

NORTHRIM BANCORP INC  
Form 10-Q  
August 11, 2014

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

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2014

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

Commission File Number 000-33501

NORTHRIM BANCORP, INC.

(Exact name of registrant as specified in its charter)

Alaska

92-0175752

(State or other jurisdiction of incorporation or  
organization)

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

3111 C Street

Anchorage, Alaska 99503

(Address of principal executive offices) (Zip Code)

(907) 562-0062

(Registrant's telephone number, including area code)

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

Yes  No

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

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer  Smaller Reporting Company

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

Yes  No

The number of shares of the issuer's Common Stock, par value \$1 per share, outstanding at August 8, 2014 was 6,830,913.

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PART I. FINANCIAL INFORMATION

These consolidated financial statements should be read in conjunction with the financial statements, accompanying notes and other relevant information included in Northrim BanCorp, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 1. FINANCIAL STATEMENTS

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## CONSOLIDATED FINANCIAL STATEMENTS

## NORTHRIM BANCORP, INC.

## Consolidated Balance Sheets

(Unaudited)

| (In Thousands, Except Share Data)   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
| <b>ASSETS</b>   |                  |                      |
| Cash and due from banks   | \$36,318         | \$33,112             |
| Interest bearing deposits in other banks  | 61,565           | 65,979               |
| Investment securities available for sale  | 207,899          | 248,688              |
| Investment securities held to maturity  | 2,204            | 2,208                |
| Total portfolio investments   | 210,103          | 250,896              |
| Investment in Federal Home Loan Bank stock  | 3,475            | 1,896                |
| Loans held for sale   | 14,189           | 11,301               |
| Loans   | 926,809          | 770,016              |
| Allowance for loan losses   | (16,032)         | (16,282)             |
| Net loans   | 924,966          | 765,035              |
| Purchased receivables, net  | 17,380           | 16,025               |
| Accrued interest receivable   | 3,136            | 2,729                |
| Other real estate owned, net  | 4,897            | 2,402                |
| Premises and equipment, net   | 32,370           | 28,324               |
| Goodwill and intangible assets, net   | 8,430            | 7,942                |
| Other assets  | 53,052           | 40,666               |
| Total assets  | \$1,355,692      | \$1,215,006          |
| <b>LIABILITIES</b>  |                  |                      |
| Deposits:   |                  |                      |
| Demand  | \$388,728        | \$363,969            |
| Interest-bearing demand   | 174,647          | 143,703              |
| Savings   | 120,118          | 94,518               |
| Alaska CDs  | 115,081          | 112,702              |
| Money market  | 220,811          | 202,606              |
| Certificates of deposit less than \$100,000   | 49,288           | 35,432               |
| Certificates of deposit greater than \$100,000  | 61,593           | 50,793               |
| Total deposits  | 1,130,266        | 1,003,723            |
| Securities sold under repurchase agreements   | 19,776           | 21,143               |
| Borrowings  | 2,186            | 6,527                |
| Junior subordinated debentures  | 18,558           | 18,558               |
| Other liabilities   | 28,008           | 20,737               |
| Total liabilities   | 1,198,794        | 1,070,688            |
| <b>SHAREHOLDERS' EQUITY</b>   |                  |                      |
| Preferred stock, \$1 par value, 2,500,000 shares authorized, none issued or outstanding   | —                | —                    |
| Common stock, \$1 par value, 10,000,000 shares authorized, 6,830,913 and 6,537,652 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively | 6,831            | 6,538                |
| Additional paid-in capital  | 61,495           | 54,089               |
| Retained earnings   | 87,592           | 82,855               |
| Accumulated other comprehensive income  | 853              | 669                  |

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|   |             |             |
|---|-------------|-------------|
| Total Northrim BanCorp shareholders' equity | 156,771     | 144,151     |
| Noncontrolling interest                     | 127         | 167         |
| Total shareholders' equity                  | 156,898     | 144,318     |
| Total liabilities and shareholders' equity  | \$1,355,692 | \$1,215,006 |

See notes to consolidated financial statements

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NORTHRIM BANCORP, INC.  
 Consolidated Statements of Income  
 (Unaudited)

