------|------------|-----------------------|------------|
|                                  | Gross                   | Fair Value | Gross                 | Fair Value |
|                                  | Unrealized              | Losses     | Unrealized            | Losses     |
| US Government agencies           | \$(23 )                 | \$ 3,485   | \$ -                  | \$ -       |
| Mortgage-backed securities       | (564)                   | 84,004     | (632 )                | 51,982     |
| State and political subdivisions | (31 )                   | 7,738      | (169 )                | 9,045      |
| Total                            | \$(618)                 | \$ 95,227  | \$ (801 )             | \$ 61,027  |

The table below summarizes the Company's gross realized gains and losses as well as gross proceeds from the sales of securities, for the periods indicated:

**Investment Portfolio - Realized Gains/(Losses)**

(dollars in thousands, unaudited)

|   | Three months ended September 30, |      | Nine months ended September 30, |           |
|---|----------------------------------|------|---------------------------------|-----------|
|   | 2015                             | 2014 | 2015                            | 2014      |
| Proceeds from sales, calls and maturities of securities available | \$ 198                           | \$ - | \$ 24,988                       | \$ 12,050 |



|              |        |      |        |        |
|--------------|--------|------|--------|--------|
| for sale     |        |      |        |        |
| Gross gains  |        |      |        |        |
| on sales,    |        |      |        |        |
| calls and    |        |      |        |        |
| maturities   | \$ 108 | \$ - | \$ 630 | \$ 289 |
| of           |        |      |        |        |
| securities   |        |      |        |        |
| available    |        |      |        |        |
| for sale     |        |      |        |        |
| Gross        |        |      |        |        |
| losses on    |        |      |        |        |
| sales, calls |        |      |        |        |
| and          |        |      |        |        |
| maturities   | -      | -    | (199 ) | (2 )   |
| of           |        |      |        |        |
| securities   |        |      |        |        |
| available    |        |      |        |        |
| for sale     |        |      |        |        |
| Net gains    |        |      |        |        |
| on sale of   |        |      |        |        |
| securities   | \$ 108 | \$ - | \$ 431 | \$ 287 |
| available    |        |      |        |        |
| for sale     |        |      |        |        |

The amortized cost and estimated fair value of investment securities available-for-sale at September 30, 2015 and December 31, 2014 are shown below, grouped by the remaining time to contractual maturity dates. The expected life of investment securities may not be consistent with contractual maturity dates, since the issuers of the securities could have the right to call or prepay obligations with or without penalties.

Estimated Fair Value of Contractual Maturities

(dollars in thousands, unaudited)

|  | September 30, 2015 |            |
|--|--------------------|------------|
|  | Amortized<br>Cost  | Fair Value |
| Maturing within one year                                       | \$4,119            | \$ 4,160   |
| Maturing after one year through five years                     | 244,792            | 247,764    |
| Maturing after five years through ten years                    | 58,634             | 59,743     |
| Maturing after ten years                                       | 50,736             | 51,444     |
| Investment securities not due at a single maturity date:       |                    |            |
| U.S Government agencies collateralized by mortgage obligations | 144,996            | 145,193    |
| Other securities   | 659                | 1,296      |
|  | \$503,936          | \$ 509,600 |

|  | December 31, 2014 |            |
|--|-------------------|------------|
|  | Amortized<br>Cost | Fair Value |
| Maturing within one year                                       | \$686             | \$ 694     |
| Maturing after one year through five years                     | 222,081           | 225,415    |
| Maturing after five years through ten years                    | 97,949            | 99,583     |
| Maturing after ten years                                       | 54,531            | 55,705     |
| Investment securities not due at a single maturity date:       |                   |            |
| U.S Government agencies collateralized by mortgage obligations | 128,107           | 128,264    |
| Other securities   | 1,210             | 2,222      |
|  | \$504,564         | \$ 511,883 |

At September 30, 2015, the Company's investment portfolio included securities issued by 279 different government municipalities and agencies located within 27 states with a fair value of \$101.3 million. The largest exposure to any single municipality or agency was a \$1.1 million (fair value) refunding bond issued by the Columbia River People's Utility District, to be repaid by future utility revenue.

The Company's investments in bonds issued by states, municipalities and political subdivisions are evaluated in accordance with Supervision and Regulation Letter 12-15 issued by the Board of Governors of the Federal Reserve System, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings," and other regulatory guidance. Credit ratings are considered in our analysis only as a guide to the historical default rate associated with similarly-rated bonds. There have been no significant differences in our internal analyses compared with the ratings assigned by the third party credit rating agencies.



The following table summarizes the amortized cost and fair values of general obligation and revenue bonds in the Company's investment securities portfolio at the indicated dates, identifying the state in which the issuing municipality or agency operates for our largest geographic concentrations:

**Revenue and General Obligation Bonds by Location**

dollars in thousands, unaudited

|  | September 30, 2015 |                      | December 31, 2014 |                      |
|--|--------------------|----------------------|-------------------|----------------------|
|  | Amortized<br>Cost  | Fair Market<br>Value | Amortized<br>Cost | Fair Market<br>Value |
| General obligation bonds                               |                    |                      |                   |                      |
| State of issuance                                      |                    |                      |                   |                      |
| California   | \$20,023           | \$ 21,110            | \$20,078          | \$ 21,288            |
| Texas  | 14,718             | 14,908               | 14,489            | 14,675               |
| Illinois   | 10,014             | 10,089               | 8,272             | 8,394                |
| Ohio   | 8,254              | 8,317                | 7,456             | 7,555                |
| Washington   | 5,920              | 6,067                | 5,966             | 6,126                |
| Utah   | 954                | 976                  | 956               | 984                  |
| Other states   | 22,618             | 23,036               | 21,253            | 21,832               |
| Total General Obligation Bonds                         | 82,501             | 84,503               | 78,470            | 80,854               |
| Revenue bonds  |                    |                      |                   |                      |
| State of issuance                                      |                    |                      |                   |                      |
| Utah   | 4,437              | 4,469                | 3,769             | 3,834                |
| Texas  | 3,744              | 3,845                | 3,273             | 3,387                |
| California   | 1,003              | 1,031                | 2,174             | 2,233                |
| Washington   | 1,370              | 1,389                | 1,167             | 1,197                |
| Ohio   | 319                | 321                  | 321               | 332                  |
| Illinois   | 292                | 293                  | 294               | 294                  |
| Other states   | 5,285              | 5,404                | 8,588             | 8,818                |
| Total Revenue Bonds                                    | 16,450             | 16,752               | 19,586            | 20,095               |
| Total Obligations of States and Political Subdivisions | \$98,951           | \$ 101,255           | \$98,056          | \$ 100,949           |

The revenue bonds in the Company's investment securities portfolios were issued by government municipalities and agencies to fund public services such as utilities (water, sewer, and power), educational facilities, and general public and economic improvements. The primary sources of revenue for these bonds are delineated in the table below, which shows the amortized cost and fair market values for the largest revenue concentrations as of the indicated dates.

#### Revenue Bonds by Type

| dollars in thousands, unaudited | September 30, 2015 |                   | December 31, 2014 |                   |
|---------------------------------|--------------------|-------------------|-------------------|-------------------|
|                                 | Amortized Cost     | Fair Market Value | Amortized Cost    | Fair Market Value |
| Revenue bonds                   |                    |                   |                   |                   |
| Revenue source:                 |                    |                   |                   |                   |
| Water                           | \$3,653            | \$ 3,712          | \$7,100           | \$ 7,278          |
| College & University            | 3,201              | 3,300             | 2,723             | 2,834             |
| Sales Tax                       | 2,292              | 2,328             | 2,361             | 2,405             |
| Lease                           | 2,198              | 2,199             | 1,356             | 1,362             |
| Electric & Power                | 1,874              | 1,884             | 1,880             | 1,914             |
| Other sources                   | 3,232              | 3,329             | 4,166             | 4,302             |
| Total Revenue Bonds             | \$ 16,450          | \$ 16,752         | \$ 19,586         | \$ 20,095         |

#### **Low-Income Housing Tax Credit ("LIHTC") Fund Investments**

The Company has the ability to invest in limited partnerships which own housing projects that qualify for federal and/or California state tax credits, by mandating a specified percentage of low-income tenants for each project. The tax credits flow through to investors, augmenting any returns that might be derived from an increase in property values. Because rent levels are lower than standard market rents and the projects are generally highly leveraged, each project also typically generates tax-deductible operating losses that are allocated to the limited partners.

The Company invested in seven such LIHTC fund limited partnerships from 2001 through 2007, and may make similar investments in the future. Our investments to date have all been in California-focused funds, which helps the Company meet its obligations under the Community Reinvestment Act. We utilize the equity method of accounting for our LIHTC fund investments. Under the equity method, our balance sheet initially reflects an asset that represents the total cash expected to be invested over the life of the partnership. Any commitments or contingent commitments for future investment are reflected as a liability. The income statement treatment under the equity method reflects tax credits received by the Company "below the line" within the income tax provision, while any fund operating results are included "above the line" in non-interest income. As noted above, operating results are typically losses that are netted against non-interest income.

As of September 30, 2015 our total remaining LIHTC investment balance was \$5.1 million, and we had no commitments or contingent commitments for additional capital contributions to the limited partnerships. There were \$578,000 in tax credits derived from our LIHTC investments which were recognized during the nine months ended September 30, 2015, and a pass-through operating loss of \$844,000 associated with those investments was included in pre-tax income for the same time period. Our LIHTC investments are evaluated annually for potential impairment, and we have concluded that the carrying value of the investments is fairly stated and is not impaired.

**Note 11 – Credit Quality and Nonperforming Assets**

**Credit Quality Classifications**

The Company monitors the credit quality of loans on a continuous basis using the regulatory and accounting classifications of pass, special mention, substandard and impaired to characterize the associated credit risk. Balances classified as “loss” are immediately charged off. The Company conforms to the following definitions for risk classifications utilized:

Pass: Larger non-homogeneous loans not meeting the risk rating definitions below, and smaller homogeneous loans that are not assessed on an individual basis.

Special mention: Loans which have potential issues that deserve the close attention of Management. If left uncorrected, those potential weaknesses could eventually diminish the prospects for full repayment of principal and interest according to the contractual terms of the loan agreement, or could result in deterioration of the Company's credit position at some future date.

Substandard: Loans that have at least one clear and well-defined weakness that could jeopardize the ultimate recoverability of all principal and interest, such as a borrower displaying a highly leveraged position, unfavorable financial operating results and/or trends, uncertain repayment sources or a deteriorated financial condition.

Impaired: A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include all nonperforming loans, restructured troubled debt ("TDRs"), and certain other loans that are still being maintained on accrual status. A TDR may be nonperforming or performing, depending on its accrual status and the demonstrated ability of the borrower to comply with restructured terms (see "Troubled Debt Restructurings" section below for additional information on TDRs).

Credit quality classifications for the Company's loan balances were as follows, as of the dates indicated:

Credit Quality Classifications

(dollars in thousands, unaudited)

|   | September 30, 2015 |                    |             |           |              |
|---|--------------------|--------------------|-------------|-----------|--------------|
|   | Pass               | Special<br>Mention | Substandard | Impaired  | Total        |
| Real Estate:                                |                    |                    |             |           |              |
| 1-4 family residential construction         | \$8,146            | \$ 374             | \$ -        | \$ -      | \$8,520      |
| Other construction/land                     | 31,396             | 185                | -           | 1,044     | 32,625       |
| 1-4 family - closed end                     | 126,900            | 686                | 403         | 6,487     | 134,476      |
| Equity lines                                | 40,952             | 281                | 1,563       | 2,034     | 44,830       |
| Multi-family residential                    | 26,299             | -                  | 626         | 416       | 27,341       |
| Commercial real estate - owner occupied     | 191,431            | 14,265             | 7,777       | 3,284     | 216,757      |
| Commercial real estate - non-owner occupied | 141,936            | 6,795              | 172         | 11,941    | 160,844      |
| Farmland                                    | 121,292            | 4,206              | 730         | 47        | 126,275      |
| Total real estate                           | 688,352            | 26,792             | 11,271      | 25,253    | 751,668      |
| Agricultural                                | 36,377             | 373                | 70          | -         | 36,820       |
| Commercial and industrial                   | 102,635            | 1,042              | 571         | 2,695     | 106,943      |
| Mortgage Warehouse                          | 142,608            | -                  | -           | -         | 142,608      |
| Consumer loans                              | 13,544             | 268                | 17          | 2,268     | 16,097       |
| Total gross loans and leases                | \$983,516          | \$ 28,475          | \$ 11,929   | \$ 30,216 | \$ 1,054,136 |
|   |                    |                    |             |           |              |
|   | December 31, 2014  |                    |             |           |              |
|   | Pass               | Special<br>Mention | Substandard | Impaired  | Total        |
| Real Estate:                                |                    |                    |             |           |              |
| 1-4 family residential construction         | \$5,858            | \$ -               | \$ -        | \$ -      | \$5,858      |
| Other construction/land                     | 15,238             | 247                | -           | 4,423     | 19,908       |
| 1-4 family - closed end                     | 105,398            | 833                | 918         | 7,110     | 114,259      |
| Equity lines                                | 46,819             | 294                | 1,237       | 1,367     | 49,717       |
| Multi-family residential                    | 18,127             | 420                | -           | 171       | 18,718       |
| Commercial real estate - owner occupied     | 191,495            | 18,694             | 3,845       | 4,620     | 218,654      |
| Commercial real estate - non-owner occupied | 114,317            | 4,250              | 631         | 12,879    | 132,077      |
| Farmland                                    | 142,295            | 1,950              | 744         | 50        | 145,039      |
| Total real estate                           | 639,547            | 26,688             | 7,375       | 30,620    | 704,230      |
| Agricultural                                | 27,215             | 531                | -           | -         | 27,746       |
| Commercial and industrial                   | 108,469            | 1,529              | 857         | 2,916     | 113,771      |
| Mortgage Warehouse                          | 106,021            | -                  | -           | -         | 106,021      |
| Consumer loans                              | 15,752             | 222                | 23          | 2,888     | 18,885       |
| Total gross loans and leases                | \$897,004          | \$ 28,970          | \$ 8,255    | \$ 36,424 | \$ 970,653   |





**Past Due and Nonperforming Assets**

Nonperforming assets are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets, including mobile homes and OREO. OREO consists of properties acquired by foreclosure or similar means, which the Company is offering or will offer for sale. Nonperforming loans and leases result when reasonable doubt surfaces with regard to the ability of the Company to collect all principal and interest. At that point, we stop accruing interest on the loan or lease in question and reverse any previously-recognized interest to the extent that it is uncollected or associated with interest-reserve loans. Any asset for which principal or interest has been in default for 90 days or more is also placed on non-accrual status even if interest is still being received, unless the asset is both well secured and in the process of collection. An aging of the Company's loan balances is presented in the following tables, by number of days past due as of the indicated dates:

**Loan Portfolio Aging**

(dollars in thousands, unaudited)

|   | September 30, 2015  |                     |   | Total Past Due | Current      | Total Financing Receivables | Non-Accrual Loans <sup>(2)</sup> |
|---|---------------------|---------------------|---|----------------|--------------|-----------------------------|----------------------------------|
|   | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days Or More Past Due <sup>(1)</sup> |                |              |                             |                                  |
| Real Estate:                                |                     |                     |   |                |              |                             |                                  |
| 1-4 family residential construction         | \$374               | \$ -                | \$ -                                    | \$ 374         | \$8,146      | \$8,520                     | \$ -                             |
| Other construction/land                     | 270                 | -                   | -                                       | 270            | 32,355       | 32,625                      | 163                              |
| 1-4 family - closed end                     | 33                  | -                   | 461                                     | 494            | 133,982      | 134,476                     | 2,478                            |
| Equity lines                                | 281                 | 47                  | 161                                     | 489            | 44,341       | 44,830                      | 1,265                            |
| Multi-family residential                    | -                   | -                   | -                                       | -              | 27,341       | 27,341                      | -                                |
| Commercial real estate - owner occupied     | 626                 | -                   | 408                                     | 1,034          | 215,723      | 216,757                     | 2,547                            |
| Commercial real estate - non-owner occupied | -                   | -                   | 6,689                                   | 6,689          | 154,155      | 160,844                     | 6,957                            |
| Farmland                                    | 47                  | -                   | -                                       | 47             | 126,228      | 126,275                     | 47                               |
| Total real estate                           | 1,631               | 47                  | 7,719                                   | 9,397          | 742,271      | 751,668                     | 13,457                           |
| Agricultural                                | 373                 | 70                  | -                                       | 443            | 36,377       | 36,820                      | -                                |
| Commercial and industrial                   | 113                 | 134                 | 214                                     | 461            | 106,482      | 106,943                     | 829                              |
| Mortgage warehouse lines                    | -                   | -                   | -                                       | -              | 142,608      | 142,608                     | -                                |
| Consumer                                    | 228                 | -                   | 1                                       | 229            | 15,868       | 16,097                      | 590                              |
| Total gross loans and leases                | \$2,345             | \$ 251              | \$ 7,934                                | \$ 10,530      | \$ 1,043,606 | \$ 1,054,136                | \$ 14,876                        |

<sup>(1)</sup> As of September 30, 2015 there were no loans over 90 days past due and still accruing.

<sup>(2)</sup> Included in total financing receivables

Edgar Filing: SIERRA BANCORP - Form 10-Q

|  | December 31, 2014            |                           |   |                   |           |                                   |                                     |
|--|------------------------------|---------------------------|---|-------------------|-----------|-----------------------------------|-------------------------------------|
|  | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days Past<br>Due | 90 Days Or<br>More<br>Past Due <sup>(1)</sup> | Total Past<br>Due | Current   | Total<br>Financing<br>Receivables | Non-Accrual<br>Loans <sup>(2)</sup> |
| Real Estate:                                   |                              |                           |   |                   |           |                                   |                                     |
| 1-4 family residential<br>construction         | \$-                          | \$ 332                    | \$ -  | \$ 332            | \$5,526   | \$ 5,858                          | \$ -                                |
| Other construction/land                        | 93                           | 59                        | 3,253   | 3,405             | 16,503    | 19,908                            | 3,547                               |
| 1-4 family - closed end                        | 1,125                        | 597                       | 2,874   | 4,596             | 109,663   | 114,259                           | 3,042                               |
| Equity lines                                   | 98                           | 44                        | 214   | 356               | 49,361    | 49,717                            | 1,049                               |
| Multi-family residential                       | 185                          | -                         | 171   | 356               | 18,362    | 18,718                            | 171                                 |
| Commercial real estate -<br>owner occupied     | 1,460                        | 26                        | 1,316   | 2,802             | 215,852   | 218,654                           | 3,417                               |
| Commercial real estate -<br>non-owner occupied | 604                          | 294                       | 6,953   | 7,851             | 124,226   | 132,077                           | 7,754                               |
| Farmland                                       | 997                          | -                         | -   | 997               | 144,042   | 145,039                           | 51                                  |
| Total real estate                              | 4,562                        | 1,352                     | 14,781  | 20,695            | 683,535   | 704,230                           | 19,031                              |
| Agricultural                                   | 618                          | -                         | -   | 618               | 27,128    | 27,746                            | -                                   |
| Commercial and industrial                      | 1,346                        | 153                       | 39  | 1,538             | 112,233   | 113,771                           | 821                                 |
| Mortgage warehouse lines                       | -                            | -                         | -   | -                 | 106,021   | 106,021                           | -                                   |
| Consumer                                       | 136                          | 17                        | -   | 153               | 18,732    | 18,885                            | 826                                 |
| Total gross loans and leases                   | \$6,662                      | \$ 1,522                  | \$ 14,820                                     | \$ 23,004         | \$947,649 | \$ 970,653                        | \$ 20,678                           |

<sup>(1)</sup> As of December 31, 2014 there were no loans over 90 days past due and still accruing.