| (In Thousands, Except Per Share Data)                                       | Three Months Ended |          | Six Months Ended |          |
|---|--------------------|----------|------------------|----------|
|   | June 30,<br>2014   | 2013     | June 30,<br>2014 | 2013     |
| Interest Income   |                    |          |                  |          |
| Interest and fees on loans  | \$13,082           | \$10,734 | \$23,953         | \$21,076 |
| Interest on investment securities available for sale                        | 750                | 630      | 1,480            | 1,289    |
| Interest on investment securities held to maturity                          | 22                 | 30       | 45               | 59       |
| Interest on deposits in other banks   | 41                 | 46       | 90               | 108      |
| Total Interest Income   | 13,895             | 11,440   | 25,568           | 22,532   |
| Interest Expense  |                    |          |                  |          |
| Interest expense on deposits, borrowings and junior subordinated debentures | 484                | 511      | 924              | 1,041    |
| Net Interest Income   | 13,411             | 10,929   | 24,644           | 21,491   |
| Provision for loan losses   | (1,136 )           | —        | (1,136 )         | 150      |
| Net Interest Income After Provision for Loan Losses                         | 14,547             | 10,929   | 25,780           | 21,341   |
| Other Operating Income  |                    |          |                  |          |
| Employee benefit plan income  | 878                | 632      | 1,754            | 1,201    |
| Service charges on deposit accounts   | 607                | 539      | 1,083            | 1,064    |
| Electronic banking income   | 604                | 536      | 1,104            | 1,040    |
| Purchased receivable income   | 484                | 768      | 965              | 1,470    |
| Equity in earnings from RML   | 355                | 538      | 224              | 780      |
| Gain on sale of securities, net   | 349                | 100      | 446              | 318      |
| Other income  | 829                | 589      | 1,264            | 968      |
| Total Other Operating Income  | 4,106              | 3,702    | 6,840            | 6,841    |
| Other Operating Expense   |                    |          |                  |          |
| Salaries and other personnel expense  | 6,839              | 5,586    | 12,759           | 11,321   |
| Occupancy expense   | 1,112              | 858      | 1,989            | 1,746    |
| Professional and outside services   | 410                | 309      | 1,134            | 658      |
| Marketing expense   | 394                | 445      | 1,008            | 892      |
| Equipment expense   | 359                | 301      | 657              | 579      |
| Software expense  | 354                | 267      | 614              | 532      |
| Amortization of low income housing tax investments                          | 330                | 247      | 672              | 492      |
| Insurance expense   | 284                | 261      | 469              | 405      |
| Reserve for (recovery from) purchased receivables                           | 243                | (115 )   | 206              | (31 )    |
| Internet banking expense  | 213                | 189      | 413              | 373      |
| Intangible asset amortization expense                                       | 81                 | 59       | 133              | 117      |
| OREO (income) expense, net rental income and gains on sale                  | (9 )               | 12       | (247 )           | 6        |
| Other operating expense   | 1,340              | 972      | 2,453            | 1,998    |
| Total Other Operating Expense   | 11,950             | 9,391    | 22,260           | 19,088   |
| Income Before Provision for Income Taxes                                    | 6,703              | 5,240    | 10,360           | 9,094    |
| Provision for income taxes  | 2,239              | 1,635    | 3,194            | 2,725    |
| Net Income  | 4,464              | 3,605    | 7,166            | 6,369    |
| Less: Net income attributable to the noncontrolling interest                | 95                 | 109      | 139              | 199      |
| Net Income Attributable to Northrim BanCorp                                 | \$4,369            | \$3,496  | \$7,027          | \$6,170  |
| Earnings Per Share, Basic   | \$0.64             | \$0.54   | \$1.05           | \$0.95   |
| Earnings Per Share, Diluted   | \$0.63             | \$0.53   | \$1.04           | \$0.94   |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Weighted Average Shares Outstanding, Basic     | 6,829,897 | 6,515,414 | 6,683,897 | 6,513,935 |
| Weighted Average Shares Outstanding, Diluted   | 6,919,568 | 6,591,003 | 6,774,434 | 6,590,899 |
| See notes to consolidated financial statements |           |           |           |           |

NORTHRIM BANCORP, INC.  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)  
 2010

| (In Thousands)   | Three Months<br>Ended June 30, |           | Six Months Ended<br>June 30, |          |
|--|--------------------------------|-----------|------------------------------|----------|
|  | 2014                           | 2013      | 2014                         | 2013     |
| Net income   | \$4,464                        | \$3,605   | \$7,166                      | \$6,369  |
| Other comprehensive income, net of tax:  |                                |           |                              |          |
| Securities available for sale:   |                                |           |                              |          |
| Unrealized gains (loss) arising during the period  | \$612                          | (\$1,070) | \$707                        | (\$919 ) |
| Reclassification of net gains included in net income (net tax expense of \$143 and \$41 for the second quarter of 2014 and 2013, respectively and \$183 and \$131 for the first six months of 2014 and 2013, respectively) | (206 )                         | (59 )     | (263 )                       | (187 )   |
| Income tax expense (benefit) related to unrealized gains   | (221 )                         | 440       | (260 )                       | 377      |
| Other comprehensive income (loss)  | 185                            | (689 )    | 184                          | (729 )   |
| Comprehensive income   | 4,649                          | 2,916     | 7,350                        | 5,640    |
| Less: comprehensive income attributable to the noncontrolling interest   | 95                             | 109       | 139                          | 199      |
| Comprehensive income attributable to Northrim BanCorp  | \$4,554                        | \$2,807   | \$7,211                      | \$5,441  |

See notes to consolidated financial statements



## NORTHRIM BANCORP, INC.

Consolidated Statements of Changes in Shareholders' Equity  
(Unaudited)

| (In Thousands)   | Common Stock        |              | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Non-controlling<br>Interest | Total     |
|--|---------------------|--------------|----------------------------------|----------------------|---|-----------------------------|-----------|
|  | Number<br>of Shares | Par<br>Value |                                  |                      |   |                             |           |
| Balance as of January 1, 2013  | 6,512               | \$6,512      | \$53,638                         | \$74,742             | \$1,368   | \$93                        | \$136,353 |
| Cash dividend declared   | —                   | —            | —                                | (4,212 )             | —   | —                           | (4,212 )  |
| Stock based compensation expense   | —                   | —            | 506                              | —                    | —   | —                           | 506       |
| Exercise of stock options  | 26                  | 26           | (155 )                           | —                    | —   | —                           | (129 )    |
| Excess tax benefits from share-based payment arrangements                        | —                   | —            | 100                              | —                    | —   | —                           | 100       |
| Distributions to noncontrolling interest   | —                   | —            | —                                | —                    | —   | (13 )                       | (13 )     |
| Change in unrealized holding (loss) on available for sale securities, net of tax | —                   | —            | —                                | —                    | (699 )  | —                           | (699 )    |
| Net income attributable to the noncontrolling interest                           | —                   | —            | —                                | —                    | —   | 87                          | 87        |
| Net income attributable to Northrim BanCorp                                      | —                   | —            | —                                | 12,325               | —   | —                           | 12,325    |
| Twelve Months Ended December 31, 2013  | 6,538               | \$6,538      | \$54,089                         | \$82,855             | \$669   | \$167                       | \$144,318 |
| Purchase of Alaska Pacific   | 290                 | 290          | 7,156                            | —                    | —   | —                           | 7,446     |
| Cash dividend declared   | —                   | —            | —                                | (2,290 )             | —   | —                           | (2,290 )  |
| Stock based compensation expense   | —                   | —            | 189                              | —                    | —   | —                           | 189       |
| Exercise of stock options  | 3                   | 3            | 61                               | —                    | —   | —                           | 64        |
| Distributions to noncontrolling interest   | —                   | —            | —                                | —                    | —   | (179 )                      | (179 )    |
| Change in unrealized holding (loss) on available for sale securities, net of tax | —                   | —            | —                                | —                    | 184   | —                           | 184       |
| Net income attributable to the noncontrolling interest                           | —                   | —            | —                                | —                    | —   | 139                         | 139       |
| Net income attributable to Northrim BanCorp                                      | —                   | —            | —                                | 7,027                | —   | —                           | 7,027     |
| Six Months Ended June 30, 2014   | 6,831               | \$6,831      | \$61,495                         | \$87,592             | \$853   | \$127                       | \$156,898 |