<sup>(2)</sup> Included in total financing receivables

## Troubled Debt Restructurings

A loan that is modified for a borrower who is experiencing financial difficulty is classified as a troubled debt restructuring if the modification constitutes a concession. At September 30, 2015, the Company had a total of \$23.2 million in TDRs, including \$11.3 million in TDRs that were on non-accrual status. Generally, a non-accrual loan that has been modified as a TDR remains on non-accrual status for a period of at least six months to demonstrate the borrower's ability to comply with the modified terms. However, performance prior to the modification, or significant events that coincide with the modification, could result in a loan's return to accrual status after a shorter performance period or even at the time of loan modification. TDRs may have the TDR designation removed in the calendar year following the restructuring, if the loan is in compliance with all modified terms and is yielding a market rate of interest. Regardless of the period of time that has elapsed, if the borrower's ability to meet the revised payment schedule is uncertain then the loan will be kept on non-accrual status. Moreover, a TDR is generally considered to be in default when it appears that the customer will not likely be able to repay all principal and interest pursuant to restructured terms.

The Company may agree to different types of concessions when modifying a loan or lease. The tables below summarize TDRs which were modified during the noted periods, by type of concession:

### Troubled Debt Restructurings, by Type of Loan Modification

(dollars in thousands, unaudited)

|   | Three months ended September 30, 2015 |                   |                          |                                   | Total    |
|---|---------------------------------------|-------------------|--------------------------|-----------------------------------|----------|
|   | Rate Modification                     | Term Modification | Rate & Term Modification | Term & Interest Only Modification |          |
| Real estate:                            |                                       |                   |                          |                                   |          |
| Other construction/land                 | \$ -                                  | \$ -              | \$ -                     | \$ -                              | \$ -     |
| 1-4 family - closed-end                 | -                                     | -                 | 4,388                    | -                                 | 4,388    |
| Equity lines                            | -                                     | 256               | -                        | -                                 | 256      |
| Multi-family residential                | -                                     | -                 | -                        | -                                 | -        |
| Commercial real estate - owner occupied | -                                     | -                 | -                        | -                                 | -        |
| Total real estate loans                 | -                                     | 256               | 4,388                    | -                                 | 4,644    |
| Commercial and industrial               | -                                     | 45                | -                        | -                                 | 45       |
| Consumer loans                          | -                                     | 10                | -                        | -                                 | 10       |
|   | \$ -                                  | \$ 311            | \$ 4,388                 | \$ -                              | \$ 4,699 |

Three months ended September 30, 2014

|  | Rate Modification | Term Modification | Rate & Term Modification | Term & Interest Only Modification | Total |
|--|-------------------|-------------------|--------------------------|-----------------------------------|-------|
|--|-------------------|-------------------|--------------------------|-----------------------------------|-------|

Edgar Filing: SIERRA BANCORP - Form 10-Q

Real Estate:

|   |      |        |        |      |        |
|---|------|--------|--------|------|--------|
| Other construction/land                 | \$ - | \$ -   | \$ -   | \$ - | \$ -   |
| 1-4 family - closed-end                 | -    | -      | -      | -    | -      |
| Equity lines                            | -    | 227    | -      | -    | 227    |
| Multi-family residential                | -    | -      | -      | -    | -      |
| Commercial real estate - owner occupied | -    | -      | -      | -    | -      |
| Total real estate loans                 | -    | 227    | -      | -    | 227    |
| Commercial and industrial               | -    | -      | -      | -    | -      |
| Consumer loans                          | -    | -      | 103    | -    | 103    |
|   | \$ - | \$ 227 | \$ 103 | \$ - | \$ 330 |

**Troubled Debt Restructurings, by Type of Loan Modification**

(dollars in thousands, unaudited)

Nine months ended September 30, 2015

|   | Rate<br>Modification | Term<br>Modification | Rate & Term<br>Modification | Term &<br>Interest Only<br>Modification | Total    |
|---|----------------------|----------------------|-----------------------------|---|----------|
| Real estate:                            |                      |                      |                             |   |          |
| Other construction/land                 | \$ -                 | \$ 111               | \$ -                        | \$ -                                    | \$ 111   |
| 1-4 family - closed-end                 | -                    | -                    | 4,614                       | -                                       | 4,614    |
| Equity lines                            | -                    | 607                  | 290                         | -                                       | 897      |
| Multi-family residential                | -                    | 418                  | -                           | -                                       | 418      |
| Commercial real estate - owner occupied | -                    | -                    | -                           | -                                       | -        |
| Total real estate loans                 | -                    | 1,136                | 4,904                       | -                                       | 6,040    |
| Commercial and industrial               | -                    | 113                  | -                           | -                                       | 113      |
| Consumer loans                          | -                    | 10                   | -                           | -                                       | 10       |
|   | \$ -                 | \$ 1,259             | \$ 4,904                    | \$ -                                    | \$ 6,163 |

Nine months ended September 30, 2014

|   | Rate<br>Modification | Term<br>Modification | Rate & Term<br>Modification | Term &<br>Interest Only<br>Modification | Total    |
|---|----------------------|----------------------|-----------------------------|---|----------|
| Real Estate:                            |                      |                      |                             |   |          |
| Other construction/land                 | \$ -                 | \$ -                 | \$ -                        | \$ -                                    | \$ -     |
| 1-4 family - closed-end                 | -                    | 13                   | -                           | -                                       | 13       |
| Equity lines                            | -                    | 548                  | 29                          | -                                       | 577      |
| Multi-family residential                | -                    | -                    | -                           | -                                       | -        |
| Commercial real estate - owner occupied | 279                  | 123                  | -                           | -                                       | 402      |
| Total real estate loans                 | 279                  | 684                  | 29                          | -                                       | 992      |
| Commercial and industrial               | -                    | 133                  | 4                           | 30                                      | 167      |
| Consumer loans                          | -                    | 9                    | 103                         | -                                       | 112      |
|   | \$ 279               | \$ 826               | \$ 136                      | \$ 30                                   | \$ 1,271 |

The following tables present, by class, additional details related to loans classified as TDRs during the referenced periods, including the recorded investment in the loan both before and after modification and balances that were modified during the period:

### **Troubled Debt Restructurings**

(dollars in thousands, unaudited)

|                               | Three months ended September 30, 2015 |  |   |                                   |         |
|-------------------------------|---------------------------------------|--|---|-----------------------------------|---------|
|                               | Number of Loans                       | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Reserve Difference <sup>(1)</sup> | Reserve |
| Real Estate:                  |                                       |  |   |                                   |         |
| Other Construction/Land       | 0                                     | \$ -   | \$ -  | \$ -                              | \$ -    |
| 1-4 family - closed-end       | 9                                     | 4,388  | 4,388   | 148                               | 85      |
| Equity Lines                  | 2                                     | 256  | 256   | 10                                | 74      |
| Multi-family residential      | 0                                     | -  | -   | -                                 | -       |
| Commercial RE- owner occupied | 0                                     | -  | -   | -                                 | -       |
| Total Real Estate Loans       |                                       | 4,644  | 4,644   | 158                               | 159     |
| Commercial and Industrial     | 1                                     | 45   | 45  | 2                                 | 2       |
| Consumer loans                | 1                                     | 10   | 10  | 1                                 | -       |
|                               |                                       | \$ 4,699   | \$ 4,699  | \$ 161                            | \$ 161  |

<sup>(1)</sup> This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

|                               | Three months ended September 30, 2014 |  |   |                                   |         |
|-------------------------------|---------------------------------------|--|---|-----------------------------------|---------|
|                               | Number of Loans                       | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Reserve Difference <sup>(1)</sup> | Reserve |
| Real Estate:                  |                                       |  |   |                                   |         |
| Other Construction/Land       | 0                                     | \$ -   | \$ -  | \$ -                              | \$ -    |
| 1-4 family - closed-end       | 0                                     | -  | -   | -                                 | -       |
| Equity Lines                  | 3                                     | 227  | 227   | 11                                | 20      |
| Multi-family residential      | 0                                     | -  | -   | -                                 | -       |
| Commercial RE- owner occupied | 0                                     | -  | -   | -                                 | -       |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|                           |   |        |        |       |       |
|---------------------------|---|--------|--------|-------|-------|
| Total Real Estate Loans   |   | 227    | 227    | 11    | 20    |
| Commercial and Industrial | 0 | -      | -      | -     | -     |
| Consumer loans            | 1 | 103    | 103    | 14    | 15    |
|                           |   | \$ 330 | \$ 330 | \$ 25 | \$ 35 |

<sup>(1)</sup> This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.



| Nine months ended September 30, 2015 |                 |  |   |                                   |         |
|--------------------------------------|-----------------|--|---|-----------------------------------|---------|
|                                      | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Reserve Difference <sup>(1)</sup> | Reserve |
| Real Estate:                         |                 |  |   |                                   |         |
| Other Construction/Land              | 2               | \$ 111   | \$ 111  | \$ 4                              | \$ 1    |
| 1-4 family - closed-end              | 11              | 4,614  | 4,614   | 154                               | 86      |
| Equity Lines                         | 9               | 897  | 897   | 152                               | 296     |
| Multi-family residential             | 1               | 418  | 418   | -                                 | 1       |
| Commercial RE- owner occupied        | 0               | -  | -   | -                                 | -       |
| Total Real Estate Loans              |                 | 6,040  | 6,040   | 310                               | 384     |
| Commercial and Industrial            | 4               | 113  | 113   | (17 )                             | 23      |
| Consumer loans                       | 1               | 10   | 10  | 1                                 | -       |
|                                      |                 | \$ 6,163   | \$ 6,163  | \$ 294                            | \$ 407  |

<sup>(1)</sup> This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

| Nine months ended September 30, 2014 |                 |  |   |                                   |         |
|--------------------------------------|-----------------|--|---|-----------------------------------|---------|
|                                      | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Reserve Difference <sup>(1)</sup> | Reserve |
| Real Estate:                         |                 |  |   |                                   |         |
| Other Construction/Land              | 0               | \$ -   | \$ -  | \$ -                              | \$ -    |
| 1-4 family - closed-end              | 1               | 13   | 13  | -                                 | -       |
| Equity Lines                         | 6               | 577  | 577   | 180                               | 33      |
| Multi-family residential             | 0               | -  | -   | -                                 | -       |
| Commercial RE- owner occupied        | 2               | 402  | 402   | -                                 | 136     |
| Total Real Estate Loans              |                 | 992  | 992   | 180                               | 169     |
| Commercial and Industrial            | 5               | 167  | 167   | 53                                | 57      |
| Consumer loans                       | 4               | 112  | 112   | 15                                | 15      |
|                                      |                 | \$ 1,271   | \$ 1,271  | \$ 248                            | \$ 241  |

<sup>(1)</sup> This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.



The table below summarizes finance receivables modified as TDRs within the previous twelve months that defaulted during the periods noted, and any charge-offs on those TDRs resulting from such default.

### **Troubled Debt Restructurings**

(dollars in thousands, unaudited)

|                           | Three months ended September 30, |      | Nine months ended September 30, |        |
|---------------------------|----------------------------------|------|---------------------------------|--------|
|                           | 2015                             | 2014 | 2015                            | 2014   |
| Commercial and Industrial |                                  |      |                                 |        |
| Number of loans           | -                                | -    | -                               | 1      |
| Recorded investment       | \$ -                             | \$ - | \$ -                            | \$ 127 |
| Charge-offs               | \$ -                             | \$ - | \$ -                            | \$ -   |

### **Purchased Credit Impaired Loans**

The Company may acquire loans which show evidence of credit deterioration since origination. These purchased credit impaired (“PCI”) loans are recorded at the amount paid, since there is no carryover of the seller’s allowance for loan losses. Potential losses on PCI loans subsequent to acquisition are recognized by an increase in the allowance for loan losses. PCI loans are accounted for individually or are aggregated into pools of loans based on common risk characteristics. The Company estimates the amount and timing of expected cash flows, and expected cash receipts in excess of the amount paid for the loan(s) are recorded as interest income over the remaining life of the loan or pool of loans (accretable yield). The excess of contractual principal and interest over expected cash flows is not recorded (nonaccretable difference). Expected cash flows are periodically re-evaluated throughout the life of the loan or pool of loans. If the present value of the expected cash flows is determined at any time to be less than the carrying amount, a reserve is recorded. If the present value of the expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

The acquisition described in Note 13, Recent Developments, included a portfolio of loans, some of which have shown evidence of credit deterioration since origination and for which it was probable at acquisition that all contractually required payments would not be collected. The carrying amount and unpaid principal balance of those PCI loans was as follows, as of the dates indicated (dollars in thousands):

### **Purchased Credit Impaired Loans:**

Edgar Filing: SIERRA BANCORP - Form 10-Q

September 30, 2015

Unpaid  
Principal            Carrying Value  
Balance

|                                       |          |        |
|---------------------------------------|----------|--------|
| Real estate secured                   | \$ 1,177 | \$ 242 |
| Commercial and industrial             | 44       | -      |
| Consumer                              | 1        | -      |
| Total purchased credit impaired loans | \$ 1,222 | \$ 242 |

December 31, 2014

Unpaid  
Principal            Carrying Value  
Balance

|                                       |          |        |
|---------------------------------------|----------|--------|
| Real estate secured                   | \$ 1,222 | \$ 228 |
| Commercial and industrial             | 92       | -      |
| Consumer                              | 1        | -      |
| Total purchased credit impaired loans | \$ 1,315 | \$ 228 |

An \$89,000 allowance for loan losses was allocated for PCI loans as of September 30, 2015, but there was no allowance for those loans at December 31, 2014. We also recorded \$216,000 in discount accretion on PCI loans during the nine months ended September 30, 2015.

**Note 12 – Allowance for Loan and Lease Losses**

The Company's allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses. The allowance is maintained at a level that is considered adequate to absorb probable losses on certain specifically identified loans, as well as probable incurred losses inherent in the remaining loan portfolio. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when cash payments are received subsequent to the charge off. We employ a systematic methodology, consistent with FASB guidelines on loss contingencies and impaired loans, for determining the appropriate level of the allowance for loan and lease losses and adjusting it at least quarterly. Pursuant to that methodology, impaired loans and leases are individually analyzed and a criticized asset action plan is completed specifying the financial status of the borrower and, if applicable, the characteristics and condition of collateral and any associated liquidation plan. A specific loss allowance is created for each impaired loan, if necessary.

The following tables disclose the unpaid principal balance, recorded investment, average recorded investment, and interest income recognized for impaired loans on our books as of the dates indicated. Balances are shown by loan type, and are further broken out by those that required an allowance and those that did not, with the associated allowance disclosed for those that required such. Included in the valuation allowance for impaired loans shown in the tables below are specific reserves allocated to TDRs, totaling \$2.421 million at September 30, 2015 and \$2.714 million at December 31, 2014.

| <u>Impaired Loans</u><br>(dollars in thousands, unaudited) | September 30, 2015                      |                                    | Related Allowance | Average Recorded Investment | Interest Income Recognized <sup>(3)</sup> |
|--|---|------------------------------------|-------------------|-----------------------------|---|
|  | Unpaid Principal Balance <sup>(1)</sup> | Recorded Investment <sup>(2)</sup> |                   |                             |   |
| With an allowance recorded                                 |   |                                    |                   |                             |   |
| Real Estate:   |   |                                    |                   |                             |   |
| Other construction/land                                    | \$ 639                                  | \$ 603                             | \$ 82             | \$ 589                      | \$ 34                                     |
| 1-4 Family - closed-end                                    | 7,935                                   | 5,987                              | 246               | 4,358                       | 189                                       |
| Equity lines   | 1,733                                   | 1,680                              | 509               | 1,578                       | 12  |
| Multi-family residential                                   | 416                                     | 416                                | 1                 | 372                         | 4   |
| Commercial real estate- owner occupied                     | 1,607                                   | 1,607                              | 743               | 1,571                       | 33  |
| Commercial real estate- non-owner occupied                 | 10,060                                  | 10,060                             | 2,039             | 9,519                       | 124                                       |
| Farmland   | -                                       | -                                  | -                 | -                           | -   |
| Total real estate  | 22,390                                  | 20,353                             | 3,620             | 17,987                      | 396                                       |
| Commercial and industrial                                  | 2,612                                   | 2,600                              | 753               | 2,486                       | 68  |
| Consumer loans   | 2,239                                   | 2,238                              | 356               | 2,227                       | 95  |
|  | 27,241                                  | 25,191                             | 4,729             | 22,700                      | 559                                       |
| With no related allowance recorded                         |   |                                    |                   |                             |   |
| Real estate:   |   |                                    |                   |                             |   |
| Other construction/land                                    | 554                                     | 441                                | -                 | 509                         | 24  |
| 1-4 family - closed-end                                    | 723                                     | 500                                | -                 | 659                         | -   |
| Equity lines   | 372                                     | 354                                | -                 | 337                         | -   |
| Multi-family residential                                   | -                                       | -                                  | -                 | -                           | -   |
| Commercial real estate- owner occupied                     | 1,677                                   | 1,677                              | -                 | 1,592                       | -   |
| Commercial real estate- non-owner occupied                 | 2,029                                   | 1,881                              | -                 | 1,881                       | 89  |
| Farmland   | 47                                      | 47                                 | -                 | 46                          | -   |
| Total real estate  | 5,402                                   | 4,900                              | -                 | 5,024                       | 113                                       |
| Commercial and industrial                                  | 112                                     | 95                                 | -                 | 138                         | -   |
| Consumer loans   | 202                                     | 30                                 | -                 | 249                         | -   |
|  | 5,716                                   | 5,025                              | -                 | 5,411                       | 113                                       |
| Total  | \$ 32,957                               | \$ 30,216                          | \$ 4,729          | \$ 28,111                   | \$ 672                                    |

<sup>(1)</sup>Contractual principal balance due from customer.

<sup>(2)</sup>Principal balance on Company's books, less any direct charge offs.