See notes to consolidated financial statements

NORTHRIM BANCORP, INC.  
Consolidated Statements of Cash Flows  
(Unaudited)

| (In Thousands)  | Six Months Ended June |           |
|---|-----------------------|-----------|
|   | 2014                  | 2013      |
| Operating Activities:   |                       |           |
| Net income  | \$7,166               | \$6,369   |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |                       |           |
| Gain on sale of securities, net   | (446                  | ) (318    |
| Depreciation and amortization of premises and equipment                           | 900                   | 893       |
| Amortization of software  | 90                    | 94        |
| Intangible asset amortization   | 133                   | 117       |
| Amortization of investment security premium, net of discount accretion            | (85                   | ) 41      |
| Deferred tax liability  | (859                  | ) (44     |
| Stock-based compensation  | 189                   | 227       |
| Excess tax benefits from share-based payment arrangements                         | —                     | (30       |
| Deferral of loan fees and costs, net  | 419                   | (16       |
| Provision for loan losses   | (1,136                | ) 150     |
| Reserve for purchased receivables   | 206                   | (31       |
| Purchases of loans held for sale  | (75,877               | ) (75,680 |
| Proceeds from the sale of loans held for sale                                     | 72,989                | 71,574    |
| Gain on sale of other real estate owned   | (368                  | ) (129    |
| Impairment on other real estate owned   | 45                    | 87        |
| Equity in undistributed earnings from mortgage affiliate                          | 145                   | 17        |
| Net changes in assets and liabilities:  |                       |           |
| (Increase) in accrued interest receivable   | (407                  | ) (111    |
| (Increase) decrease in other assets   | (557                  | ) 65      |
| (Decrease) increase in other liabilities  | (2,998                | ) 1,563   |
| Net Cash (Used) Provided by Operating Activities                                  | (451                  | ) 4,838   |
| Investing Activities:   |                       |           |
| Investment in securities:   |                       |           |
| Purchases of investment securities available for sale                             | (92,934               | ) (78,197 |
| Proceeds from sales/maturities of securities available for sale                   | 140,085               | 58,333    |
| Purchases of domestic certificates of deposit                                     | (3,500                | ) (3,500  |
| Proceeds from maturities of domestic certificates of deposit                      | 3,500                 | 3,500     |
| Proceeds from redemption of FHLB stock  | 95                    | 35        |
| Alaska Pacific acquisition, net of cash received                                  | 6,367                 | —         |
| Decrease in purchased receivables, net  | (1,561                | ) (7,493  |
| (Increase) decrease in loans, net   | (19,052               | ) (14,323 |
| Proceeds from sale of other real estate owned                                     | 1,599                 | 634       |
| (Increase) decrease in loan to Elliott Cove, net                                  | 49                    | (66       |
| Purchases of premises and equipment   | (2,414                | ) (1,185  |
| Net Cash Provided (Used) by Investing Activities                                  | 32,234                | (42,262   |
| Financing Activities:   |                       |           |
| (Decrease) in deposits  | (24,895               | ) (11,197 |
| (Decrease) increase in securities sold under repurchase agreements                | (1,367                | ) 1,283   |
| (Decrease) increase in borrowings   | (4,341                | ) 2,150   |
| Distributions to noncontrolling interest  | (179                  | ) (217    |

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|   |           |             |
|---|-----------|-------------|
| Proceeds from the issuance of common stock                                  | 64        | —           |
| Excess tax benefits from share-based payment arrangements                   | —         | 30          |
| Cash dividends paid   | (2,273    | ) (1,953 )  |
| Net Cash Used by Financing Activities                                       | (32,991   | ) (9,904 )  |
| Net (Decrease) increase in Cash and Cash Equivalents                        | (1,208    | ) (47,328 ) |
| Cash and Cash Equivalents at Beginning of Period                            | 85,591    | 141,313     |
| Cash and Cash Equivalents at End of Period                                  | \$84,383  | \$93,985    |
| Supplemental Information:   |           |             |
| Income taxes paid   | \$1,877   | \$2,196     |
| Interest paid   | \$858     | \$1,037     |
| Noncash commitments to invest in Low Income Housing Tax Credit Partnerships | \$8,518   | \$—         |
| Transfer of loans to other real estate owned                                | \$1,158   | \$365       |
| Transfer of premises to other real estate owned                             | \$904     | \$—         |
| Cash dividends declared but not paid  | \$17      | \$20        |
| Acquisitions:   |           |             |
| Assets acquired   | \$167,199 | \$—         |
| Liabilities assumed   | \$153,172 | \$—         |

See notes to consolidated financial statements

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

### 1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by Northrim BanCorp, Inc. (the "Company") in accordance with accounting principles generally accepted in the United States of America ("GAAP") and with instructions to Form 10-Q under the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain reclassifications have been made to prior year amounts to maintain consistency with the current year with no impact on net income or total shareholders' equity. The Company determined that it operates as a single operating segment. Operating results for the interim period ended June 30, 2014, are not necessarily indicative of the results anticipated for the year ending December 31, 2014. These consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

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

The Company's significant accounting policies are discussed in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

The Company acquired Alaska Pacific Bancshares, Inc. ("Alaska Pacific") on April 1, 2014. The following accounting policies augment the disclosures included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 for new items in the Company's financial statements as a result of the acquisition:

**Acquired Loans:** Loans are recorded at their fair value at the acquisition date. Credit discounts are included in the determination of fair value; therefore, an allowance for loan losses is not recorded at the acquisition date. Purchased loans are evaluated upon acquisition and classified as either purchased impaired or purchased non-impaired.

Purchased impaired loans reflect credit deterioration since origination such that it is probable at acquisition that the Company will be unable to collect all contractually required payments.

Purchased impaired loans were individually evaluated for credit impairment at acquisition using expected future cash flows or the estimated value of underlying collateral. A purchased impaired loan will be removed from impaired loans only if the loan is sold, foreclosed, or assets are received in full satisfaction of the loan, and it will be removed from impaired loans at its carrying value. If an individual loan is removed, the difference between its relative carrying amount and its cash, fair value of the collateral, or other assets received will be recognized in other income immediately as a gain and would not affect the effective yield used to recognize the accretable yield on impaired loans.

The excess of the undiscounted contractual balances due over the cash flows expected to be collected is considered to be the nonaccretable difference. The nonaccretable difference represents our estimate of the credit losses expected to occur and was considered in determining the fair value of the purchased impaired loans as of the acquisition date. Subsequent to the acquisition date, any increases in expected cash flows over those expected at purchase date in excess of fair value are adjusted through an increase to the accretable yield on a prospective basis. The purchased impaired loans are and will continue to be subject to the Company's internal and external credit review and monitoring. If credit deterioration is experienced subsequent to the initial acquisition fair value amount, such deterioration will be measured, and a charge off will be recorded.

For purchased non-impaired loans, the difference between the fair value and unpaid principal balance of the loan at the acquisition date is amortized or accreted to interest income over the estimated life of the loans.

**Mortgage Servicing Rights:** The Company purchased mortgage servicing rights, ("MSR") in conjunction with the acquisition of Alaska Pacific. MSRs are the rights to service mortgage loans for others. The Company initially records all of our MSRs at fair value. Subsequently, MSRs are carried at fair value. The Company uses a model derived valuation methodology to estimate the fair value of MSRs, obtained from an independent broker on an annual basis. The model pools loans into buckets of homogeneous characteristics and performs a present value analysis of the future

cash flows. The buckets are created by individual loan characteristics such as note rate, product type, and the remittance schedule. Current market rates are utilized for discounting the future cash flows. Significant assumptions used in the valuation of MSR include discount rates, projected prepayment speeds, escrow calculations, ancillary income, delinquencies and option adjusted spreads. Changes in the fair value of MSRs occur primarily due to the collection/realization of expected cash flows, as well as changes in valuation inputs and assumptions. Changes

in the fair value of MSRs are reported in noninterest income in the period in which the change occurs. The amortization of MSRs is reported in noninterest income.

#### Recent Accounting Pronouncements:

In March 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity (“ASU 2014-08”). The amendments to the Codification in ASU 2014-08 change the requirements for reporting discontinued operations. A discontinued operation may include a component of an entity or a group of components of an entity, or a business or nonprofit activity. A disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity’s operations and financial results when any of the following occurs: 1) the component of an entity or group of components of an entity meets the criteria to be classified as held for sale, 2) the component of an entity or group of components of an entity is disposed of by sale, or 3) the component of an entity or group of components of an entity is disposed of other than by sale (for example, by abandonment or in a distribution to owners in a spinoff). A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group. This ASU is effective for the Company’s financial statements for annual and interim periods beginning on or after December 15, 2014, and must be applied prospectively. The Company does not believe that the adoption of this standard will have a material impact on the Company’s consolidated financial position or results of operations.

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”). The amendments to the Codification in ASU 2014-09 change the core principal for recognizing 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. To achieve the core principal, an entity should apply the following steps: 1) identify the contract(s) with a customer, 2) identify the performance obligations in the contract, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations in the contract, and 5) recognize revenue when (or as) the entity satisfies a performance obligation. The guidance also specifies the accounting for some costs to obtain or fulfill a contract with a customer. An entity is required to 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. This ASU is effective for the Company’s financial statements for annual and interim periods beginning on or after December 15, 2016, and must be applied prospectively. The Company does not believe that the adoption of this standard will have a material impact on the Company’s consolidated financial position or results of operations.

In June 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-11, Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures (“ASU 2014-11”). The amendments to the Codification in ASU 2014-11 require two accounting changes. First, the amendments change the accounting for repurchase-to maturity transactions to secured borrowing accounting. Second, for repurchase financing agreements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. This ASU is effective for the Company’s financial statements for annual and interim periods beginning on or after December 15, 2014, and must be applied prospectively. The Company does not believe that the adoption of this standard will have a material impact on the Company’s consolidated financial position or results of operations.

### 3. Business Combinations

On April 1, 2014, the Company completed the acquisition of 100% of the outstanding shares of Alaska Pacific for a total purchase price of \$13.9 million, which was comprised of the issuance of 290,212 shares of the Company’s common stock (at a volume weighted average closing price of \$25.66 per share) and \$6.4 million in cash. The assets acquired and liabilities assumed have been accounted for under the acquisition method of accounting and were

recorded at their estimated fair values as of the April 1, 2014 acquisition date. Estimated fair values recorded in the transaction are subject to change for up to one year after the closing date of the acquisition. The primary reason for the acquisition was to expand the Company's geographic footprint in Alaska.

The application of the acquisition method of accounting resulted in the recognition of a bargain purchase gain of \$158,000 and a core deposit intangible of \$623,000, or 0.5% of core deposits. The bargain purchase gain represents the excess of the estimated fair value of the net assets acquired in excess of the purchase price and is included in Other Income in the Consolidated Statements of Net Income in this Form 10-Q. This acquisition resulted in a bargain purchase gain primarily due to the inclusion of certain adjustments to the purchase price for potential risks identified by the Company during the due diligence and price negotiation stages of the acquisition that were concluded in October of 2013. The Company has concluded that the potential risks identified

at that time do not represent a liability to the Company and, accordingly, they have not been allocated any value in the application of the acquisition method of accounting.