<sup>(3)</sup>Interest income is recognized on performing balances on a regular accrual basis.



|  | December 31, 2014                       |                                    | Related Allowance | Average Recorded Investment | Interest Income Recognized <sup>(3)</sup> |
|--|---|------------------------------------|-------------------|-----------------------------|---|
|  | Unpaid Principal Balance <sup>(1)</sup> | Recorded Investment <sup>(2)</sup> |                   |                             |   |
| With an allowance recorded                 |   |                                    |                   |                             |   |
| Real estate:                               |   |                                    |                   |                             |   |
| Other construction/land                    | \$ 1,155                                | \$ 1,078                           | \$ 179            | \$ 1,193                    | \$ 70                                     |
| 1-4 family - closed-end                    | 4,167                                   | 4,167                              | 288               | 4,276                       | 258                                       |
| Equity lines                               | 797                                     | 797                                | 230               | 878                         | 14  |
| Multifamily residential                    | 171                                     | 171                                | 51                | 173                         | -   |
| Commercial real estate- owner occupied     | 2,791                                   | 2,681                              | 1,385             | 3,069                       | 60  |
| Commercial real estate- non-owner occupied | 3,463                                   | 3,463                              | 1,731             | 3,545                       | 263                                       |
| Farmland                                   | -                                       | -                                  | -                 | -                           | -   |
| Total real estate                          | 12,544                                  | 12,357                             | 3,864             | 13,134                      | 665                                       |
| Commercial and industrial                  | 2,910                                   | 2,898                              | 916               | 3,046                       | 123                                       |
| Consumer loans                             | 2,790                                   | 2,788                              | 668               | 3,115                       | 150                                       |
|  | 18,244                                  | 18,043                             | 5,448             | 19,295                      | 938                                       |
| With no related allowance recorded         |   |                                    |                   |                             |   |
| Real estate:                               |   |                                    |                   |                             |   |
| Other construction/land                    | 3,345                                   | 3,345                              | -                 | 4,143                       | -   |
| 1-4 family - closed-end                    | 2,943                                   | 2,943                              | -                 | 9,186                       | -   |
| Equity lines                               | 609                                     | 570                                | -                 | 611                         | -   |
| Multifamily residential                    | -                                       | -                                  | -                 | -                           | -   |
| Commercial real estate- owner occupied     | 2,915                                   | 1,939                              | -                 | 3,046                       | -   |
| Commercial real estate- non-owner occupied | 9,563                                   | 9,416                              | -                 | 10,306                      | 118                                       |
| Farmland                                   | 51                                      | 50                                 | -                 | 52                          | -   |
| Total real estate                          | 19,426                                  | 18,263                             | -                 | 27,344                      | 118                                       |
| Commercial and industrial                  | 35                                      | 18                                 | -                 | 81                          | -   |
| Consumer loans                             | 275                                     | 100                                | -                 | 347                         | -   |
|  | 19,736                                  | 18,381                             | -                 | 27,772                      | 118                                       |
| Total                                      | \$ 37,980                               | \$ 36,424                          | \$ 5,448          | \$ 47,067                   | \$ 1,056                                  |

<sup>(1)</sup>Contractual principal balance due from customer.

<sup>(2)</sup>Principal balance on Company's books, less any direct charge offs.

<sup>(3)</sup>Interest income is recognized on performing balances on a regular accrual basis.

The specific loss allowance for an impaired loan generally represents the difference between the book value of the loan and either the fair value of underlying collateral less estimated disposition costs, or the loan's net present value as determined by a discounted cash flow analysis. The discounted cash flow approach is typically used to measure impairment on loans for which it is anticipated that repayment will be provided from cash flows other than those generated solely by the disposition or operation of underlying collateral. However, historical loss rates may be used to determine a specific loss allowance if they indicate a higher potential reserve need than the discounted cash flow



analysis. Any change in impairment attributable to the passage of time is accommodated by adjusting the loss allowance accordingly.

For loans where repayment is expected to be provided by the disposition or operation of the underlying collateral, impairment is measured using the fair value of the collateral. If the collateral value, net of the expected costs of disposition where applicable, is less than the loan balance, then a specific loss reserve is established for the shortfall in collateral coverage. If the discounted collateral value is greater than or equal to the loan balance, no specific loss reserve is required. At the time a collateral-dependent loan is designated as nonperforming, a new appraisal is ordered and typically received within 30 to 60 days if a recent appraisal is not already available. We generally use external appraisals to determine the fair value of the underlying collateral for nonperforming real estate loans, although the Company's licensed staff appraisers may update older appraisals based on current market conditions and property value trends. Until an updated appraisal is received, the Company uses the existing appraisal to determine the amount of the specific loss allowance that may be required. The specific loss allowance is adjusted, as necessary, once a new appraisal is received. Updated appraisals are generally ordered at least annually for collateral-dependent loans that remain impaired. Current appraisals were available for 97% of the Company's impaired real estate loan balances at September 30, 2015. Furthermore, the Company analyzes collateral-dependent loans on at least a quarterly basis, to determine if any portion of the recorded investment in such loans can be identified as uncollectible and would therefore constitute a confirmed loss. All amounts deemed to be uncollectible are promptly charged off against the Company's allowance for loan and lease losses, with the loan then carried at the fair value of the collateral, as appraised, less estimated costs of disposition if applicable. Once a charge-off or write-down is recorded, it will not be restored to the loan balance on the Company's accounting books.

Our methodology also provides that a “general” allowance be established for probable incurred losses inherent in loans and leases that are not impaired. Unimpaired loan balances are segregated by credit quality, and are then evaluated in pools with common characteristics. At the present time, pools are based on the same segmentation of loan types presented in our regulatory filings. While this methodology utilizes historical loss data and other measurable information, the classification of loans and the establishment of the allowance for loan and lease losses are both to some extent based on Management’s judgment and experience. Our methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan and lease losses that Management believes is appropriate at each reporting date. Quantitative information includes our historical loss experience, delinquency and charge-off trends, and current collateral values. Qualitative factors include the general economic environment in our markets and, in particular, the condition of the agricultural industry and other key industries. Lending policies and procedures (including underwriting standards), the experience and abilities of lending staff, the quality of loan review, credit concentrations (by geography, loan type, industry and collateral type), the rate of loan portfolio growth, and changes in legal or regulatory requirements are additional factors that are considered. The total general reserve established for probable incurred losses on unimpaired loans was \$5.683 million at September 30, 2015.

There were no material changes to the methodology used to determine our allowance for loan and lease losses during the three months ended September 30, 2015. We continue to consider the potential impact of drought conditions and lower oil prices on loan losses, in qualitative factors. As we add new products and expand our geographic coverage, and as the economic environment changes, we expect to enhance our methodology to keep pace with the size and complexity of the loan and lease portfolio and respond to pressures created by external forces. We engage outside firms on a regular basis to assess our methodology and perform independent credit reviews of our loan and lease portfolio. In addition, the Company’s external auditors, the FDIC, and the California DBO review the allowance for loan and lease losses as an integral part of their audit and examination processes. Management believes that the current methodology is appropriate given our size and level of complexity.

The tables that follow detail the activity in the allowance for loan and lease losses for the periods noted:

**Allowance for Credit Losses and Recorded Investment in Financing Receivables**

(dollars in thousands, unaudited)

|                                    | Three months ended September 30, 2015 |                          |                              |           |             |             |
|------------------------------------|---------------------------------------|--------------------------|------------------------------|-----------|-------------|-------------|
|                                    | Real Estate                           | Agricultural<br>Products | Commercial and<br>Industrial | Consumer  | Unallocated | Total       |
| Allowance for credit losses:       |                                       |                          |                              |           |             |             |
| Beginning Balance                  | \$5,602                               | \$ 625                   | \$ 2,592                     | \$ 1,404  | \$ 326      | \$10,549    |
| Charge-offs                        | -                                     | -                        | (80 )                        | (522 )    | -           | (602 )      |
| Recoveries                         | 65                                    | 73                       | 65                           | 262       | -           | 465         |
| Provision                          | 14                                    | (25 )                    | (353 )                       | 212       | 152         | -           |
| Ending Balance                     | \$5,681                               | \$ 673                   | \$ 2,224                     | \$ 1,356  | \$ 478      | \$10,412    |
|                                    |                                       |                          |                              |           |             |             |
|                                    | Nine months ended September 30, 2015  |                          |                              |           |             |             |
|                                    | Real Estate                           | Agricultural<br>Products | Commercial and<br>Industrial | Consumer  | Unallocated | Total       |
| Allowance for credit losses:       |                                       |                          |                              |           |             |             |
| Beginning Balance                  | \$6,243                               | \$ 986                   | \$ 1,944                     | \$ 1,765  | \$ 310      | \$11,248    |
| Charge-offs                        | (686 )                                | -                        | (255 )                       | (1,313 )  | -           | (2,254 )    |
| Recoveries                         | 441                                   | 78                       | 189                          | 710       | -           | 1,418       |
| Provision                          | (317 )                                | (391 )                   | 346                          | 194       | 168         | -           |
| Ending Balance                     | \$5,681                               | \$ 673                   | \$ 2,224                     | \$ 1,356  | \$ 478      | \$10,412    |
| Reserves:                          |                                       |                          |                              |           |             |             |
| Specific                           | \$3,620                               | \$ -                     | \$ 753                       | \$ 356    | \$ -        | \$4,729     |
| General                            | 2,061                                 | 673                      | 1,471                        | 1,000     | 478         | 5,683       |
| Ending Balance                     | \$5,681                               | \$ 673                   | \$ 2,224                     | \$ 1,356  | \$ 478      | \$10,412    |
| Loans evaluated for<br>impairment: |                                       |                          |                              |           |             |             |
| Individually                       | \$25,253                              | \$ -                     | \$ 2,695                     | \$ 2,268  | \$ -        | \$30,216    |
| Collectively                       | 726,415                               | 36,820                   | 246,856                      | 13,829    | -           | 1,023,920   |
| Ending Balance                     | \$751,668                             | \$ 36,820                | \$ 249,551                   | \$ 16,097 | \$ -        | \$1,054,136 |

Edgar Filing: SIERRA BANCORP - Form 10-Q

Year ended December 31, 2014

|                                    | Real Estate | Agricultural<br>Products | Commercial and<br>Industrial | Consumer  | Unallocated | Total     |
|------------------------------------|-------------|--------------------------|------------------------------|-----------|-------------|-----------|
| Allowance for credit losses:       |             |                          |                              |           |             |           |
| Beginning Balance                  | \$5,544     | \$ 978                   | \$ 3,787                     | \$ 1,117  | \$ 251      | \$11,677  |
| Charge-offs                        | (1,629 )    | (124 )                   | (625 )                       | (1,837 )  | -           | (4,215 )  |
| Recoveries                         | 1,913       | 6                        | 801                          | 716       | -           | 3,436     |
| Provision                          | 415         | 126                      | (2,019 )                     | 1,769     | 59          | 350       |
| Ending Balance                     | \$6,243     | \$ 986                   | \$ 1,944                     | \$ 1,765  | \$ 310      | \$11,248  |
| Reserves:                          |             |                          |                              |           |             |           |
| Specific                           | \$3,864     | \$ -                     | \$ 916                       | \$ 668    | \$ -        | \$5,448   |
| General                            | 2,379       | 986                      | 1,028                        | 1,097     | 310         | 5,800     |
| Ending Balance                     | \$6,243     | \$ 986                   | \$ 1,944                     | \$ 1,765  | \$ 310      | \$11,248  |
| Loans evaluated for<br>impairment: |             |                          |                              |           |             |           |
| Individually                       | \$30,620    | \$ -                     | \$ 2,916                     | \$ 2,888  | \$ -        | \$36,424  |
| Collectively                       | 673,610     | 27,746                   | 216,876                      | 15,997    | -           | 934,229   |
| Ending Balance                     | \$704,230   | \$ 27,746                | \$ 219,792                   | \$ 18,885 | \$ -        | \$970,653 |

Note 13 – Recent Developments

In July 2014 the Bank entered into a definitive agreement to acquire Santa Clara Valley Bank, a community bank with branches in Santa Paula, Santa Clarita, and Fillmore, California. Subsequent to the receipt of requisite regulatory and shareholder approvals the deal closed on November 14, 2014, and SCVB results of operations were included in the Company's results beginning on the same date. As part of the transaction, cash consideration of \$12.3 million, or \$6.00 per share, was paid to SCVB common shareholders, and \$3.0 million was paid to SCVB preferred shareholders to retire outstanding preferred stock and associated warrants. One-time acquisition costs of \$2.1 million were included in the Company's pre-tax non-interest expense in 2014, and residual acquisition costs totaling \$101,000 have been reflected in pre-tax non-interest expense in 2015.

As of the merger date the SCVB acquisition contributed approximately \$62 million to the Company's outstanding loan balances, \$44 million to investment securities, and \$108 million to total deposits. In accordance with GAAP, assets and liabilities were acquired at their estimated fair values and there was no carryover of the allowance for loan losses that had previously been recorded by SCVB. At the time of the acquisition the Company also recorded a deferred income tax asset of \$2.3 million related primarily to SCVB's net operating loss carry-forward, along with the effects of fair value adjustments resulting from applying the acquisition method of accounting. In accordance with GAAP, the Company recorded \$1.4 million of goodwill and \$1.1 in core deposit intangibles. Goodwill represents the excess of consideration transferred (cash) over the fair values of the identifiable net assets acquired. The core deposit intangible is being amortized on a straight line basis over eight years, commencing at the date of acquisition. Goodwill and core deposit intangibles are not deductible for income tax purposes.

The following table presents unaudited pro forma information as if the acquisition had occurred at the beginning of 2014. The unaudited pro forma information includes adjustments for interest income on loans and securities acquired, amortization of intangibles arising from the transaction, depreciation expense on property acquired, interest expense on deposits acquired, and the related income tax effects. The unaudited pro forma financial information is not necessarily indicative of the results of operations that would have occurred had the transactions been effected on the assumed dates (dollars in thousands):

**Business Combinations - Pro forma Income Statement**

|                     | Pro forma for the quarter<br>ended September 30, 2014 | Pro forma for the nine months<br>ended September 30, 2014 |
|---------------------|---|---|
| Net interest income | \$ 14,285   | \$ 41,551   |
| Net Income          | \$ 3,534  | \$ 11,449   |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|                            |         |         |
|----------------------------|---------|---------|
| Earnings per share basic   | \$ 0.25 | \$ 0.81 |
| Earnings per share diluted | \$ 0.25 | \$ 0.81 |

**PART I - FINANCIAL INFORMATION**

**ITEM 2**

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

**FORWARD-LOOKING STATEMENTS**

This Form 10-Q includes forward-looking statements that involve inherent risks and uncertainties. Words such as “expects”, “anticipates”, “believes”, “projects”, and “estimates” or variations of such words and similar expressions are intended to identify forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, forecast in, or implied by such forward-looking statements.

A variety of factors could have a material adverse impact on the Company's financial condition or results of operations, and should be considered when evaluating the Company's potential future financial performance. They include, but are not limited to, the potential impact of extreme drought conditions on businesses and consumers located in the Company's market areas; unfavorable economic conditions in the Company's service areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; reductions in the market value of available-for-sale securities that could result if interest rates increase substantially or an issuer has real or perceived financial difficulties; the Company's ability to attract and retain skilled employees; the Company's ability to successfully deploy new technology; the success of acquisitions or branch expansion; and risks associated with the multitude of current and prospective laws and regulations to which the Company is and will be subject. Additional risk factors that could cause actual results to differ materially from results that might be implied by forward-looking statements include the risk factors disclosed in the Company's Form 10-K for the fiscal year ended December 31, 2014.

**CRITICAL ACCOUNTING POLICIES**

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management's estimates and judgments, which are based on historical experience and incorporate various assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the allowance for loan and lease losses, as explained in detail in Note 12 to the consolidated financial statements and in the "Provision for Loan and Lease Losses" and "Allowance for Loan and Lease Losses" sections of this discussion and analysis; the valuation of impaired loans and foreclosed assets, as discussed in Note 11 to the consolidated financial statements; income taxes and deferred tax assets and liabilities, especially with regard to the ability of the Company to recover deferred tax assets as discussed in the "Provision for Income Taxes" and "Other Assets" sections of this discussion and analysis; and goodwill and other intangible assets, which are evaluated annually for impairment and for which we have determined that no impairment exists, as discussed in the "Other Assets" section of this discussion and analysis. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate the most recent expectations with regard to those areas.



**OVERVIEW OF THE RESULTS OF OPERATIONS**

**AND FINANCIAL CONDITION**

**results of operations Summary**

**Third Quarter 2015 compared to Third Quarter 2014**

Net income for the quarter ended September 30, 2015 was \$4.410 million, representing an increase of \$859,000, or 24%, relative to net income of \$3.551 million for the quarter ended September 30, 2014. Basic and diluted earnings per share for the third quarter of 2015 were both \$0.33, compared to \$0.25 basic and diluted earnings per share for the third quarter of 2014. The Company's annualized return on average equity was 9.32% and annualized return on average assets was 1.03% for the quarter ended September 30, 2015, compared to 7.51% and 0.95%, respectively, for the quarter ended September 30, 2014. The primary drivers behind the quarter over quarter variance in net income are as follows:

Net interest income was up \$1.585 million, or 12%, for the comparative quarters, due to an increase of \$203 million, or 15%, in average interest-earning assets that was partially offset by the impact of an eleven basis point drop in our net interest margin.

Total non-interest income rose by \$476,000, or 13%, for the quarterly comparison, due in large part to fees earned from increased activity on deposit accounts and gains on investments, partially offset by a drop in income on bank-owned life insurance ("BOLI") and higher pass-through costs on low-income housing tax credit investments.

Total non-interest expense increased \$535,000, or 5%, due in large part to ongoing operating costs related to our acquisition of Santa Clara Valley Bank, other increases in personnel costs, an increase in telecommunications expense, and higher debit card losses, partially offset by reductions in loan costs, non-recurring acquisition costs, and deferred compensation expense (related to the drop in bank-owned life insurance income).

The Company's provision for income taxes was 36% of pre-tax income in the third quarter of 2015 relative to 33% in the third quarter of 2014. The higher tax provisioning in 2015 is primarily the result of higher taxable income and a declining level of available tax credits.

**First Nine Months of 2015 compared to First Nine Months of 2014**

Net income for the first nine months of 2015 was \$12.704 million, representing an increase of \$1.118 million, or 10%, relative to net income of \$11.586 million for the first nine months of 2014. Basic and diluted earnings per share for the first nine months of 2015 were \$0.94 and \$0.93, respectively, compared to \$0.82 basic earnings per share and \$0.81 diluted earnings per share for the first nine months of 2014. The Company's annualized return on average equity was 9.02% and annualized return on average assets was 1.01% for the nine months ended September 30, 2015, compared to a return on equity of 8.33% and return on assets of 1.06% for the nine months ended September 30, 2014. The primary drivers behind the variance in year-to-date net income are as follows:

Net interest income increased \$6.158 million, or 16%, due to a \$216 million increase in average interest-earning assets that was partially offset by a three basis point decline in our net interest margin.

Total non-interest income was up \$1.412 million, or 12%, in the first nine months of 2015 due primarily to fees earned from increased activity on customer deposit accounts, investment gains, and a special dividend on our FHLB stock in the second quarter of 2015, partially offset by a drop in BOLI income.

There was no loan loss provision for the first nine months of 2015, relative to a \$350,000 provision in the first nine months of 2014.

Total non-interest expense increased by \$5.010 million, or 15%, with the year-to-date increase impacted by the same factors as the third quarter comparison, as well as higher core processing costs subsequent to our core system conversion in mid-February 2014, and a \$507,000 unfavorable swing in expenses associated with foreclosed assets due to substantial gains from the sale of OREO in the first quarter of 2014.

The Company's provision for income taxes was 33% of pre-tax income for the first nine months of 2015, relative to 28% for the first nine months of 2014.

Financial Condition Summary

**September 30, 2015 relative to December 31, 2014**

The Company's assets totaled \$1.717 billion at September 30, 2015, relative to total assets of \$1.637 billion at December 31, 2014. Total liabilities were \$1.530 billion at September 30, 2015 compared to \$1.450 billion at the end of 2014, and shareholders' equity totaled \$187 million at both September 30, 2015 and December 31, 2014. The following is a summary of key balance sheet changes during the first nine months of 2015:

The Company's assets increased \$80 million, or 5%, due to growth in loans that was partially offset by slightly lower cash balances and investments.

While declining during the third quarter due to lower utilization on mortgage warehouse lines, gross loans increased by \$83 million, or 9%, for the first nine months of 2015 and ended the period at \$1.054 billion as a result of strong year-to-date growth in mortgage warehouse loans, the first quarter purchase of \$28 million in residential mortgage loans, and organic growth in other non-farm real estate loans and agricultural production loans.

Total nonperforming assets were reduced by \$7 million, or 28%, during the first nine months of 2015. The Company's ratio of nonperforming assets to total loans plus foreclosed assets was 1.69% at September 30, 2015, compared to 2.53% at December 31, 2014.

The Company's deposit balances peaked at the end of June and are down \$43 million since then, but they still reflect net growth of \$62 million, or 5%, during the nine months ended September 30, 2015 due primarily to an increase of \$61 million, or 6%, in core non-maturity deposits. The drop in deposits in the third quarter is due to a combination of factors, including seasonality and our customers' reallocation of resources to other investments and tax payments, among other things. Deposits totaled \$1.429 billion at September 30, 2015.

We increased non-deposit interest-bearing liabilities by \$22 million, or 36%, during the first nine months of 2015 to support our strong loan growth.

Total capital of \$187 million at September 30, 2015 was unchanged relative to the beginning of the year, since the Company's repurchase of shares, the payment of cash dividends, and a drop in accumulated other comprehensive income offset the addition of net income to retained earnings and the impact of stock options exercised during the first nine months of 2015. While still robust, our consolidated total risk-based capital ratio declined to 17.71% at September 30, 2015 from 18.44% at year-end 2014, due to higher risk-adjusted assets resulting from loan growth.

## **EARNINGS PERFORMANCE**

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by loans and investments less interest expense on deposits and other borrowed money. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expense is comprised of operating costs that relate to providing a full range of banking services to our customers.

### **Net interest income AND NET INTEREST MARGIN**

Net interest income increased by \$1.585 million, or 12%, for the third quarter of 2015 relative to the third quarter of 2014, and by \$6.158 million, or 16%, in the first nine months of 2015 compared to the first nine months of 2014. The level of net interest income we recognize in any given period depends on a combination of factors including the average volume and yield for interest-earning assets, the average volume and cost of interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income is also impacted by the reversal of interest for loans placed on non-accrual status during the reporting period, and the recovery of interest on loans that had been on non-accrual and were paid off, sold or returned to accrual status.

The following tables show average balances for significant balance sheet categories and the amount of interest income or interest expense associated with each category for the noted periods. The tables also display the calculated yields on each major component of the Company's investment and loan portfolios, the average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin for the noted periods.

Edgar Filing: SIERRA BANCORP - Form 10-Q

| <u>Average Balances and Rates</u><br>(dollars in thousands, except per share data) | For the three months ended<br>Ended September 30, 2015 |                    |                                      |                  | For the three months ended<br>Ended September 30, 2014 |                    |   |   |
|--|--|--------------------|--------------------------------------|------------------|--|--------------------|---|---|
|  | Average<br>Balance <sup>(1)</sup>                      | Income/<br>Expense | Average<br>Rate/Yield <sup>(2)</sup> | % <sup>(3)</sup> | Average<br>Balance <sup>(1)</sup>                      | Income/<br>Expense | Average<br>Rate/Yield <sup>(2)(3)</sup> | % |
| <b>Assets</b>  |  |                    |                                      |                  |  |                    |   |   |
| <b>Investments:</b>  |  |                    |                                      |                  |  |                    |   |   |
| Federal funds sold/due from time   | \$11,338   | \$7                | 0.24                                 | %                | \$6,149  | \$4                | 0.25                                    | % |
| Taxable  | 405,815  | 1,847              | 1.78                                 | %                | 364,441  | 2,008              | 2.16                                    | % |
| Non-taxable  | 100,352  | 746                | 4.48                                 | %                | 97,819   | 729                | 4.49                                    | % |
| Total investments  | 517,505  | 2,600              | 2.27                                 | %                | 468,409  | 2,741              | 2.62                                    | % |
| <b><u>Loans and Leases:</u><sup>(4)</sup></b>                                      |  |                    |                                      |                  |  |                    |   |   |
| Real estate  | 739,583  | 9,608              | 5.15                                 | %                | 641,766  | 8,403              | 5.19                                    | % |
| Agricultural   | 33,305   | 346                | 4.12                                 | %                | 25,926   | 244                | 3.73                                    | % |
| Commercial   | 106,526  | 1,212              | 4.51                                 | %                | 98,552   | 1,078              | 4.34                                    | % |
| Consumer   | 16,548   | 430                | 10.31                                | %                | 20,297   | 501                | 9.79                                    | % |
| Mortgage warehouse lines   | 138,657  | 1,271              | 3.64                                 | %                | 95,323   | 966                | 4.02                                    | % |
| Direct financing leases  | 1,813  | 24                 | 5.25                                 | %                | 2,266  | 31                 | 5.43                                    | % |
| Other  | 2,008  | 33                 | 6.52                                 | %                | 305  | 14                 | 18.21                                   | % |
| Total loans and leases   | 1,038,440  | 12,924             | 4.94                                 | %                | 884,435  | 11,237             | 5.04                                    | % |
| Total interest earning assets <sup>(5)</sup>                                       | 1,555,945  | 15,524             | 4.06                                 | %                | 1,352,844  | 13,978             | 4.10                                    | % |
| Other earning assets   | 7,546  |                    |                                      |                  | 6,122  |                    |   |   |
| Non-earning assets   | 138,800  |                    |                                      |                  | 126,454  |                    |   |   |
| Total assets   | \$1,702,291  |                    |                                      |                  | \$1,485,420  |                    |   |   |
| <b>Liabilities and shareholders' equity</b>  |  |                    |                                      |                  |  |                    |   |   |
| <b>Interest bearing deposits:</b>  |  |                    |                                      |                  |  |                    |   |   |
| Demand deposits  | \$130,932  | \$97               | 0.29                                 | %                | \$109,825  | \$76               | 0.27                                    | % |
| NOW  | 293,575  | 86                 | 0.12                                 | %                | 251,825  | 84                 | 0.13                                    | % |
| Savings accounts   | 191,776  | 54                 | 0.11                                 | %                | 153,670  | 44                 | 0.11                                    | % |
| Money market   | 106,373  | 19                 | 0.07                                 | %                | 74,014   | 16                 | 0.09                                    | % |
| CDAR's   | 11,605   | 2                  | 0.07                                 | %                | 12,817   | 8                  | 0.25                                    | % |
| Certificates of deposit<\$100,000  | 75,770   | 60                 | 0.31                                 | %                | 75,713   | 80                 | 0.42                                    | % |
| Certificates of deposit≥\$100,000  | 219,034  | 134                | 0.24                                 | %                | 199,666  | 172                | 0.34                                    | % |
| Brokered deposits  | -  | -                  | 0.00                                 | %                | 6,337  | 23                 | 1.44                                    | % |
| Total interest bearing deposits  | 1,029,065  | 452                | 0.17                                 | %                | 883,867  | 503                | 0.23                                    | % |
| <b>Borrowed Funds:</b>   |  |                    |                                      |                  |  |                    |   |   |
| Federal funds purchased  | 17   | -                  | -                                    |                  | 1  | -                  | -                                       |   |
| Repurchase agreements  | 10,093   | 10                 | 0.39                                 | %                | 5,289  | 5                  | 0.38                                    | % |
| Short term borrowings  | 3,915  | 2                  | 0.20                                 | %                | 6,413  | 1                  | 0.06                                    | % |
| Long term borrowings   | 2,000  | 2                  | 0.40                                 | %                | -  | -                  | -                                       |   |
| TRUPS  | 30,928   | 181                | 2.32                                 | %                | 30,928   | 177                | 2.27                                    | % |
| Total borrowed funds   | 46,953   | 195                | 1.65                                 | %                | 42,631   | 183                | 1.70                                    | % |
| Total interest bearing liabilities   | 1,076,018  | 647                | 0.24                                 | %                | 926,498  | 686                | 0.29                                    | % |
| Demand deposits - non-interest bearing   | 423,789  |                    |                                      |                  | 355,994  |                    |   |   |
| Other liabilities  | 14,788   |                    |                                      |                  | 15,320   |                    |   |   |
| Shareholders' equity   | 187,696  |                    |                                      |                  | 187,608  |                    |   |   |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|   |              |      |   |              |      |   |
|---|--------------|------|---|--------------|------|---|
| Total liabilities and shareholders' equity          | \$ 1,702,291 |      |   | \$ 1,485,420 |      |   |
| Interest income/interest earning assets             |              | 4.06 | % |              | 4.21 | % |
| Interest expense/interest earning assets            |              | 0.16 | % |              | 0.20 | % |
| <b>Net interest income and margin<sup>(6)</sup></b> | \$ 14,877    | 3.90 | % | \$ 13,292    | 4.01 | % |

(1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(2) Yields and net interest margin have been computed on a tax equivalent basis utilizing a 35% effective tax rate.

(3) Annualized

Loan costs have been included in the calculation of interest income. Loan costs were approximately \$56 thousand (4) and \$259 thousand for the quarters ended September 30, 2015 and 2014. Loans are gross of the allowance for possible loan losses.

(5) Non-accrual loans have been included in total loans for purposes of total earning assets.

(6) Net interest margin represents net interest income as a percentage of average interest-earning assets.

Edgar Filing: SIERRA BANCORP - Form 10-Q

| <u>Average Balances and Rates</u><br>(dollars in thousands, except per share data) | For the nine months ended         |                    |   |   | For the nine months ended         |                    |   |   |
|--|-----------------------------------|--------------------|---|---|-----------------------------------|--------------------|---|---|
|  | September 30, 2015                |                    |   |   | September 30, 2014                |                    |   |   |
|  | Average<br>Balance <sup>(1)</sup> | Income/<br>Expense | Average<br>Rate/Yield <sup>(2)(3)</sup> |   | Average<br>Balance <sup>(1)</sup> | Income/<br>Expense | Average<br>Rate/Yield <sup>(2)(3)</sup> |   |
| <b>Assets</b>  |                                   |                    |   |   |                                   |                    |   |   |
| <b>Investments:</b>  |                                   |                    |   |   |                                   |                    |   |   |
| Federal funds sold/Due from time   | \$12,943                          | \$26               | 0.26                                    | % | \$28,239                          | \$55               | 0.26                                    | % |
| Taxable  | 408,609                           | 6,191              | 2.00                                    | % | 354,033                           | 5,709              | 2.13                                    | % |
| Non-taxable  | 99,222                            | 2,202              | 4.50                                    | % | 97,193                            | 2,203              | 4.60                                    | % |
| Total Investments  | 520,774                           | 8,419              | 2.43                                    | % | 479,465                           | 7,967              | 2.52                                    | % |
| <b><u>Loans and Leases:</u><sup>(4)</sup></b>                                      |                                   |                    |   |   |                                   |                    |   |   |
| Real Estate  | 715,300                           | 28,048             | 5.24                                    | % | 618,600                           | 24,626             | 5.32                                    | % |
| Agricultural   | 29,850                            | 915                | 4.10                                    | % | 24,798                            | 737                | 3.97                                    | % |
| Commercial   | 107,514                           | 3,751              | 4.66                                    | % | 97,493                            | 3,253              | 4.46                                    | % |
| Consumer   | 17,401                            | 1,273              | 9.78                                    | % | 21,747                            | 1,469              | 9.03                                    | % |
| Mortgage Warehouse Lines   | 142,832                           | 3,965              | 3.71                                    | % | 77,343                            | 2,429              | 4.20                                    | % |
| Direct Financing Leases  | 1,926                             | 76                 | 5.28                                    | % | 2,367                             | 96                 | 5.42                                    | % |
| Other  | 2,100                             | 96                 | 6.11                                    | % | 293                               | 34                 | 15.51                                   | % |
| Total Loans and Leases   | 1,016,923                         | 38,124             | 5.01                                    | % | 842,641                           | 32,644             | 5.18                                    | % |
| Total Interest Earning Assets <sup>(5)</sup>                                       | 1,537,697                         | 46,543             | 4.15                                    | % | 1,322,106                         | 40,611             | 4.23                                    | % |
| Other Earning Assets   | 7,330                             |                    |   |   | 6,043                             |                    |   |   |
| Non-Earning Assets   | 138,318                           |                    |   |   | 129,603                           |                    |   |   |
| Total Assets   | \$1,683,345                       |                    |   |   | \$1,457,752                       |                    |   |   |
| <b>Liabilities and Shareholders' Equity</b>  |                                   |                    |   |   |                                   |                    |   |   |
| <b>Interest Bearing Deposits:</b>  |                                   |                    |   |   |                                   |                    |   |   |
| Demand Deposits  | \$122,329                         | \$270              | 0.30                                    | % | \$104,481                         | \$209              | 0.27                                    | % |
| NOW  | 290,102                           | 258                | 0.12                                    | % | 239,614                           | 253                | 0.14                                    | % |
| Savings Accounts   | 184,303                           | 154                | 0.11                                    | % | 151,362                           | 195                | 0.17                                    | % |
| Money Market   | 111,916                           | 61                 | 0.07                                    | % | 73,035                            | 57                 | 0.10                                    | % |
| CDAR's   | 11,392                            | 6                  | 0.07                                    | % | 12,999                            | 24                 | 0.25                                    | % |
| Certificates of Deposit<\$100,000  | 77,639                            | 187                | 0.32                                    | % | 77,797                            | 258                | 0.44                                    | % |
| Certificates of Deposit≥\$100,000  | 215,095                           | 398                | 0.25                                    | % | 201,697                           | 546                | 0.36                                    | % |
| Brokered Deposits  | 861                               | 11                 | 1.71                                    | % | 6,256                             | 72                 | 1.54                                    | % |
| Total Interest Bearing Deposits  | 1,013,637                         | 1,345              | 0.18                                    | % | 867,241                           | 1,614              | 0.25                                    | % |
| <b>Borrowed Funds:</b>   |                                   |                    |   |   |                                   |                    |   |   |
| Federal Funds Purchased  | 8                                 | -                  | -                                       |   | 15                                | -                  | -                                       |   |
| Repurchase Agreements  | 8,498                             | 25                 | 0.39                                    | % | 5,753                             | 14                 | 0.33                                    | % |
| Short Term Borrowings  | 13,259                            | 18                 | 0.18                                    | % | 2,408                             | 2                  | 0.11                                    | % |
| Long Term Borrowings   | 2,674                             | 9                  | 0.45                                    | % | -                                 | -                  | -                                       |   |
| TRUPS  | 30,928                            | 533                | 2.30                                    | % | 30,928                            | 526                | 2.27                                    | % |
| Total Borrowed Funds   | 55,367                            | 585                | 1.41                                    | % | 39,104                            | 542                | 1.85                                    | % |
| Total Interest Bearing Liabilities   | 1,069,004                         | 1,930              | 0.24                                    | % | 906,345                           | 2,156              | 0.32                                    | % |
| Demand deposits- non interest bearing  | 410,955                           |                    |   |   | 347,941                           |                    |   |   |
| Other liabilities  | 15,101                            |                    |   |   | 17,416                            |                    |   |   |
| Shareholders' equity   | 188,285                           |                    |   |   | 186,050                           |                    |   |   |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|   |             |      |   |             |      |   |
|---|-------------|------|---|-------------|------|---|
| Total liabilities and shareholders' equity          | \$1,683,345 |      |   | \$1,457,752 |      |   |
| Interest Income/Interest Earning Assets             |             | 4.15 | % |             | 4.23 | % |
| Interest Expense/Interest Earning Assets            |             | 0.17 | % |             | 0.22 | % |
| <b>Net Interest Income and Margin<sup>(6)</sup></b> | \$44,613    | 3.98 | % | \$38,455    | 4.01 | % |

(1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(2) Yields and net interest margin have been computed on a tax equivalent basis utilizing a 35% effective tax rate.

(3) Annualized

Loan costs have been included in the calculation of interest income. Loan costs were approximately \$(303) thousand and \$608 thousand for the nine months ended September 30, 2015 and 2014. Loans are gross of the allowance for possible loan losses.

(5) Non-accrual loans have been included in total loans for purposes of total earning assets.

(6) Net interest margin represents net interest income as a percentage of average interest-earning assets.