A summary of the net assets acquired and the estimated fair value adjustments of Alaska Pacific are presented below:

| (In Thousands)            | Alaska Pacific<br>April 1, 2014 |   |
|---------------------------|---------------------------------|---|
| Cost basis net assets     | \$14,733                        |   |
| Cash payment made         | (6,423                          | ) |
| Common stock issued       | (7,446                          | ) |
| Fair value adjustments:   |                                 |   |
| Net loans                 | (1,137                          | ) |
| Premises and equipment    | 547                             |   |
| Other intangible assets   | 623                             |   |
| Mortgage servicing rights | (119                            | ) |
| Deposits                  | (844                            | ) |
| Other                     | 224                             |   |
| Bargain purchase gain     | \$158                           |   |

A summary of assets acquired and liabilities assumed at their estimated fair values are presented below:

| (In Thousands)            | Alaska Pacific<br>April 1, 2014 |
|---------------------------|---------------------------------|
| Assets Acquired:          |                                 |
| Cash and equivalents      | \$12,956                        |
| Investment securities     | 7,240                           |
| Net loans                 | 138,432                         |
| Premises and equipment    | 3,436                           |
| Other intangibles         | 623                             |
| Mortgage servicing rights | 1,170                           |
| Other real estate owned   | 1,709                           |
| Other assets              | 1,633                           |
| Total assets acquired     | \$167,199                       |

Liabilities Assumed:

|                           |           |
|---------------------------|-----------|
| Deposits                  | \$151,438 |
| Other liabilities         | 1,734     |
| Total liabilities assumed | \$153,172 |

Alaska Pacific purchased loans not subject to the requirements of FASB ASC 310-30 Loans and Debt Securities Acquired with Deteriorated Credit Quality ("ASC 310-30") are presented below at acquisition:

| (In Thousands)   | April 1, 2014 |
|--|---------------|
| Contractually required principal payments                    | \$133,921     |
| Purchase adjustment for credit, interest rate, and liquidity | 612           |
| Fair value of purchased non-credit impaired loans            | \$134,533     |



Alaska Pacific purchased loans subject to the requirements of FASB ASC 310-30 Loans and Debt Securities Acquired with Deteriorated Credit Quality. The Company identified eighteen purchased credit impaired loans as of April 1, 2014. This group of loans consists primarily of commercial and commercial real estate loans, and unlike a pool of consumer mortgages, it is not practicable for the Company to analyze the accretable yield of these loans. As such, the Company has elected the cost recovery method of income recognition for these loans, and thus no accretable difference has been identified for these loans.

Purchased credit impaired loans at acquisition are presented below:

| (In Thousands)                                | April 1, 2014 |
|---|---------------|
| Contractually required principal payments     | \$7,553       |
| Nonaccretable difference                      | (3,654 )      |
| Fair value of purchased credit impaired loans | \$3,899       |

The acquisition of Alaska Pacific is not considered significant to the Company's financial statements. The operations of Alaska Pacific are included in our operating results from April 1, 2014, and added revenue of \$2.4 million, non-interest expense of \$1.3 million, and net income of \$1.1 million, before taxes, for the quarter ended June 30, 2014. Alaska Pacific's results of operations prior to the acquisition are not included in our operating results. Additionally, merger-related expenses of \$452,000 and \$199,000 for the six months ended June 30, 2014 have been incurred in connection with the acquisition of Alaska Pacific and recognized within the professional and outside services and other operating expense line items, respectively, on the Consolidated Statements of Income.

The following table presents unaudited pro forma results of operations for the six month periods ended June 30, 2014 and 2013 as if the acquisition of Alaska Pacific had occurred on January 1, 2013. The proforma results have been prepared for comparative purposes only and are not necessarily indicative of the results that would have been obtained had the acquisition actually occurred on January 1, 2013.

| (In Thousands, except earnings per share data)    | June 30, 2014 |                             |                       |                    |
|---|---------------|-----------------------------|-----------------------|--------------------|
|   | Company       | Alaska Pacific <sup>1</sup> | Pro Forma Adjustments | Pro Forma Combined |
| Net interest and other income                     | \$31,484      | \$2,095                     | (\$4 ) <sup>2</sup>   | \$33,575           |
| Net income attributable to Northrim BanCorp, Inc. | 7,027         | (1,282                      | )(175 ) <sup>3</sup>  | 5,570              |
| Earnings Per Share, Basic                         | \$1.05        |                             |                       | \$0.83             |
| Earnings Per Share, Diluted                       | \$1.04        |                             |                       | \$0.82             |
| Weighted Average Shares Outstanding, Basic        | 6,683,897     |                             |                       | 6,683,897          |
| Weighted Average Shares Outstanding, Diluted      | 6,774,434     |                             |                       | 6,774,434          |

| (In Thousands, except earnings per share data)    | June 30, 2013 |                             |                       |                    |
|---|---------------|-----------------------------|-----------------------|--------------------|
|   | Company       | Alaska Pacific <sup>1</sup> | Pro Forma Adjustments | Pro Forma Combined |
| Net interest and other income                     | \$28,332      | \$4,845                     | (\$20 ) <sup>2</sup>  | \$33,157           |
| Net income attributable to Northrim BanCorp, Inc. | 6,170         | 82                          | 113 ) <sup>3</sup>    | 6,365              |
| Earnings Per Share, Basic                         | \$0.95        |                             |                       | \$0.98             |
| Earnings Per Share, Diluted                       | \$0.94        |                             |                       | \$0.97             |
| Weighted Average Shares Outstanding, Basic        | 6,513,935     |                             |                       | 6,513,935          |
| Weighted Average Shares Outstanding, Diluted      | 6,590,899     |                             |                       | 6,590,899          |

<sup>1</sup> Alaska Pacific represents results from January 1 to March 31 for 2014 and represents results from January 1 to June 30 for 2013.

<sup>2</sup> Amount of amortization/ accretion of the fair value adjustments on loans and certificates of deposit.

<sup>3</sup> Amount of amortization/accretion of the fair value adjustments on loans and certificates of deposit, bargain purchase gain, amortization of cored deposit intangible, and the change in the provision for income taxes.