The Volume and Rate Variances table below sets forth the dollar difference for the comparative periods in interest earned or paid for each major category of interest-earning assets and interest-bearing liabilities, and the amount of such change attributable to fluctuations in average balances (volume) or differences in average interest rates. Volume variances are equal to the increase or decrease in average balances multiplied by prior period rates, and rate variances are equal to the increase or decrease in rates multiplied by prior period average balances. Variances attributable to both rate and volume changes, calculated by multiplying the change in rates by the change in average balances, have been allocated to the rate variance.

| <u>Volume &amp; Rate Variances</u><br>(dollars in thousands) | Three months ended September 30,<br>2015 over 2014 |           |          | Nine months ended September 30,<br>2015 over 2014 |             |          |
|--|--|-----------|----------|---|-------------|----------|
|  | Increase(decrease) due to<br>Volume                | Rate      | Net      | Increase(decrease) due to<br>Volume               | Rate        | Net      |
| <b>Assets:</b>   |  |           |          |   |             |          |
| <b>Investments:</b>  |  |           |          |   |             |          |
| Federal funds sold / Due from time                           | \$ 3   | \$ -      | \$ 3     | \$ (30 )  | \$ 1        | \$ (29 ) |
| Taxable  | 228  | (389 )    | (161 )   | 880   | (398 )      | 482      |
| Non-taxable <sup>(1)</sup>                                   | 19   | (2 )      | 17       | 46  | (47 )       | (1 )     |
| Total Investments  | 250  | (391 )    | (141 )   | 896   | (444 )      | 452      |
| <b>Loans and Leases:</b>                                     |  |           |          |   |             |          |
| Real Estate  | 1,281  | (76 )     | 1,205    | 3,850   | (428 )      | 3,422    |
| Agricultural   | 69   | 33        | 102      | 150   | 28          | 178      |
| Commercial   | 87   | 47        | 134      | 334   | 164         | 498      |
| Consumer   | (93 )  | 22        | (71 )    | (294 )  | 98          | (196 )   |
| Mortgage Warehouse   | 439  | (134 )    | 305      | 2,057   | (521 )      | 1,536    |
| Direct Financing Leases                                      | (6 )   | (1 )      | (7 )     | (18 )   | (2 )        | (20 )    |
| Other  | 78   | (59 )     | 19       | 210   | (148 )      | 62       |
| Total Loans and Leases                                       | 1,855  | (168 )    | 1,687    | 6,289   | (809 )      | 5,480    |
| Total Interest Earning Assets                                | \$ 2,105   | \$ (559 ) | \$ 1,546 | \$ 7,185  | \$ (1,253 ) | \$ 5,932 |
| <b>Liabilities</b>   |  |           |          |   |             |          |
| <b>Interest Bearing Deposits:</b>                            |  |           |          |   |             |          |
| Demand Deposits  | \$ 15  | \$ 6      | \$ 21    | \$ 36   | \$ 25       | \$ 61    |
| NOW  | 14   | (12 )     | 2        | 53  | (48 )       | 5        |
| Savings Accounts   | 11   | (1 )      | 10       | 42  | (83 )       | (41 )    |
| Money Market   | 7  | (4 )      | 3        | 30  | (26 )       | 4        |
| CDAR's   | (1 )   | (5 )      | (6 )     | (3 )  | (15 )       | (18 )    |
| Certificates of Deposit < \$100,000                          | -  | (20 )     | (20 )    | (1 )  | (70 )       | (71 )    |
| Certificates of Deposit ≥ \$100,000                          | 17   | (55 )     | (38 )    | 36  | (184 )      | (148 )   |
| Brokered Deposits  | (23 )  | -         | (23 )    | (62 )   | 1           | (61 )    |
| Total Interest Bearing Deposits                              | 40   | (91 )     | (51 )    | 131   | (400 )      | (269 )   |
| <b>Borrowed Funds:</b>                                       |  |           |          |   |             |          |
| Federal Funds Purchased                                      | -  | -         | -        | -   | -           | -        |
| Repurchase Agreements  | 5  | -         | 5        | 7   | 4           | 11       |
| Short Term Borrowings  | -  | 1         | 1        | 9   | 7           | 16       |
| Long Term Borrowings   | -  | 2         | 2        | -   | 9           | 9        |
| TRUPS  | -  | 4         | 4        | -   | 7           | 7        |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|                                    |          |           |          |          |           |          |
|------------------------------------|----------|-----------|----------|----------|-----------|----------|
| Total Borrowed Funds               | 5        | 7         | 12       | 16       | 27        | 43       |
| Total Interest Bearing Liabilities | 45       | (84 )     | (39 )    | 147      | (373 )    | (226 )   |
| Net Interest Margin/Income         | \$ 2,060 | \$ (475 ) | \$ 1,585 | \$ 7,038 | \$ (880 ) | \$ 6,158 |

(1) Yields on tax exempt income have not been computed on a tax equivalent basis.

The volume variance calculated for the third quarter of 2015 relative to the third quarter of 2014 was a favorable \$2.060 million, due primarily to a \$203 million increase in the average balance of interest-earning assets resulting from our acquisition of Santa Clara Valley Bank, organic growth, and loan purchases. The volume variance for the comparative quarters was enhanced by the fact that the average balance of loans grew by 17% relative to only 10% growth in the average balance of lower-yielding investments, but was unfavorably impacted by the fact that much of the growth in average loan balances occurred in lower-yielding mortgage warehouse loans.

The rate variance for the quarter over quarter comparison was an unfavorable \$475,000, due in part to a drop of 15 basis points in our yield on earning assets relative to a decline of only five basis points in the cost of interest-bearing liabilities. Investment yields have dropped due to the reinvestment of portfolio cash flows in a historically low interest rate environment, and the weighted average yield on loans was lower due to the impact of continued competition on loan rates and relatively robust growth in lower-yielding mortgage warehouse loans. Our weighted average cost of interest-bearing liabilities was lower for the quarter primarily because of lower deposit rates. The unfavorable rate variance was exacerbated by the allocation of the variance attributable to both rate and volume changes (as per the calculations noted above), and also by the volume differential between our interest-earning assets and interest-bearing liabilities. That differential averaged \$426 million for the third quarter of 2014, the base period for the rate variance calculation, thus the decrease in our earning asset yield was applied to a much higher balance than the rate decrease for interest-bearing liabilities and had a greater impact on net interest income.

The Company's net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, is affected by the same factors discussed above relative to rate and volume variances. Our net interest margin was 3.90% in the third quarter of 2015, a drop of 11 basis points relative to the third quarter of 2014. The principal developments impacting our net interest margin in the third quarter of 2015 include lower yields on loans and investments, and a shift within loans to lower-yielding loan segments. Lower deposit rates helped partially offset those negative factors. Nonrecurring interest income, primarily in the form of interest recovered on non-accrual loans (net of interest reversed on loans placed on non-accrual status), totaled \$102,000 in the third quarter of 2015 relative to \$135,000 in the third quarter of 2014.

For net interest income in the first nine months of 2015 relative to the first nine months of 2014, a favorable variance of \$7.038 million attributable to volume changes was partially offset by an unfavorable rate variance of \$880,000. The volume variance for the year-to-date period was due primarily to a \$216 million increase in average interest-earning assets, which was enhanced by a shift from Federal Reserve Bank balances into investment securities and strong growth in the average balance of loans relative to investments. While our cost of interest-bearing liabilities and our yield on earning assets were both down by eight basis points for the comparative year-to-date periods, there was a negative rate variance because the decrease in our yield on earning assets was applied to a much higher balance than the rate decrease for interest-bearing liabilities and had a greater impact on net interest income, and because the variance attributable to both rate and volume changes was allocated to the rate variance. The weighted average yield on interest-earning assets dropped due to lower loan yields resulting from continued competition for quality loans. However, partially alleviating the negative pressures on loan rates for the year-to-date period was higher non-recurring interest income such as net interest recovered on non-accrual loans and prepayment penalties, which totaled \$513,000 in the first nine months of 2015 relative to \$423,000 in the first nine months of 2014. The Company's net interest

margin for the first nine months of 2015 was 3.98%, three basis points lower than our net interest margin for the first nine months of 2014.

#### Provision for loan and LEASE losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses, a contra-asset account, through periodic charges to earnings which are reflected in the income statement as the provision for loan and lease losses. A loan loss provision has not been necessary thus far in 2015 and a provision was not recorded in the third quarter of 2014, but there was a loan loss provision of \$350,000 for the first nine months of 2014.

The Company's loan loss provision has been sufficient to maintain our allowance for loan and lease losses at a level that, in Management's judgment, is adequate to absorb probable loan losses related to specifically-identified impaired loans as well as probable incurred losses in the remaining loan portfolio. Specifically identifiable and quantifiable loan losses are immediately charged off against the allowance. Net loans charged off by the Company totaled \$137,000 in the third quarter of 2015 relative to \$622,000 in the third quarter of 2014, for a reduction of \$485,000, or 78%, and net charge-offs were \$836,000 in the first nine months of 2015 relative to \$1.015 million in the first nine months of 2014, for a reduction of \$179,000, or 18%. A loan loss provision has not been recorded in 2015 due to the following factors: loan charge-offs were primarily recorded against reserves established in previous periods and did not necessitate reserve replenishment; loan growth occurred in portfolio segments with low historical loss rates; and, credit quality improvement was evident in the remainder of the loan portfolio.

The Company's policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed in note 12 to the consolidated financial statements and below under "Allowance for Loan and Lease Losses." The process utilized to establish an appropriate allowance for loan and lease losses can result in a high degree of variability in the Company's loan loss provision, and consequently in our net earnings.

#### NON-INTEREST INCOME and NON-INTEREST expense

The following table provides details on the Company's non-interest income and non-interest expense for the three-month and nine-month periods ended September 30, 2015 and 2014 (dollars in thousands):

#### Non Interest Income/Expense

(dollars in thousands, unaudited)

|  | For the three months ended September 30, |            |         |            | For the nine months ended September 30, |            |          |            |
|--|--|------------|---------|------------|---|------------|----------|------------|
|  | 2015                                     | % of Total | 2014    | % of Total | 2015                                    | % of Total | 2014     | % of Total |
| <b>NON-INTEREST INCOME:</b>                              |  |            |         |            |   |            |          |            |
| Service charges on deposit accounts                      | \$2,611                                  | 61.28 %    | \$2,214 | 58.49 %    | \$6,880                                 | 53.24 %    | \$6,139  | 53.34 %    |
| Other service charges, commissions & fees                | 1,714                                    | 40.23 %    | 1,538   | 40.63 %    | 5,186                                   | 40.13 %    | 4,630    | 40.23 %    |
| Gains on securities                                      | 108                                      | 2.53 %     | -       | -          | 431                                     | 3.34 %     | 287      | 2.49 %     |
| Bank owned life insurance                                | (93 )                                    | -2.18 %    | 156     | 4.12 %     | 495                                     | 3.83 %     | 844      | 7.33 %     |
| Other  | (79 )                                    | -1.86 %    | (123 )  | -3.24 %    | (70 )                                   | -0.54 %    | (390 )   | -3.39 %    |
| Total non-interest income                                | \$4,261                                  | 100.00 %   | \$3,785 | 100.00 %   | \$12,922                                | 100.00 %   | \$11,510 | 100.00 %   |
| As a % of average interest-earning assets <sup>(1)</sup> |  | 1.09 %     |         | 1.11 %     |   | 1.12 %     |          | 1.16 %     |
| <b>OTHER OPERATING EXPENSE:</b>                          |  |            |         |            |   |            |          |            |
|  | \$5,904                                  | 48.06 %    | \$5,459 | 46.46 %    | \$18,924                                | 49.16 %    | \$16,772 | 50.09 %    |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|  |          |        |   |          |        |   |          |        |   |          |        |   |
|--|----------|--------|---|----------|--------|---|----------|--------|---|----------|--------|---|
| Salaries and employee benefits                           |          |        |   |          |        |   |          |        |   |          |        |   |
| Occupancy costs  |          |        |   |          |        |   |          |        |   |          |        |   |
| Furniture & equipment                                    | 515      | 4.19   | % | 458      | 3.90   | % | 1,527    | 3.97   | % | 1,378    | 4.12   | % |
| Premises   | 1,319    | 10.74  | % | 1,204    | 10.25  | % | 3,633    | 9.44   | % | 3,322    | 9.92   | % |
| Advertising and marketing costs                          | 425      | 3.46   | % | 468      | 3.98   | % | 1,671    | 4.34   | % | 1,679    | 5.01   | % |
| Data processing costs                                    | 791      | 6.44   | % | 673      | 5.73   | % | 2,488    | 6.46   | % | 1,937    | 5.78   | % |
| Deposit services costs                                   | 872      | 7.10   | % | 657      | 5.59   | % | 2,421    | 6.29   | % | 1,935    | 5.78   | % |
| Loan services costs                                      |          |        |   |          |        |   |          |        |   |          |        |   |
| Loan processing  | 259      | 2.11   | % | 572      | 4.87   | % | 743      | 1.93   | % | 1,033    | 3.08   | % |
| Foreclosed assets  | (64 )    | -0.52  | % | 51       | 0.43   | % | 173      | 0.45   | % | (334 )   | -1.00  | % |
| Other operating costs                                    |          |        |   |          |        |   |          |        |   |          |        |   |
| Telephone & data communications                          | 455      | 3.70   | % | 329      | 2.80   | % | 1,435    | 3.73   | % | 804      | 2.40   | % |
| Postage & mail   | 287      | 2.34   | % | 221      | 1.88   | % | 739      | 1.92   | % | 571      | 1.71   | % |
| Other  | 210      | 1.70   | % | 147      | 1.25   | % | 588      | 1.53   | % | 499      | 1.49   | % |
| Professional services costs                              |          |        |   |          |        |   |          |        |   |          |        |   |
| Legal & accounting                                       | 405      | 3.30   | % | 310      | 2.64   | % | 1,114    | 2.89   | % | 952      | 2.84   | % |
| Other professional service                               | 255      | 2.08   | % | 744      | 6.33   | % | 1,299    | 3.37   | % | 1,791    | 5.35   | % |
| Stationery & supply costs                                | 361      | 2.94   | % | 331      | 2.82   | % | 1,022    | 2.65   | % | 859      | 2.57   | % |
| Sundry & tellers   | 291      | 2.36   | % | 126      | 1.07   | % | 719      | 1.87   | % | 288      | 0.86   | % |
| Total non-interest expense                               | \$12,285 | 100.00 | % | \$11,750 | 100.00 | % | \$38,496 | 100.00 | % | \$33,486 | 100.00 | % |
| As a % of average interest-earning assets <sup>(1)</sup> |          | 3.13   | % |          | 3.45   | % |          | 3.35   | % |          | 3.39   | % |
| Efficiency Ratio <sup>(2)</sup>                          | 63.38    | %      |   | 66.94    | %      |   | 65.74    | %      |   | 65.25    | %      |   |

(1) Annualized

(2) Tax Equivalent

Total non-interest income rose by \$476,000, or 13%, for the quarterly comparison and \$1.412 million, or 12%, for the comparative year-to-date periods due in large part to a higher level of customer activity that generated additional fee income, investment gains, and higher dividends on restricted stock. The increases were offset in part by a drop in BOLI income and, for the third quarter, higher pass-through costs on our low-income housing tax credit investments. Total non-interest income was an annualized 1.09% of average interest-earning assets in the third quarter of 2015 relative to 1.11% in the third quarter of 2014, and was 1.12% for the first nine months of 2015 relative to 1.16% for the first nine months of 2014. The lower ratio is due to an increase in average interest-earning assets.

Service charge income on deposits increased by \$397,000, or 18%, for the quarterly comparison and by \$741,000, or 12%, for the year-to-date comparison due primarily to fees earned from increased activity on commercial accounts and higher overdraft income. The year-to-date comparison was also favorably impacted by certain non-recurring fee waivers made in the course of our core software conversion in the first quarter of 2014. Other service charges, commissions, and fees increased by \$176,000, or 11%, for the third quarter and \$556,000, or 12%, for the first nine months, largely as a result of higher debit card interchange income and increases in other activity-based fees. Gains realized on the sale of investment securities totaled \$108,000 in the third quarter of 2015 relative to no investment gains in the third quarter of 2014. For the first nine months, investment gains totaled \$431,000 in 2015 compared to \$287,000 in 2014, for an increase of \$144,000.

Bank-owned life insurance (“BOLI”) income was down \$249,000 in the third quarter of 2015 relative to the third quarter of 2014, and also dropped by \$349,000 for the year-to-date comparison mainly due to fluctuations in income on BOLI associated with deferred compensation plans. The Company owns and derives income from two basic types of BOLI: “general account” and “separate account.” At September 30, 2015 the Company had \$39.0 million invested in single-premium general account BOLI, which generates income that is used to fund expenses associated with executive salary continuation plans, director retirement plans and other employee benefits. Interest credit rates on general account BOLI do not change frequently and the income is typically fairly consistent, but rate reductions have led to slightly lower income levels in recent periods. In addition to general account BOLI the Company had \$4.6 million invested in separate account BOLI at September 30, 2015, which produces income that helps offset deferred compensation accruals for certain directors and senior officers. These deferred compensation BOLI accounts have returns pegged to participant-directed investment allocations that can include equity, bond, or real estate indices, and are thus subject to gains or losses which often contribute to significant fluctuations in income (and associated expense accruals). There was a loss on separate account BOLI totaling \$337,000 in the third quarter of 2015 relative to a loss of \$82,000 in the third quarter of 2014, for a quarter over quarter drop of \$255,000 in deferred compensation BOLI income. For the first nine months, there was a \$229,000 loss in 2015 compared to a gain of \$115,000 in 2014, for an absolute difference of \$344,000. As noted, gains and losses on separate account BOLI are related to expense accruals or reversals associated with participant gains and losses on deferred compensation balances, thus their impact on taxable income tends to be neutral.

The “Other” category under non-interest income reflects net favorable changes of \$44,000 for the quarter and \$320,000 for the year-to-date period. This category includes gains and losses on the disposition of assets other than OREO, rent on bank-owned property other than OREO, dividends on restricted stock, and other miscellaneous income. Pass-through expenses associated with our investments in low-income housing tax credit funds are netted against this

income category. Income generated through the Company's alliance with Investment Centers of America ("ICA") has also been included in other non-interest income, but the Company terminated its affiliation with ICA effective July 31, 2014 so related income was down \$10,000 for the third quarter of 2015 compared to the third quarter of 2014, and also declined \$68,000 for the comparative year-to-date periods. However, dividends on restricted stock increased by \$110,000 for the quarter and \$428,000 for the first nine months, with the year-to-date increase including a \$245,000 special dividend received on our FHLB stock in the second quarter of 2015 and the quarterly increase resulting from dividends received on another illiquid equity investment. Pass-through expenses on our low-income housing tax credit funds increased by \$58,000 for the third quarter comparison and thus partially offset income increases in other areas, but these expenses were down slightly for the first nine months.

Total non-interest expense increased by \$535,000, or 5%, in the third quarter of 2015 relative to the third quarter of 2014, and \$5.010 million, or 15%, for the first nine months of 2015 in comparison to the first nine months of 2014. As detailed below the largest increases are in personnel costs, telecommunications expense, other ongoing operating costs incidental to our November 2014 acquisition and February 2014 core banking system conversion, debit card losses, and, for the year-to-date comparison, net expenses associated with foreclosed assets and data processing costs. Despite higher overhead expenses, total non-interest expense dropped to an annualized 3.13% of average interest-earning assets in the third quarter of 2015 from 3.45% in the third quarter of 2014 due to a sizeable increase in the denominator. For the first nine months, the ratio fell to 3.35% in 2015 from 3.39% for 2014.



The largest component of non-interest expense, salaries and employee benefits, increased by \$445,000, or 8%, for the quarter and \$2.152 million, or 13%, for the first nine months due primarily to personnel increases associated with our acquisition, regular annual salary increases, strategic additions to business development staff in 2015, an increased accrual for Company contributions to the employee 401(k) retirement plan, and higher group health insurance premiums. A higher level of deferred salaries directly related to successful loan originations partially offset the increase in other compensation costs in 2015, and the year-to-date comparison was also favorably impacted by a drop in temporary help and overtime costs related to the impact of our core banking system conversion in the first quarter of 2014. The change in salaries and benefits benefitted further from lower deferred compensation accruals in 2015, associated with the aforementioned drop in BOLI income. We recorded a deferred compensation expense reversals of \$93,000 in the third quarter of 2015 and \$44,000 in the third quarter of 2014 due to losses on employee deferred compensation plans, for a quarter-over-quarter reduction of \$49,000 in compensation costs. For the first nine months of 2015 there was also a net deferred compensation expense accrual reversal of \$27,000, but an expense accrual of \$105,000 was recorded for the first nine months of 2014 for an absolute difference of \$132,000 between the comparative periods. Despite their overall dollar increase, salaries and benefits dropped as a percentage of total non-interest expense for the comparative year-to-date periods due to a higher percentage increase in total non-interest expense.

Occupancy expense increased by \$172,000 for the quarter and \$460,000 for the year-to-date period, representing increases of 10% for both periods due primarily to the three branches added via our acquisition in November 2014 and our loan production office opened in May 2015, with associated expenses including but not limited to rent and depreciation, utilities, janitorial, and security. Marketing costs were down \$43,000, or 9%, for the third quarter but were about the same for the first nine months of 2015 relative to 2014. Data processing costs were up \$118,000, or 18%, for the third quarter due to ongoing costs related to the acquisition and our loan production office, and they increased \$551,000, or 28%, for the year-to-date period as a result of an increase in our cost structure subsequent to the core processing conversion in the first quarter of 2014 and the additional offices. Total deposit services costs increased by \$215,000, or 33%, for the quarterly comparison and by \$486,000, or 25%, for the first nine months due in part to amortization expense on our core deposit intangible totaling \$34,000 for the quarter and \$101,000 for the first nine months, in addition to increases in internet banking, electronic check exchange, and debit card processing costs.

Loan processing costs were down \$313,000, or 55%, for the third quarter and \$290,000, or 28%, for the first nine months due primarily to lower loan sale costs and a reduction in expenditures for appraisals. Net costs associated with foreclosed assets fell by \$115,000 for the third quarter comparison, but increased by \$507,000 in the first nine months of 2015 relative to the first nine months of 2014. Net costs on foreclosed assets increased for the year-to-date period due to net gains on the sale of OREO totaling \$166,000 in 2015 relative to net gains of \$904,000 in 2014, partially offset by the favorable impact of lower write-downs and declining OREO operating expense in 2015.

Telecommunications expense increased by \$126,000, or 38%, in the third quarter of 2015 relative to the third quarter of 2014, and by \$631,000, or 78%, for the first nine months, due in part to increased expenses associated with the SCVB acquisition and our new loan production office, as well as upgraded circuits and certain redundant circuits that will ultimately be consolidated. The year-to-date increase further reflects credits received in 2014 for prior-period

overpayments totaling \$155,000. Postage costs also increased by \$66,000, or 30%, for the quarterly comparison and \$168,000, or 29%, for the first nine months due to an increase in the volume of mailings related to compliance requirements, monthly statements, and customer education. The “Other” category under other operating costs was up by \$63,000 for the third quarter and \$89,000 for the first nine months, due higher training and education costs and, for the quarter, an increase in recruiting costs.

Under professional services costs, legal and accounting costs increased by \$95,000, or 31%, in the third quarter of 2015 and by \$162,000, or 17%, for the first nine months due to higher costs for both internal and independent audits as well as increased legal expense. The cost of other professional services declined by \$489,000, or 66%, for the quarter and \$492,000, or 27%, the year-to-date period, due to reductions in non-recurring acquisition costs totaling \$267,000 for the third quarter and \$166,000 for the first nine months, lower expense accruals for regulatory assessments, and lower directors deferred compensation expense accruals. As with the deferred compensation accruals included with compensation expense, directors deferred compensation accruals are associated with BOLI income. Due to losses on deferred compensation plans we recorded deferred compensation expense reversals against director costs totaling \$172,000 in the third quarter and \$63,000 in the first nine months of 2015, relative to expense accruals in 2014 of \$11,000 for the third quarter \$113,000 for the first nine months. Stationery and supply costs increased by \$30,000, or 9%, for the third quarter and by \$163,000, or 19%, for the first nine months, primarily due to higher recurring costs stemming from our whole-bank acquisition and core conversion in 2014. Sundry and teller losses increased by \$165,000, or 131%, in the third quarter and \$431,000, or 150%, for the first nine months due mainly to an increase in debit card fraud losses.

The Company's tax-equivalent overhead efficiency ratio improved to 63.38% in the third quarter of 2015 from 66.94% in the third quarter of 2014, and was 65.74% for the first nine months of 2015 compared to 65.25% for the first nine months of 2014. The overhead efficiency ratio represents total non-interest expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses and investment gains/losses excluded from the equation.

## PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. The amount of that provision is determined by first applying the Company's statutory income tax rates to estimated taxable income, which is pre-tax book income adjusted for permanent differences, and then subtracting available tax credits. Permanent differences include but are not limited to tax-exempt interest income, BOLI income, and certain book expenses that are not allowed as tax deductions. Our income tax provision was \$2.443 million, or 36% of pre-tax income in the third quarter of 2015, relative to a provision of \$1.776 million, or 33% of pre-tax income in the third quarter of 2014. For the first nine months our income tax provision was \$6.335 million, or 33% of pre-tax income in 2015, and \$4.543 million, or 28% of pre-tax income in 2014.

Higher taxable income and a declining level of available tax credits were the primary factors impacting the increase in our tax accrual rate in 2015 relative to 2014. Tax-exempt BOLI income was substantially lower in the third quarter of 2015 than in the third quarter of 2014 and reflects a drop of 41% for the first nine months, as discussed above, although interest income on municipal securities was roughly the same. Our tax credits, which consist primarily of those generated by investments in low-income housing tax credit funds and California state employment tax credits, were down \$127,000, or 32%, for the quarterly comparison and \$392,000, or 33%, for the comparative year-to-date periods.

## balance sheet analysis

## EARNING ASSETS

The Company's interest-earning assets are comprised of investments and loans, and the composition, growth characteristics, and credit quality of both are significant determinants of the Company's financial condition. Investments are analyzed in the section immediately below, while the loan and lease portfolio and other factors affecting earning assets are discussed in the sections following investments.

INVESTMENTS

The Company's investments can at any given time consist of debt securities and marketable equity securities (together, the "investment portfolio"), investments in the time deposits of other banks, surplus interest-earning balances in our Federal Reserve Bank ("FRB") account, and overnight fed funds sold. Surplus FRB balances and fed funds sold to correspondent banks represent the temporary investment of excess liquidity. The Company's investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are another interest-earning option for surplus funds when loan demand is light; and 5) they can provide partially tax exempt income. Aggregate investments totaled \$513 million, or 30% of total assets at September 30, 2015, compared to \$514 million, or 31% of total assets at December 31, 2014.

We had no fed funds sold at September 30, 2015 or December 31, 2014, and interest-bearing balances at other banks increased to \$3 million at September 30, 2015 from \$2 million at December 31, 2014 due to the timing of cash flows in our FRB account. The Company's investment portfolio reflects a reduction of \$2 million, or less than 1%, for the first nine months of 2015, ending the period with a book balance of \$510 million. The Company carries investments at their fair market values. Although we currently have the intent and ability to hold our investment securities to maturity, the securities are all marketable and are classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management. The expected average life for all bonds in our investment portfolio was 3.9 years and their average effective duration was 2.4 as of September 30, 2015, both up slightly relative to year-end 2014.

The following table sets forth the amortized cost and fair market value of Company's investment portfolio by investment type as of the dates noted:

Investment Portfolio

| (dollars in thousands, unaudited)     | September 30, 2015 |                   | December 31, 2014 |                   |
|---------------------------------------|--------------------|-------------------|-------------------|-------------------|
|                                       | Amortized Cost     | Fair Market Value | Amortized Cost    | Fair Market Value |
| Available for Sale                    |                    |                   |                   |                   |
| US Government agencies & corporations | \$29,360           | \$ 29,741         | \$26,959          | \$ 27,270         |
| Mortgage-backed securities            | 374,966            | 377,308           | 378,339           | 381,442           |
| State & political subdivisions        | 98,951             | 101,255           | 98,056            | 100,949           |
| Other securities                      | 659                | 1,296             | 1,210             | 2,222             |
| Total investment securities           | \$503,936          | \$ 509,600        | \$504,564         | \$ 511,883        |

The net unrealized gain on our investment portfolio, or the difference between the fair market value and amortized cost, was \$5.7 million at September 30, 2015, down from \$7.3 million at December 31, 2014 due to higher interest rates. The balance of US Government agency securities increased \$2 million, or 9%, during the first nine months due to bond purchases net of sales and maturities. Mortgage-backed securities were down \$4 million, or 1%, due to prepayments and lower market values. Municipal bond balances were effectively unchanged, while the balance of other securities fell by \$926,000, or 42%, due to the sale of certain equity securities. Not all cash flows from our investment portfolio were reinvested during the first nine months of 2015, since a small portion of that liquidity was used to fund loan growth.

Investment portfolio securities that were pledged as collateral for Federal Home Loan Bank borrowings, repurchase agreements, public deposits and other purposes as required or permitted by law totaled \$190 million at September 30, 2015 and \$141 million at December 31, 2014, leaving \$318 million in unpledged debt securities at September 30, 2015 and \$369 million at December 31, 2014. Securities that were pledged in excess of actual pledging needs and were thus available for liquidity purposes, if needed, totaled \$66 million at September 30, 2015 and \$25 million at December 31, 2014.

Loan AND LEASE Portfolio

The Company's loans and leases, gross of the associated allowance for losses and deferred fees and origination costs, totaled \$1.054 billion at September 30, 2015, an increase of \$83 million, or 9%, since December 31, 2014. The increase is due mainly to increased utilization on mortgage warehouse lines, the purchase of \$28 million in single family mortgage loans, and organic growth in other non-farm real estate loans and agricultural production loans.

A distribution of the Company's loans showing the balance and percentage of loans by type is presented for the noted periods in the table below. The balances shown are before deferred or unamortized loan origination, extension, or commitment fees, and deferred origination costs. While not reflected in the loan totals and not currently comprising a material segment of our lending activities, the Company also occasionally originates and sells, or participates out portions of, loans to non-affiliated investors.

**Loan and Lease Distribution**

(dollars in thousands, unaudited)

|  | September 30, 2015 | December 31, 2014 |         |   |
|--|--------------------|-------------------|---------|---|
| Real Estate:                               |                    |                   |         |   |
| 1-4 family residential construction        | \$ 8,520           | \$                | 5,858   |   |
| Other construction/land                    | 32,625             |                   | 19,908  |   |
| 1-4 family - closed-end                    | 134,476            |                   | 114,259 |   |
| Equity lines                               | 44,830             |                   | 49,717  |   |
| Multi-family residential                   | 27,341             |                   | 18,718  |   |
| Commercial real estate- owner occupied     | 216,757            |                   | 218,654 |   |
| Commercial real estate- non-owner occupied | 160,844            |                   | 132,077 |   |
| Farmland                                   | 126,275            |                   | 145,039 |   |
| Total real estate                          | 751,668            |                   | 704,230 |   |
| Agricultural                               | 36,820             |                   | 27,746  |   |
| Commercial and industrial                  | 106,943            |                   | 113,771 |   |
| Mortgage warehouse lines                   | 142,608            |                   | 106,021 |   |
| Consumer loans                             | 16,097             |                   | 18,885  |   |
| Total loans and leases                     | \$ 1,054,136       | \$                | 970,653 |   |
| Percentage of Total Loans and Leases       |                    |                   |         |   |
| Real Estate:                               |                    |                   |         |   |
| 1-4 family residential construction        | 0.81               | %                 | 0.60    | % |
| Other construction/land                    | 3.09               | %                 | 2.05    | % |
| 1-4 family - closed-end                    | 12.76              | %                 | 11.77   | % |
| Equity lines                               | 4.25               | %                 | 5.12    | % |
| Multi-family residential                   | 2.59               | %                 | 1.93    | % |
| Commercial real estate- owner occupied     | 20.56              | %                 | 22.53   | % |
| Commercial real estate- non-owner occupied | 15.26              | %                 | 13.61   | % |
| Farmland                                   | 11.98              | %                 | 14.94   | % |
| Total real estate                          | 71.30              | %                 | 72.55   | % |
| Agricultural                               | 3.49               | %                 | 2.86    | % |
| Commercial and industrial                  | 10.15              | %                 | 11.72   | % |
| Mortgage warehouse lines                   | 13.53              | %                 | 10.92   | % |
| Consumer loans                             | 1.53               | %                 | 1.95    | % |
| Total loans and leases                     | 100.00             | %                 | 100.00  | % |

Outstanding balances on mortgage warehouse lines were up \$37 million, or 35%, as utilization on lines increased to 52% at September 30, 2015 from 47% at December 31, 2014. As noted above, mortgage warehouse balances were higher earlier in the year and utilization on lines was 63% at the end of the second quarter. Certain lines have also been judiciously increased during 2015 to accommodate strong borrower demand. Mortgage lending activity is highly correlated with changes in interest rates and refinancing activity and has historically been subject to significant fluctuations, so no assurance can be provided with regard to our ability to maintain or grow mortgage warehouse balances.

Real estate loans classified as 1-4 family closed-end loans increased \$20 million, or 18%, due to the aforementioned opportunistic purchase of well-underwritten, newer vintage residential mortgage loans which had an expected average life of about seven years at the time of purchase. Material increases are also evident in residential construction loans, which were up about \$3 million, or 45% for the first nine months of 2015, non-residential construction loans, which were up \$13 million, or 64%, non-owner occupied commercial real estate loans, which increased \$29 million, or 22%, and multi-family residential loans, which increased \$9 million, or 46%. Other real estate loan categories declined as loan payoffs outpaced new originations. Loans secured by farmland, in particular, were down \$19 million, or 13%, due in part to the payoff of a large dairy loan subsequent to the sale of the business by the borrower. Management expects continued growth in commercial real estate loans based on the current pipeline of loans in the process of approval, although no assurance can be provided in that regard.



Agricultural production loans have also experienced growth thus far in 2015, increasing by about \$9 million, or 33%. Commercial loans, on the other hand, reflect a decline of \$7 million, or 6%, and consumer loans were down \$3 million, or 15%.

### NONPERFORMING ASSETS

Nonperforming assets are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets including mobile homes and OREO. If the Company grants a concession to a borrower in financial difficulty, the loan falls into the category of a troubled debt restructuring (“TDR”). TDRs may be classified as either nonperforming or performing loans depending on their accrual status. The following table presents comparative data for the Company’s nonperforming assets and performing TDRs as of the dates noted:

#### Nonperforming Assets and Performing Troubled Debt Restructurings

| (dollars in thousands, unaudited)   | September 30,<br>2015 | December 31,<br>2014 | September 30,<br>2014 |   |
|---|-----------------------|----------------------|-----------------------|---|
| <b>NON-ACCRUAL LOANS:</b>   |                       |                      |                       |   |
| <b>Real Estate:</b>   |                       |                      |                       |   |
| 1-4 family residential construction   | \$ -                  | \$ -                 | \$ -                  |   |
| Other construction/land   | 163                   | 3,547                | 3,338                 |   |
| 1-4 family - closed-end   | 2,478                 | 3,042                | 8,446                 |   |
| Equity lines  | 1,265                 | 1,049                | 385                   |   |
| Multi-family residential  | -                     | 171                  | -                     |   |
| Commercial real estate- owner occupied  | 2,547                 | 3,417                | 2,359                 |   |
| Commercial real estate- non-owner occupied  | 6,957                 | 7,754                | 7,655                 |   |
| Farmland  | 47                    | 51                   | -                     |   |
| <b>TOTAL REAL ESTATE</b>  | <b>13,457</b>         | <b>19,031</b>        | <b>22,183</b>         |   |
| Agriculture   | -                     | -                    | 127                   |   |
| Commercial and industrial   | 829                   | 821                  | 791                   |   |
| Mortgage warehouse lines  | -                     | -                    | -                     |   |
| Consumer loans  | 590                   | 826                  | 775                   |   |
| <b>TOTAL NONPERFORMING LOANS</b>  | <b>14,876</b>         | <b>20,678</b>        | <b>23,876</b>         |   |
| Foreclosed assets   | 3,003                 | 3,991                | 4,719                 |   |
| <b>Total nonperforming assets</b>   | <b>\$ 17,879</b>      | <b>\$ 24,669</b>     | <b>\$ 28,595</b>      |   |
| Performing TDR's <sup>(1)</sup>   | \$ 11,928             | \$ 12,359            | \$ 12,977             |   |
| Nonperforming loans as a % of total gross loans and leases                        | 1.41                  | % 2.13               | % 2.70                | % |
| Nonperforming assets as a % of total gross loans and leases and foreclosed assets | 1.69                  | % 2.53               | % 3.22                | % |

(1) Performing TDRs are not included in nonperforming loans above, nor are they included in the numerators used to calculate the ratios disclosed in this table.

Total nonperforming assets were reduced by \$6.8 million, or 28%, during the first nine months of 2015. Nonperforming loans were decreased by \$5.8 million, or 28%, while foreclosed assets were down \$988,000, or 25%. The balance of nonperforming loans at September 30, 2015 includes \$6.6 million in TDRs and other loans that were paying as agreed, but which met the technical definition of nonperforming and were classified as such. As shown in the table, we also had \$11.9 million in loans classified as performing TDRs for which we were still accruing interest as of September 30, 2015, a reduction of \$431,000, or 3%, relative to the balance of performing TDRs at December 31, 2014.

Non-accruing loan balances secured by real estate comprised \$13.5 million of total nonperforming loans at September 30, 2015, down \$5.6 million, or 29%, since December 31, 2014. The gross reduction in nonperforming real estate loans in the first nine months of 2015 totaled \$11.8 million including principal pay-downs of \$10.2 million, gross charge-offs of \$647,000, balances totaling \$606,000 returned to accrual status, and transfers to OREO, but reductions were partially offset by \$6.3 million in additions. Nonperforming commercial loans were essentially unchanged during the period, and nonperforming consumer loans were reduced by \$236,000, or 29%, during the first nine months of 2015.

As noted above, foreclosed assets were reduced by \$988,000, or 25%, during the first nine months of 2015 due primarily to OREO sold, but write-downs on OREO contributed \$193,000 to the reduction. The balance of foreclosed assets had an aggregate carrying value of \$3.0 million at September 30, 2015, and was comprised of 19 properties classified as OREO and one mobile home. At the end of 2014 foreclosed assets totaled \$4.0 million, consisting of 24 properties classified as OREO and three mobile homes. All foreclosed assets are periodically evaluated and written down to their fair value less expected disposition costs, if lower than the then-current carrying value.