#### 4. Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits with other banks, banker's acceptances, commercial paper, securities purchased under agreement to resell, federal funds sold, and securities with maturities of less than 90 days at acquisition. As of June 30, 2014, the Company had two certificates of deposits totaling \$13.5 million in another bank with original maturities greater than 90 days. Cash and cash equivalent balances placed with the Federal Reserve of San Francisco is the only concentration representing more than 10% of the Company's equity.

## 5. Investment Securities

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

| (In Thousands)                                  | Amortized<br>Cost | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses | Fair Value |
|---|-------------------|---------------------------|----------------------------|------------|
| June 30, 2014                                   |                   |                           |                            |            |
| Securities available for sale                   |                   |                           |                            |            |
| U.S. Treasury and government sponsored entities | \$147,691         | \$223                     | \$21                       | \$147,893  |
| Municipal securities                            | 15,517            | 376                       | 6                          | 15,887     |
| U.S. Agency mortgage-backed securities          | 1,148             | 11                        | 5                          | 1,154      |
| Corporate bonds                                 | 39,167            | 639                       | —                          | 39,806     |
| Preferred stock                                 | 2,999             | 160                       | —                          | 3,159      |
| Total securities available for sale             | \$206,522         | \$1,409                   | \$32                       | \$207,899  |
| Securities held to maturity                     |                   |                           |                            |            |
| Municipal securities                            | \$2,204           | \$145                     | \$—                        | \$2,349    |
| Total securities held to maturity               | \$2,204           | \$145                     | \$—                        | \$2,349    |
| December 31, 2013                               |                   |                           |                            |            |
| Securities available for sale                   |                   |                           |                            |            |
| U.S. Treasury and government sponsored entities | \$168,922         | \$103                     | \$323                      | \$168,702  |
| Municipal securities                            | 19,825            | 378                       | 54                         | 20,149     |
| U.S. Agency mortgage-backed securities          | 25                | —                         | —                          | 25         |
| Corporate bonds                                 | 55,798            | 1,000                     | 20                         | 56,778     |
| Preferred stock                                 | 2,999             | 35                        | —                          | 3,034      |
| Total securities available for sale             | \$247,569         | \$1,516                   | \$397                      | \$248,688  |
| Securities held to maturity                     |                   |                           |                            |            |
| Municipal securities                            | \$2,208           | \$153                     | \$—                        | \$2,361    |
| Total securities held to maturity               | \$2,208           | \$153                     | \$—                        | \$2,361    |

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2014 and December 31, 2013 were as follows:

| (In Thousands)                                  | Less Than 12 Months |                   | More Than 12 Months |                   | Total      |                   |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| June 30, 2014:                                  |                     |                   |                     |                   |            |                   |
| Securities Available for Sale                   |                     |                   |                     |                   |            |                   |
| U.S. Treasury and government sponsored entities | \$19,977            | \$21              | \$—                 | \$—               | \$19,977   | \$21              |
| U.S. Agency mortgage-backed securities          | 172                 | 6                 | —                   | —                 | \$172      | \$6               |
| Municipal Securities                            | 879                 | 3                 | 285                 | 2                 | 1,164      | 5                 |
| Total   | \$21,028            | \$30              | \$285               | \$2               | \$21,313   | \$32              |
| December 31, 2013:                              |                     |                   |                     |                   |            |                   |
| Securities Available for Sale                   |                     |                   |                     |                   |            |                   |
| U.S. Treasury and government sponsored entities | \$122,560           | \$323             | \$—                 | \$—               | \$122,560  | \$323             |
| Municipal Securities                            | 5,613               | 54                | —                   | —                 | 5,613      | 54                |
| Corporate Bonds                                 | 6,051               | 20                | —                   | —                 | 6,051      | 20                |
| Total   | \$134,224           | \$397             | \$—                 | \$—               | \$134,224  | \$397             |

There were nine and twenty-six available-for-sale securities with unrealized losses as of June 30, 2014 and December 31, 2013, respectively, that have been in a loss position for less than twelve months. There was one security with unrealized losses as of June 30, 2014 and no securities as of December 31, 2013 that have been in an unrealized loss position for more than twelve months. The contractual terms of the investments in a loss position do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company does not intend to sell, nor is it required to sell these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

At June 30, 2014, \$50.7 million in securities, or 24%, of the investment portfolio was pledged for deposits and borrowings, as compared to \$46.8 million, or 19%, at December 31, 2013. We held no securities of any single issuer (other than government sponsored entities) that exceeded 10% of our shareholders' equity at June 30, 2014 and December 31, 2013.

The amortized cost and fair values of debt securities at June 30, 2014, are distributed by contractual maturity as shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Although preferred stock has no stated maturity, it is aggregated in the calculation of weighted average yields presented below in the category of investments that mature in ten years or more.

| (In Thousands)                                | Amortized<br>Cost | Fair Value | Weighted<br>Average Yield |   |
|---|-------------------|------------|---------------------------|---|
| US Treasury and government sponsored entities |                   |            |                           |   |
| 1-5 years                                     | \$147,213         | \$147,404  | 1.02                      | % |
| 5-10 years                                    | 478               | 489        | 2.27                      | % |
| Total   | \$147,691         | \$147,893  | 1.02                      | % |
| U.S. Agency mortgage-backed securities        |                   |            |                           |   |
| Within 1 year                                 | \$247             | \$243      | 1.85                      | % |
| 1-5 years                                     | 88                | 89         | 2.40                      | % |
| 5-10 years                                    | 350               | 355        | 3.42                      | % |
| Over 10 years                                 | 463               | 467        | 3.63                      | % |
| Total   | \$1,148           | \$1,154    | 3.09                      | % |
| Corporate bonds                               |                   |            |                           |   |
| 1-5 years                                     | \$37,167          | \$37,801   | 1.46                      | % |
| 5-10 years                                    | 2,000             | 2,005      | 1.04                      | % |
| Total   | \$39,167          | \$39,806   | 1.44                      | % |
| Preferred stock                               |                   |            |                           |   |
| Over 10 years                                 | \$2,999           | \$3,159    | 5.61                      | % |
| Total   | \$2,999           | \$3,159    | 5.61                      | % |
| Municipal securities                          |                   |            |                           |   |
| Within 1 year                                 | \$7,151           | \$7,173    | 0.87                      | % |
| 1-5 years                                     | 4,324             | 4,472      | 3.05                      | % |
| 5-10 years                                    | 6,246             | 6,591      | 4.43                      | % |
| Total   | \$17,721          | \$18,236   | 2.66                      | % |

The proceeds and resulting gains and losses, computed using specific identification, from sales of investment securities for the three months ending June 30, 2014 and 2013 respectively, are as follows:

| (In Thousands)                | Proceeds | Gross<br>Gains | Gross<br>Losses |
|-------------------------------|----------|----------------|-----------------|
| 2014                          |          |                |                 |
| Available for sale securities | \$23,588 | \$450          | \$4             |
| 2013                          |          |                |                 |
| Available for sale securities | \$22,013 | \$318          | \$—             |

A summary of interest income for the six months ending June 30, 2014 and 2013 on available for sale investment securities is as follows:

| (In Thousands)                                | 2014    | 2013    |
|---|---------|---------|
| US Treasury and government sponsored entities | \$775   | \$419   |
| U.S. Agency mortgage-backed securities        | 9       | 1       |
| Other   | 488     | 581     |
| Total taxable interest income                 | \$1,272 | \$1,001 |
| Municipal securities                          | \$208   | \$288   |
| Total tax-exempt interest income              | \$208   | \$288   |
| Total   | \$1,480 | \$1,289 |

#### 6. Loans Held for Sale

From time to time, the Company has purchased residential loans from our mortgage affiliate, Residential Mortgage Holding Company LLC (“RML”). The Company then sells these loans in the secondary market. The Company purchased \$75.9 million and sold \$73.0 million in loans during the six-month period ending June 30, 2014. The Company purchased \$75.7 million and sold \$71.6 million in loans during the six-month period ending June 30, 2013.

#### 7. Loans

The following table presents total portfolio loans by portfolio segment and class of financing receivable, based on our risk classification criteria:

| (In Thousands)  | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deeds of trust | Consumer other | Total     |
|---|------------|---|--------------------------------|---------------------------------|-------------------------------------|------------------------|--|----------------|-----------|
| June 30, 2014   |            |   |                                |                                 |                                     |                        |  |                |           |
| AQR Pass  | \$333,734  | \$39,825                                    | \$49,098                       | \$105,031                       | \$280,143                           | \$37,153               | \$32,128                               | \$33,511       | \$910,623 |
| AQR Special Mention                                       | 2,904      | 353   | 803                            | 6,266                           | 3,496                               | 588                    | 428                                    | 94             | 14,932    |
| AQR Substandard   | 2,373      | —   | —                              | 1,222                           | 1,185                               | 152                    | 663                                    | 99             | 5,694     |
| AQR Doubtful  | —          | —   | —                              | —                               | —                                   | —                      | —                                      | —              | —         |
| AQR Loss  | —          | —   | —                              | —                               | —                                   | —                      | —                                      | —              | —         |
| Subtotal  | \$339,011  | \$40,178                                    | \$49,901                       | \$112,519                       | \$284,824                           | \$37,893               | \$33,219                               | \$33,704       | \$931,249 |
| Less: Unearned origination fees, net of origination costs |            |   |                                |                                 |                                     |                        |  |                | (4,440 )  |
| Total   |            |   |                                |                                 |                                     |                        |  |                | \$926,809 |
| loans   |            |   |                                |                                 |                                     |                        |  |                |           |
| December 31, 2013   |            |   |                                |                                 |                                     |                        |  |                |           |
| AQR Pass  | \$293,803  | \$28,227                                    | \$31,633                       | \$84,191                        | \$251,384                           | \$28,684               | \$15,877                               | \$17,694       | \$751,493 |
| AQR Special Mention                                       | 6,022      | 1,934                                       | 966                            | 6,235                           | 2,620                               | —                      | 397                                    | 196            | 18,370    |
| AQR Substandard   | 513        | —   | —                              | 672                             | 1,320                               | 1,292                  | 209                                    | 168            | 4,174     |
| AQR Doubtful  | —          | —   | —                              | —                               | —                                   | —                      | —                                      | —              | —         |
| AQR Loss  | —          | —   | —                              | —                               | —                                   | —                      | —                                      | —              | —         |
| Subtotal  | \$300,338  | \$30,161                                    | \$32,599                       | \$91,098                        | \$255,324                           | \$29,976               | \$16,483                               | \$18,058       | \$774,037 |

|   |           |
|---|-----------|
| Less: Unearned origination fees, net of origination costs | (4,021 )  |
| Total   | \$770,016 |

loans

Loans are carried at their principal amount outstanding, net of charge-offs, unamortized fees and direct loan origination costs. Loan balances are charged-off to the allowance for loan losses ("Allowance") when management believes that collection of principal is unlikely. Interest income on loans is accrued and recognized on the principal amount outstanding except for loans in a nonaccrual status. All classes of loans are placed on nonaccrual and considered impaired when management believes doubt exists as to the collectability of the interest or principal. Cash payments received on nonaccrual loans are directly applied to the

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

Nonaccrual loans totaled \$3.1 million and \$1.8 million at June 30, 2014 and December 31, 2013, respectively.