Total nonperforming assets were 1.69% of gross loans and leases plus foreclosed assets at September 30, 2015, down from 2.53% at December 31, 2014 and 3.22% at September 30, 2014. An action plan is in place for each of our non-accruing loans and foreclosed assets and they are all being actively managed. Collection efforts are continuously pursued for all nonperforming loans, but we cannot provide assurance that all will be resolved in a timely manner or that nonperforming balances will not increase further.

#### Allowance for loan and lease Losses

The allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses. It is maintained at a level that is considered adequate to absorb probable losses on specifically identified impaired loans, as well as probable incurred losses inherent in the remaining loan portfolio. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when sufficient cash payments are received subsequent to the charge off.

The Company's allowance for loan and lease losses was \$10.4 million, or 0.99% of gross loans at September 30, 2015, relative to \$11.2 million, or 1.16% of gross loans at December 31, 2014. The decline in the allowance in the first nine months of 2015 was facilitated by the fact that many loan charge-offs during the period were charged against loss reserves established in previous periods and did not necessarily lead to the need for reserve replenishment. Moreover, while the lower allowance for loan and lease losses is not directionally consistent with the increase in outstanding loan balances, our need for an additional allowance was favorably impacted by loan growth occurring in portfolio segments with low historical loss rates, and credit quality improvement in the remainder of the performing loan portfolio. The ratio of the allowance to nonperforming loans was 69.99% at September 30, 2015, relative to 54.40% at December 31,

2014 and 46.12% at September 30, 2014. A separate allowance for potential losses inherent in unused commitments is included in other liabilities, and totaled \$304,000 at September 30, 2015.

The table that follows summarizes the activity in the allowance for loan and lease losses for the noted periods:

### Allowance for Loan and Lease Losses

| (dollars in thousands, unaudited)                                       | For the three<br>months<br>ended<br>September<br>30,<br>2015 | For the<br>three<br>months<br>ended<br>September<br>30,<br>2014 | For the nine<br>months<br>ended<br>September<br>30,<br>2015 | For the<br>nine<br>months<br>ended<br>September<br>30,<br>2014 | For the<br>year<br>ended<br>December<br>31,<br>2014 |
|---|--|---|---|--|---|
| Balances:   |  |   |   |  |   |
| Average gross loans and leases outstanding during period <sup>(1)</sup> | \$ 1,038,440   | \$ 884,435  | \$ 1,016,923  | \$ 842,641   | \$ 859,981  |
| Gross loans and leases outstanding at end of period                     | \$ 1,054,136   | \$ 883,675  | \$ 1,054,136  | \$ 883,675   | \$ 970,653  |
| Allowance for Loan and Lease Losses:                                    |  |   |   |  |   |
| Balance at beginning of period  | \$ 10,549  | \$ 11,634   | \$ 11,248   | \$ 11,677  | \$ 11,677   |
| Provision charged to expense  | -  | -   | -   | 350  | 350   |
| Charge-offs   |  |   |   |  |   |
| Real Estate   |  |   |   |  |   |
| 1-4 family residential construction                                     | -  | -   | -   | -  | -   |
| Other Construction/Land   | -  | -   | 72  | 58   | 135   |
| 1-4 family - closed-end   | -  | 421   | 224   | 431  | 431   |
| Equity Lines  | -  | 472   | 72  | 761  | 828   |
| Multi-family residential  | -  | -   | -   | -  | -   |
| Commercial real estate- owner occupied                                  | -  | 141   | 318   | 171  | 171   |
| Commercial real estate- non-owner occupied                              | -  | -   | -   | 45   | 45  |
| Farmland  | -  | 19  | -   | 19   | 19  |
| TOTAL REAL ESTATE   | -  | 1,053   | 686   | 1,485  | 1,629   |
| Agricultural  | -  | -   | -   | 124  | 124   |
| Commercial & industrial loans   | 80   | 170   | 255   | 583  | 625   |
| Consumer Loans  | 522  | 424   | 1,313   | 1,410  | 1,837   |
| Total   | \$ 602   | \$ 1,647  | \$ 2,254  | \$ 3,602   | \$ 4,215  |
| Recoveries  |  |   |   |  |   |
| Real Estate   |  |   |   |  |   |
| 1-4 family residential construction                                     | -  | 13  | -   | 38   | 38  |
| Other Construction/Land   | 58   | 162   | 117   | 702  | 702   |
| 1-4 family - closed-end   | 4  | 10  | 32  | 164  | 317   |
| Equity Lines  | 3  | 7   | 186   | 55   | 273   |
| Multi-family residential  | -  | -   | -   | -  | -   |
| Commercial real estate- owner occupied                                  | -  | 72  | 106   | 452  | 504   |
| Commercial real estate- non-owner occupied                              | -  | 27  | -   | 79   | 79  |
| Farmland  | -  | -   | -   | -  | -   |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|                                   |           |           |           |           |           |
|-----------------------------------|-----------|-----------|-----------|-----------|-----------|
| TOTAL REAL ESTATE                 | 65        | 291       | 441       | 1,490     | 1,913     |
| Agricultural                      | 73        | 1         | 78        | 4         | 6         |
| Commercial and Industrial         | 65        | 538       | 189       | 635       | 801       |
| Consumer Loans                    | 262       | 195       | 710       | 458       | 716       |
| Total                             | \$ 465    | \$ 1,025  | \$ 1,418  | \$ 2,587  | \$ 3,436  |
| Net loan charge offs (recoveries) | \$ 137    | \$ 622    | \$ 836    | \$ 1,015  | \$ 779    |
| Balance at end of period          | \$ 10,412 | \$ 11,012 | \$ 10,412 | \$ 11,012 | \$ 11,248 |

RATIOS

|  |       |   |       |   |       |   |        |   |        |   |
|--|-------|---|-------|---|-------|---|--------|---|--------|---|
| Net Charge-offs to Average Loans and Leases (annualized)             | 0.05  | % | 0.28  | % | 0.11  | % | 0.16   | % | 0.09   | % |
| Allowance for Loan Losses to Gross Loans and Leases at End of Period | 0.99  | % | 1.25  | % | 0.99  | % | 1.25   | % | 1.16   | % |
| Allowance for Loan Losses to NonPerforming Loans                     | 69.99 | % | 46.12 | % | 69.99 | % | 46.12  | % | 54.40  | % |
| Net Loan Charge-offs to Allowance for Loan Losses at End of Period   | 1.32  | % | 5.65  | % | 8.03  | % | 9.22   | % | 6.93   | % |
| Net Loan Charge-offs to Provision for Loan Losses                    | -     |   | -     |   | -     |   | 290.00 | % | 222.57 | % |

(1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

As shown in the table above, the Company has not recorded a provision for loan and lease losses thus far in 2015 but had a provision of \$350,000 in the first nine months of 2014. Net loans charged off declined by \$179,000, or 18%, for the year-to-date comparison. Any shortfall in the allowance identified pursuant to our analysis of remaining probable losses is covered by quarter-end. Our allowance for probable losses on specifically identified impaired loans was reduced by \$719,000, or 13%, during the nine months ended September 30, 2015, due to the charge-off of losses against the allowance and the release of reserves subsequent to the resolution of certain non-performing loans during that period. The allowance for probable losses inherent in non-impaired loans was also down \$117,000, or 2%, during the first nine months of 2015 despite higher loan balances, as a result of continued improvement in the credit quality of our performing loans. The “Provision for Loan and Lease Losses” section above includes additional details on our provision and its relationship to actual charge-offs.

The Company’s allowance for loan and lease losses at September 30, 2015 represents Management’s best estimate of probable losses in the loan portfolio as of that date, but no assurance can be given that the Company will not experience substantial losses relative to the size of the allowance. Furthermore, fluctuations in credit quality, changes in economic conditions, updated accounting or regulatory requirements, and/or other factors could induce us to augment or reduce the allowance.

#### OFF-BALANCE SHEET ARRANGEMENTS

The Company maintains commitments to extend credit in the normal course of business, as long as there are no violations of conditions established in the outstanding contractual arrangements. Unused commitments to extend credit totaled \$371 million at September 30, 2015 and \$367 million at December 31, 2014, although it is not likely that all of those commitments will ultimately be drawn down. Unused commitments represented approximately 35% of gross loans outstanding at September 30, 2015 and 38% at December 31, 2014, with the drop due primarily to the increase in loan balances. The Company also had undrawn letters of credit issued to customers totaling \$17 million at September 30, 2015 and \$14 million at December 31, 2014. The effect on the Company’s revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will ever be used. However, the “Liquidity” section in this Form 10-Q outlines resources available to draw upon should we be required to fund a significant portion of unused commitments.

In addition to unused commitments to provide credit, the Company is utilizing a \$107 million letter of credit issued by the Federal Home Loan Bank on the Company’s behalf as security for certain deposits. That letter of credit is backed by loans which are pledged to the FHLB by the Company. For more information regarding the Company’s off-balance sheet arrangements, see Note 8 to the financial statements located elsewhere herein.

#### **OTHER ASSETS**

The Company's balance of non-interest earning cash and due from banks was \$46 million at September 30, 2015 and \$48 million at December 31, 2014. The balance of cash and due from banks depends on the timing of collection of outstanding cash items (checks) and our reserve requirement, among other things, and is subject to significant fluctuation in the normal course of business. While cash flows are normally predictable within limits, those limits are fairly broad and the Company manages its short-term cash position through the utilization of overnight loans to and borrowings from correspondent banks, including the Federal Reserve Bank and the Federal Home Loan Bank. Should a large "short" overnight position persist for any length of time, the Company typically raises money through focused retail deposit gathering efforts or by adding brokered time deposits. If a "long" position is prevalent, the Company will let brokered deposits or other wholesale borrowings roll off as they mature, or might invest excess liquidity in higher-yielding, longer-term bonds.

Net premises and equipment increased by \$324,000, or 1%, during the first nine months of 2015. Foreclosed assets are discussed above, in the section titled "Nonperforming Assets." Goodwill did not change during the period, ending the first nine months of 2015 with a balance of \$7 million, but other intangible assets, namely the Company's core deposit intangible generated by the SCVB acquisition, dropped slightly due to amortization. The Company's goodwill and other intangible assets are evaluated annually for potential impairment. Because the estimated fair value of the Company exceeded its book value (including goodwill and intangible assets) as of the measurement date and no impairment was indicated, no further testing was deemed necessary and it was determined that goodwill and other intangible assets were not impaired. Company owned life insurance, with a balance of almost \$44 million at September 30, 2015, is discussed above in the "Non-Interest Income and Non-Interest Expense" section.



The aggregate balance of “Other assets” was down \$1.3 million, or 4%, during the first nine months of 2015, ending the period at \$36.1 million. At September 30, 2015, the balance of other assets included as its largest components a net deferred tax asset of \$11.7 million, a \$7.5 million investment in restricted stock, accrued interest receivable totaling \$5.7 million, a \$5.1 million investment in low-income housing tax credit funds, and a \$1.4 million investment in a small business investment corporation. Restricted stock is comprised primarily of Federal Home Loan Bank of San Francisco stock held in conjunction with our FHLB borrowings, and is not deemed to be marketable or liquid. Our net deferred tax asset is evaluated as of every reporting date pursuant to FASB guidance, and we have determined that no impairment exists.

## DEPOSITS AND INTEREST BEARING LIABILITIES

### DEPOSITS

Deposits are another key balance sheet component impacting the Company’s net interest margin and other profitability metrics. Deposits provide liquidity to fund growth in earning assets, and the Company’s net interest margin is improved to the extent that growth in deposits is concentrated in less volatile and typically less costly non-maturity deposits such as demand deposit accounts, NOW accounts, savings accounts, and money market demand accounts. Information concerning average balances and rates paid by deposit type for the three-month and nine-month periods ended September 30, 2015 and 2014 is included in the Average Balances and Rates tables appearing above, in the section titled “Net Interest Income and Net Interest Margin.” A distribution of the Company’s deposits showing the balance and percentage of total deposits by type is presented for the noted periods in the following table.

### Deposit Distribution

(dollars in thousands, unaudited)

|                                      | September 30, 2015 | December 31, 2014 |
|--------------------------------------|--------------------|-------------------|
| Non-interest bearing demand deposits | \$ 423,449         | \$ 390,897        |
| Interest bearing demand deposits     | 122,116            | 110,840           |
| NOW                                  | 292,595            | 275,494           |
| Savings                              | 189,607            | 167,655           |
| Money market                         | 95,603             | 117,907           |
| CDAR's                               | 11,476             | 11,299            |
| Time, under \$250,000                | 142,475            | 151,719           |
| Time, \$250,000 or more              | 151,793            | 135,884           |
| Brokered deposits                    | -                  | 5,000             |
| Total deposits                       | \$ 1,429,114       | \$ 1,366,695      |

### Percentage of Total Deposits

|                                      |       |   |       |   |
|--------------------------------------|-------|---|-------|---|
| Non-interest bearing demand deposits | 29.64 | % | 28.60 | % |
| Interest bearing demand deposits     | 8.54  | % | 8.11  | % |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|                         |        |   |        |   |
|-------------------------|--------|---|--------|---|
| NOW                     | 20.47  | % | 20.16  | % |
| Savings                 | 13.27  | % | 12.27  | % |
| Money market            | 6.69   | % | 8.63   | % |
| CDAR's                  | 0.80   | % | 0.83   | % |
| Time, under \$250,000   | 9.97   | % | 11.09  | % |
| Time, \$250,000 or more | 10.62  | % | 9.94   | % |
| Brokered deposits       | -      |   | 0.37   | % |
| Total                   | 100.00 | % | 100.00 | % |

The Company's deposit balances peaked at the end of June but have declined \$43 million since then due to a combination of factors, including seasonality and our customers' reallocation of resources for non-deposit investments and tax payments, among other things. Despite the third quarter decline, total deposit balances still reflect net growth of \$62 million, or 5%, during the first nine months of 2015, including an increase in core non-maturity deposits of \$61 million, or 6%. Within non-maturity deposits we saw an increase of \$61 million, or 8%, in transaction accounts (comprised of demand deposits and NOW accounts), due to a growing number of accounts and an increase in the average balance per account, and savings deposits were also up \$22 million, or 13%, during the first nine months of 2015. Money market deposits were down \$22 million, or 19%, however, as there is not currently a significant rate advantage for customers in money market deposits versus more liquid interest-bearing demand accounts. Total time deposits were up \$2 million, or 1%, due to a \$20 million increase in our deposits from the State of California that was largely offset by a \$5 million reduction in wholesale brokered deposits and runoff in other customer time deposits. Management is of the opinion that a relatively high level of core customer deposits is one of the Company's key strengths and we continue to strive for deposit retention and growth, although no assurance can be provided with regard to future core deposit increases or runoff.

**OTHER INTEREST-BEARING LIABILITIES**

The Company's non-deposit borrowings may, at any given time, include fed funds purchased from correspondent banks, borrowings from the Federal Home Loan Bank, advances from the Federal Reserve Bank, securities sold under agreement to repurchase, and/or junior subordinated debentures. The Company uses short-term FHLB advances and fed funds purchased on uncommitted lines to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. The FHLB line is committed, but the amount of available credit depends on the level of pledged collateral.

Total non-deposit interest-bearing liabilities were up \$22 million, or 36%, in the first nine months of 2015, due primarily to increased borrowings from the Federal Home Loan Bank to facilitate our strong loan growth. Overnight FHLB borrowings were \$42 million at September 30, 2015, up from \$18 million at December 31, 2014, while long-term borrowings totaled \$2 million at September 30, 2015 relative to \$6 million at December 31, 2014. Repurchase agreements totaled \$10 million at September 30, 2015, up from \$7 million at December 31, 2014. Repurchase agreements represent "sweep accounts", where commercial deposit balances above a specified threshold are transferred at the close of each business day into non-deposit accounts secured by investment securities. We had no fed funds purchased and no advances from the FRB on our books at September 30, 2015 or December 31, 2014. The Company had junior subordinated debentures totaling \$31 million at September 30, 2015 and December 31, 2014, in the form of long-term borrowings from trust subsidiaries formed specifically to issue trust preferred securities.

**OTHER NON-INTEREST BEARING LIABILITIES**

Other liabilities are principally comprised of accrued interest payable, other accrued but unpaid expenses, and certain clearing amounts. Other liabilities fell by \$4.7 million, or 22%, during the first nine months of 2015, due in part to a drop in our accrued liability for income taxes subsequent to tax payments and a reductions in other payables.

**liquidity and market Risk MANAGEMENT**

**LIQUIDITY**

Liquidity management refers to the Company's ability to maintain cash flows that are adequate to fund operations and meet other obligations and commitments in a timely and cost-effective manner. Detailed cash flow projections are reviewed by Management on a monthly basis, with various scenarios applied to assess our ability to meet liquidity

needs under adverse conditions. Liquidity ratios are also calculated and reviewed on a regular basis. While those ratios are merely indicators and are not measures of actual liquidity, they are closely monitored and we are focused on maintaining adequate liquidity resources to draw upon should unexpected needs arise.

The Company, on occasion, experiences cash needs as the result of loan growth, deposit outflows, asset purchases or liability repayments. To meet short-term needs, the Company can borrow overnight funds from other financial institutions, draw advances via Federal Home Loan Bank lines of credit, or solicit brokered deposits if deposits are not immediately obtainable from local sources. Availability on lines of credit from correspondent banks and the FHLB totaled \$246 million at September 30, 2015. An additional \$193 million in credit is available from the FHLB if the Company pledges sufficient additional collateral and maintains the required amount of FHLB stock. The Company is also eligible to borrow approximately \$61 million at the Federal Reserve Discount Window, if necessary, based on pledged assets at September 30, 2015. Furthermore, funds can be obtained by drawing down the Company's correspondent bank deposit accounts, or by liquidating unpledged investments or other readily saleable assets. In addition, the Company can raise immediate cash for temporary needs by selling under agreement to repurchase those investments in its portfolio which are not pledged as collateral. As of September 30, 2015, unpledged debt securities plus pledged securities in excess of current pledging requirements comprised \$384 million of the Company's investment balances, compared to \$399 million at December 31, 2014. Other forms of balance sheet liquidity include but are not necessarily limited to any outstanding fed funds sold and vault cash. The Company has a higher level of actual balance sheet liquidity than might otherwise be the case, since we utilize a letter of credit from the FHLB rather than investment securities for certain pledging requirements. That letter of credit, which is backed by loans that are pledged to the FHLB by the Company, totaled \$107 million at September 30, 2015. Management is of the opinion that available investments and other potentially liquid assets, along with the standby funding sources it has arranged, are more than sufficient to meet the Company's current and anticipated short-term liquidity needs.

The Company's net loans to assets and available investments to assets ratios were 62% and 23%, respectively, at September 30, 2015, as compared to internal policy guidelines of "less than 78%" and "greater than 3%." Other liquidity ratios reviewed periodically by Management and the Board include net loans to total deposits and wholesale funding to total assets (including ratios and sub-limits for the various components comprising wholesale funding), which were well within policy guidelines at September 30, 2015. Despite the increase in loan balances in the first nine months of 2015, growth in core deposits and relatively high levels of potentially liquid investments have had a positive impact on our liquidity position in recent periods. However, no assurance can be provided that our liquidity will continue at current robust levels.

The holding company's primary uses of funds are ordinary operating expenses, shareholder dividends and stock repurchases, and its primary source of funds is dividends from the Bank since the holding company does not conduct regular banking operations. Management anticipates that the Bank will have sufficient earnings to provide dividends to the holding company to meet its funding requirements for the foreseeable future. Both the holding company and the Bank are subject to legal and regulatory limitations on dividend payments, as outlined in Item 5(c) Dividends in the Company's Annual Report on Form 10-K for the year ended December 31, 2014 which was filed with the Securities and Exchange Commission.

#### INTEREST RATE RISK MANAGEMENT

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company does not engage in the trading of financial instruments, nor does it have exposure to currency exchange rates. Our market risk exposure is primarily that of interest rate risk, and we have established policies and procedures to monitor and limit our earnings and balance sheet exposure to changes in interest rates. The principal objective of interest rate risk management is to manage the financial components of the Company's balance sheet in a manner that will optimize the risk/reward equation for earnings and capital under a variety of interest rate scenarios.

To identify areas of potential exposure to interest rate changes, we utilize commercially available modeling software to perform earnings simulations and calculate the Company's market value of portfolio equity under varying interest rate scenarios every month. The model imports relevant information for the Company's financial instruments and incorporates management's assumptions on pricing, duration, and optionality for anticipated new volumes. Various rate scenarios consisting of key rate and yield curve projections are then applied in order to calculate the expected effect of a given interest rate change on interest income, interest expense, and the value of the Company's financial instruments. The rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), economic (based on current trends and econometric models) or stable (unchanged from current actual levels).

Edgar Filing: SIERRA BANCORP - Form 10-Q

We use eight standard interest rate scenarios in conducting our rolling 12-month net interest income simulations: “stable,” upward shocks of 100, 200, 300 and 400 basis points, and downward shocks of 100, 200, and 300 basis points. Pursuant to policy guidelines, we typically attempt to limit the projected decline in net interest income relative to the stable rate scenario to no more than 5% for a 100 basis point (bp) interest rate shock, 10% for a 200 bp shock, 15% for a 300 bp shock, and 20% for a 400 bp shock. As of September 30, 2015 the Company had the following estimated net interest income sensitivity profile, without factoring in any potential negative impact on spreads resulting from competitive pressures or credit quality deterioration:

|                                      | Immediate Change in Rate |           |          |          |          |          |          |
|--------------------------------------|--------------------------|-----------|----------|----------|----------|----------|----------|
|                                      | -300 bp                  | -200 bp   | -100 bp  | +100 bp  | +200 bp  | +300 bp  | +400 bp  |
| Change in Net Int. Inc. (in \$000's) | \$-13,917                | \$-10,377 | \$-5,597 | \$+1,274 | \$+2,483 | \$+3,589 | \$+4,240 |
| % Change                             | -23.00 %                 | -17.15 %  | -9.25 %  | +2.11 %  | +4.10 %  | +5.93 %  | +7.01 %  |

Our current simulations indicate that the Company has an asset-sensitive profile, meaning that net interest income increases with a parallel shift up in the yield curve but a drop in interest rates could have a negative impact. This profile is consistent with the Company's relatively large balance of less rate-sensitive non-maturity deposits and large volume of variable-rate loans, which contribute to higher net interest income in rising rate scenarios and compression in net interest income in declining rate scenarios.

If there were an immediate and sustained downward adjustment of 100 basis points in interest rates, all else being equal, net interest income over the next twelve months would likely be around \$5.597 million lower than in a stable interest rate scenario, for a negative variance of 9.25%. The unfavorable variance increases when rates drop 200 or 300 basis points, due to the fact that certain deposit rates are already relatively low (on NOW accounts and savings accounts, for example), and will hit a natural floor of close to zero while non-floored variable-rate loan yields continue to drop. This effect is exacerbated by accelerated prepayments on fixed-rate loans and mortgage-backed securities when rates decline, although rate floors on some of our variable-rate loans partially offset other negative pressures. While we view further interest rate reductions as highly unlikely, the potential percentage drop in net interest income exceeds our internal policy guidelines in declining interest rate scenarios and we will continue to monitor our interest rate risk profile and take corrective action as deemed appropriate.

Net interest income would likely improve by \$1.274 million, or 2.11%, if interest rates were to increase by 100 basis points relative to a stable interest rate scenario, with the favorable variance expanding the higher interest rates rise. The initial increase in rising rate scenarios will be limited to some extent by the fact that many of our variable-rate loans are currently at rate floors, resulting in a re-pricing lag while variable rates are increasing to floored levels, but the Company still appears well-positioned to benefit from an upward shift in the yield curve.

We have added scenarios to our net interest income simulations to model the possibility of no balance sheet growth, the potential runoff of "surge" core deposits which flowed into the Bank in the most recent economic cycle, and potential unfavorable movement in deposit rates relative to yields on earning assets. Even though net interest income will naturally be lower under static growth assumptions, the changes under declining and rising rates relative to a base case of flat rates are similar to the changes noted above for our standard projections. If a certain level of deposit runoff is assumed, projected net interest income in declining rate and flat rate scenarios does not change materially relative to standard growth projections, but the benefit we would otherwise experience in rising rate scenarios is muted. When unfavorable rate changes on deposits are factored into the model, net interest income remains relatively flat even in rising interest rate scenarios.

The economic value (or "fair value") of financial instruments on the Company's balance sheet will also vary under the interest rate scenarios previously discussed. The difference between the projected fair value of the Company's financial assets and the fair value of its financial liabilities is referred to as the economic value of equity ("EVE"), and changes in EVE under different interest rate scenarios are effectively a gauge of the Company's longer-term exposure to interest rate risk. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at projected replacement interest rates for each account type, while the fair value of non-financial accounts is

assumed to equal their book value for all rate scenarios. An economic value simulation is a static measure utilizing balance sheet accounts at a given point in time, and the measurement can change substantially over time as the characteristics of the Company's balance sheet evolve and interest rate and yield curve assumptions are updated.

The change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including stated interest rates or spreads relative to current or projected market-level interest rates or spreads, the likelihood of principal prepayments, whether contractual interest rates are fixed or floating, and the average remaining time to maturity. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical patterns and management's best estimates. We have found that model results are highly sensitive to changes in assumed decay rates for non-maturity deposits, in particular. The table below shows estimated changes in the Company's EVE as of September 30, 2015, under different interest rate scenarios relative to a base case of current interest rates:



|                            | Immediate Change in Rate |           |           |           |           |           |
|----------------------------|--------------------------|-----------|-----------|-----------|-----------|-----------|
|                            | -300 bp                  | -200 bp   | -100 bp   | +100 bp   | +200 bp   | +300 bp   |
| Change in EVE (in \$000's) | \$-69,650                | \$-92,913 | \$-61,017 | \$+32,294 | \$+55,031 | \$+72,042 |
| % Change                   | -18.38 %                 | -24.52 %  | -16.11 %  | +8.52 %   | +14.53 %  | +19.02 %  |

The table shows that our EVE will generally deteriorate in declining rate scenarios, but should benefit from a parallel shift upward in the yield curve. While still negative relative to the base case, we see a favorable swing in EVE as interest rates drop more than 200 basis points. This is due to the relative durations of our fixed-rate assets and liabilities, combined with the optionality inherent in our balance sheet. As noted previously, however, management is of the opinion that the potential for a significant rate decline is low.

## **CAPITAL RESOURCES**

At September 30, 2015 the Company had total shareholders' equity of \$187.1 million, comprised of \$62.3 million in common stock, \$2.7 million in additional paid-in capital, \$118.8 million in retained earnings, and an accumulated other comprehensive gain of \$3.3 million. Total shareholders' equity at the end of 2014 was also \$187.1 million. Shareholders' equity was effectively unchanged during the first nine months of 2015 due to the fact that capital added via net earnings of \$12.7 million and stock option exercises was offset by stock repurchases totaling \$8.0 million, dividends of \$4.2 million, and a drop in accumulated other comprehensive income of \$1.0 million.

The Company uses a variety of measures to evaluate its capital adequacy, including risk-based capital and leverage ratios that are calculated separately for the Company and the Bank. Management reviews these capital measurements on a quarterly basis and takes appropriate action to help ensure that they meet or surpass established internal and external guidelines. As permitted by the regulators for financial institutions that are not deemed to be "advanced approaches" institutions, the Company has elected to opt out of the Basel III requirement to include accumulated other comprehensive income in risk-based capital. The following table sets forth the Company's and the Bank's regulatory capital ratios as of the dates indicated.

### **Regulatory Capital Ratios**

|  | September 30, 2015 |   | December 31, 2014 |   |
|--|--------------------|---|-------------------|---|
| Sierra Bancorp                               |                    |   |                   |   |
| Common Equity Tier 1 Capital Ratio           | 14.49              | % | n/a               |   |
| Tier 1 Capital to Total Risk-weighted Assets | 16.80              | % | 17.39             | % |
| Total Capital to Total Risk-weighted Assets  | 17.71              | % | 18.44             | % |
| Tier 1 Leverage Ratio                        | 12.01              | % | 12.99             | % |
| Bank of the Sierra                           |                    |   |                   |   |
| Common Equity Tier 1 Capital Ratio           | 16.63              | % | n/a               |   |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|  |       |   |       |   |
|--|-------|---|-------|---|
| Tier 1 Capital to Total Risk-weighted Assets | 16.63 | % | 17.01 | % |
| Total Capital to Total Risk-weighted Assets  | 17.52 | % | 18.02 | % |
| Tier 1 Leverage Ratio                        | 11.87 | % | 12.72 | % |

Regulatory capital ratios declined in the first nine months of 2015 despite an increase in risk-based capital, due to higher risk-weighted assets resulting primarily from loan growth. Even though our capital ratios have declined in recent periods they remain strong relative to industry averages, and at September 30, 2015 these ratios are well above the threshold for the Company and the Bank to be classified as “well capitalized,” the highest rating of the categories defined under the Bank Holding Company Act and the Federal Deposit Insurance Corporation Improvement Act of 1991. We do not foresee any circumstances that would cause the Company or the Bank to be less than well capitalized, although no assurance can be given that this will not occur.

## **PART I – FINANCIAL INFORMATION**

### **Item 3**

## **QUALITATIVE & QUANTITATIVE DISCLOSURES**

### **ABOUT MARKET RISK**

The information concerning quantitative and qualitative disclosures about market risk is included in Part I, Item 2 above. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Market Risk Management.”

## **PART I – FINANCIAL INFORMATION**

### **Item 4**

### **CONTROLS AND PROCEDURES**

#### Evaluation of Disclosure Controls and Procedures

The Company’s Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company’s disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report (the “Evaluation Date”) have concluded that as of the Evaluation Date, the Company’s disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities, particularly during the period in which this quarterly report was being prepared.

Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our Management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized, and reported within the time periods specified by the SEC.

Changes in Internal Controls

There were no significant changes in the Company's internal controls over financial reporting that occurred in the third quarter of 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1: LEGAL PROCEEDINGS**

The Company is involved in various legal proceedings in the normal course of business. In the opinion of Management, any liability resulting from such proceedings would not have a material adverse effect on the Company's financial condition or results of operation.

### **ITEM 1A: RISK FACTORS**

There were no material changes from the risk factors disclosed in the Company's Form 10-K for the fiscal year ended December 31, 2014.

### **ITEM 2: UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

#### **(c) Stock Repurchases**

Subsequent to completion of the Company's stock buyback plan whereby 700,000 shares were repurchased from March 2014 through April 2015, the Company's Board announced their authorization of an additional 500,000 shares for repurchase. Repurchase activity under that allotment commenced after a new trading plan was established and the Company's insider trading window opened in the latter part of April. The authorization of shares for repurchase does not provide assurance that a specific quantity of shares will be repurchased, and the program may be discontinued at any time at Management's discretion.

While in general the Company has ultimate discretion with regard to potential share repurchases based upon market conditions and any other relevant considerations, all of the Company's repurchases of its common stock during 2015 have been executed pursuant to plans established by the Company in accordance with SEC Rule 10b5-1. A 10b5-1 plan enables us to continue to repurchase stock during the trading blackout for insiders unless the plan is cancelled, but it also imposes volume restrictions and limits our ability to change pricing and other parameters outlined the plan. The following table provides information concerning the Company's stock repurchase transactions during the third quarter of 2015:

Edgar Filing: SIERRA BANCORP - Form 10-Q

|  | July    | August  | September |
|--|---------|---------|-----------|
| Total shares purchased   | 0       | 69,186  | 91,658    |
| Average per share price  | N/A     | \$16.98 | \$16.70   |
| Number of shares purchased as part of publicly announced plan or program | 0       | 69,186  | 91,658    |
| Maximum number of shares remaining for purchase under a plan or program  | 265,163 | 195,977 | 104,319   |

ITEM 3: DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4: (REMOVED AND RESERVED)

Item 5: Other Information

Not applicable

57

Item 6: Exhibits

| Exhibit # | Description  |
|-----------|--|
| 2.1       | Agreement and Plan of Consolidation by and among Sierra Bancorp, Bank of the Sierra and Santa Clara Valley Bank, N.A., dated as of July 17, 2014 (1) |
| 3.1       | Restated Articles of Incorporation of Sierra Bancorp (2)   |
| 3.2       | Amended and Restated By-laws of the Company (3)  |
| 10.1      | 1998 Stock Option Plan (4)   |
| 10.2      | Salary Continuation Agreement for Kenneth R. Taylor (5)  |
| 10.3      | Salary Continuation Agreement for James C. Holly (5)   |
| 10.4      | Salary Continuation Agreement and Split Dollar Agreement for James F. Gardunio (6)   |
| 10.5      | Split Dollar Agreement for Kenneth R. Taylor (7)   |
| 10.6      | Split Dollar Agreement and Amendment thereto for James C. Holly (7)  |
| 10.7      | Director Retirement Agreement and Split dollar Agreement for Vincent Jurkovich (7)   |
| 10.8      | Director Retirement Agreement and Split dollar Agreement for Robert Fields (7)   |
| 10.9      | Director Retirement Agreement and Split dollar Agreement for Gordon Woods (7)  |
| 10.10     | Director Retirement Agreement and Split dollar Agreement for Morris Tharp (7)  |
| 10.11     | Director Retirement Agreement and Split dollar Agreement for Albert Berra (7)  |
| 10.12     | 401 Plus Non-Qualified Deferred Compensation Plan (7)  |
| 10.13     | Indenture dated as of March 17, 2004 between U.S. Bank N.A., as Trustee, and Sierra Bancorp, as Issuer (8)   |
| 10.14     | Amended and Restated Declaration of Trust of Sierra Statutory Trust II, dated as of March 17, 2004 (8)   |
| 10.15     | Guarantee Agreement between Sierra Bancorp and U.S. Bank National Association dated as of March 17, 2004 (8)   |
| 10.16     | Indenture dated as of June 15, 2006 between Wilmington Trust Co., as Trustee, and Sierra Bancorp, as Issuer (9)                                      |
| 10.17     | Amended and Restated Declaration of Trust of Sierra Capital Trust III, dated as of June 15, 2006 (9)   |
| 10.18     | Guarantee Agreement between Sierra Bancorp and Wilmington Trust Company dated as of June 15, 2006 (9)  |
| 10.19     | 2007 Stock Incentive Plan (10)   |
| 10.20     | Sample Retirement Agreement Entered into with Each Non-Employee Director Effective January 1, 2007 (11)  |
| 10.21     | Salary Continuation Agreement for Kevin J. McPhaill (11)   |
| 10.22     | First Amendment to the Salary Continuation Agreement for Kenneth R. Taylor (11)  |
| 10.23     | Second Amendment to the Salary Continuation Agreement for Kenneth R. Taylor (12)   |
| 10.24     | First Amendment to the Salary Continuation Agreement for Kevin J. McPhaill (13)  |
| 11        | Statement of Computation of Per Share Earnings (14)  |
| 31.1      | Certification of Chief Executive Officer (Section 302 Certification)   |
| 31.2      | Certification of Chief Financial Officer (Section 302 Certification)   |
| 32        | Certification of Periodic Financial Report (Section 906 Certification)   |
| 101.INS   | XBRL Instance Document   |
| 101.SCH   | XBRL Taxonomy Extension Schema Document  |
| 101.CAL   | XBRL Taxonomy Extension Calculation Linkbase Document  |

Edgar Filing: SIERRA BANCORP - Form 10-Q

|         |  |
|---------|--|
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

- (1) Filed as an Exhibit to the Form 8-K filed with the SEC on July 18, 2014 and incorporated herein by reference.
- (2) Filed as Exhibit 3.1 to the Form 10-Q filed with the SEC on August 7, 2009 and incorporated herein by reference.
- (3) Filed as an Exhibit to the Form 8-K filed with the SEC on February 21, 2007 and incorporated herein by reference.  
Filed as Exhibit 10.1 to the Registration Statement of Sierra Bancorp on Form S-4 filed with the Securities and
- (4) Exchange Commission (“SEC”) (Registration No. 333-53178) on January 4, 2001 and incorporated herein by reference.
- (5) Filed as Exhibits 10.5 and 10.7 to the Form 10-Q filed with the SEC on May 15, 2003 and incorporated herein by reference.
- (6) Filed as an Exhibit to the Form 8-K filed with the SEC on August 11, 2005 and incorporated herein by reference.
- (7) Filed as Exhibits 10.10, 10.12, and 10.15 through 10.20 to the Form 10-K filed with the SEC on March 15, 2006 and incorporated herein by reference.
- (8) Filed as Exhibits 10.9 through 10.11 to the Form 10-Q filed with the SEC on May 14, 2004 and incorporated herein by reference.
- (9) Filed as Exhibits 10.26 through 10.28 to the Form 10-Q filed with the SEC on August 9, 2006 and incorporated herein by reference.
- (10) Filed as Exhibit 10.20 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference.
- (11) Filed as an Exhibit to the Form 8-K filed with the SEC on January 8, 2007 and incorporated herein by reference.
- (12) Filed as Exhibit 10.23 to the Form 10-K filed with the SEC on March 13, 2014 and incorporated herein by reference.
- (13) Filed as Exhibit 10.24 to the Form 10-Q filed with the SEC on May 7, 2015 and incorporated herein by reference.
- (14) Computation of earnings per share is incorporated by reference to Note 6 of the Financial Statements included herein.



SIGNATURES

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

November 6, 2015 /s/ *Kevin J. McPhaill*

Date SIERRA BANCORP  
Kevin J. McPhaill  
President & Chief  
Executive Officer  
(Principal Executive  
Officer)

November 6, 2015 /s/ *Kenneth R. Taylor*

Date SIERRA BANCORP  
Kenneth R. Taylor  
Chief Financial  
Officer  
(Principal Financial  
and Principal  
Accounting Officer)