Nonaccrual loans at the periods indicated, by segment are presented below:

| (In Thousands)                              | June 30, 2014 | December 31, 2013 |
|---|---------------|-------------------|
| Commercial                                  | \$934         | \$222             |
| Real estate construction one-to-four family | —             | —                 |
| Real estate construction other              | —             | —                 |
| Real estate term owner occupied             | 383           | —                 |
| Real estate term non-owner occupied         | 1,194         | 151               |
| Real estate term other                      | —             | 1,136             |
| Consumer secured by 1st deeds of trust      | 473           | 187               |
| Consumer other                              | 96            | 119               |
| Total                                       | \$3,080       | \$1,815           |

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

| (In Thousands)  | 30-59<br>Days<br>Past Due<br>Still<br>Accruing | 60-89<br>Days<br>Past Due<br>Still<br>Accruing | Greater<br>Than<br>90 Days<br>Still<br>Accruing | Nonaccrual | Total Past<br>Due | Current   | Total     |
|---|--|--|---|------------|-------------------|-----------|-----------|
| June 30, 2014   |  |  |   |            |                   |           |           |
| AQR Pass  | \$261  | \$—  | \$—   | \$—        | \$261             | \$910,362 | \$910,623 |
| AQR Special Mention                                       | 488  | —  | —   | —          | 488               | 14,444    | 14,932    |
| AQR Substandard   | —  | —  | —   | 3,080      | 3,080             | 2,614     | 5,694     |
| AQR Doubtful  | —  | —  | —   | —          | —                 | —         | —         |
| AQR Loss  | —  | —  | —   | —          | —                 | —         | —         |
| Subtotal  | \$749  | \$—  | \$—   | \$3,080    | \$3,829           | \$927,420 | \$931,249 |
| Less: Unearned origination fees, net of origination costs |  |  |   |            |                   |           | (4,440 )  |
| Total   |  |  |   |            |                   |           | \$926,809 |
| December 31, 2013   |  |  |   |            |                   |           |           |
| AQR Pass  | \$672  | \$—  | \$—   | \$127      | \$799             | \$750,694 | \$751,493 |
| AQR Special Mention                                       | 385  | —  | —   | —          | 385               | 17,985    | 18,370    |
| AQR Substandard   | —  | —  | —   | 1,688      | 1,688             | 2,486     | 4,174     |
| AQR Doubtful  | —  | —  | —   | —          | —                 | —         | —         |
| AQR Loss  | —  | —  | —   | —          | —                 | —         | —         |
| Subtotal  | \$1,057  | \$—  | \$—   | \$1,815    | \$2,872           | \$771,165 | \$774,037 |
| Less: Unearned origination fees, net of origination costs |  |  |   |            |                   |           | (4,021 )  |
| Total   |  |  |   |            |                   |           | \$770,016 |

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



financially responsible guarantors.

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At June 30, 2014 and December 31, 2013, the recorded investment in loans that are considered to be impaired was \$11.7 million and \$8.8 million, respectively. The following table presents information about impaired loans by class as of the periods indicated:

| (In Thousands)  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
|---|------------------------|--------------------------------|----------------------|
| June 30, 2014   |                        |                                |                      |
| With no related allowance recorded                        |                        |                                |                      |
| Commercial - AQR pass                                     | \$59                   | \$59                           | \$—                  |
| Commercial - AQR special mention                          | 346                    | 346                            | —                    |
| Commercial - AQR substandard                              | 2,262                  | 2,727                          | —                    |
| Real estate term owner occupied- AQR pass                 | 507                    | 507                            | —                    |
| Real estate term owner occupied- AQR special mention      | 330                    | 330                            | —                    |
| Real estate term owner occupied- AQR substandard          | 1,183                  | 1,183                          | —                    |
| Real estate term non-owner occupied- AQR pass             | 614                    | 614                            | —                    |
| Real estate term non-owner occupied- AQR special mention  | 3,132                  | 3,132                          | —                    |
| Real estate term non-owner occupied- AQR substandard      | 1,141                  | 1,141                          | —                    |
| Real estate term other - AQR special mention              | 1,156                  | 1,156                          | —                    |
| Real estate term other - AQR substandard                  | 152                    | 152                            | —                    |
| Consumer secured by 1st deeds of trust - AQR pass         | 85                     | 85                             | —                    |
| Consumer secured by 1st deeds of trust - AQR substandard  | 293                    | 299                            | —                    |
| Consumer other - AQR substandard                          | 53                     | 53                             | —                    |
| Subtotal  | \$11,313               | \$11,784                       | \$—                  |
| With an allowance recorded                                |                        |                                |                      |
| Consumer secured by 1st deeds of trust - AQR substandard  | \$349                  | \$349                          | \$14                 |
| Subtotal  | \$349                  | \$349                          | \$14                 |
| Commercial - AQR pass                                     | \$59                   | \$59                           | \$—                  |
| Commercial - AQR special mention                          | 346                    | 346                            | —                    |
| Commercial - AQR substandard                              | 2,262                  | 2,727                          | —                    |
| Real estate term owner-occupied - AQR pass                | 507                    | 507                            | —                    |
| Real estate term owner-occupied - AQR special mention     | 330                    | 330                            | —                    |
| Real estate term owner-occupied - AQR substandard         | 1,183                  | 1,183                          | —                    |
| Real estate term non-owner occupied - AQR pass            | 614                    | 614                            | —                    |
| Real estate term non-owner occupied - AQR special mention | 3,132                  | 3,132                          | —                    |
| Real estate term non-owner occupied - AQR substandard     | 1,141                  | 1,141                          | —                    |
| Real estate term other - AQR special mention              | 1,156                  | 1,156                          | —                    |
| Real estate term other - AQR substandard                  | 152                    | 152                            | —                    |
| Consumer secured by 1st deeds of trust - AQR pass         | 85                     | 85                             | —                    |
| Consumer secured by 1st deeds of trust - AQR substandard  | 642                    | 648                            | 14                   |
| Consumer other - AQR substandard                          | 53                     | 53                             | —                    |
| Total   | \$11,662               | \$12,133                       | \$14                 |

| (In Thousands)  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
|---|------------------------|--------------------------------|----------------------|
| December 31, 2013   |                        |                                |                      |
| With no related allowance recorded                                |                        |                                |                      |
| Commercial - AQR pass   | \$181                  | \$181                          | \$—                  |
| Commercial - AQR special mention                                  | 314                    | 314                            | —                    |
| Commercial - AQR substandard                                      | 343                    | 488                            | —                    |
| Real estate construction one-to-four family - AQR special mention | 353                    | 353                            | —                    |
| Real estate construction other - AQR pass                         | 1,686                  | 1,686                          | —                    |
| Real estate construction other - AQR special mention              | 834                    | 834                            | —                    |
| Real estate term owner occupied - AQR pass                        | 512                    | 512                            | —                    |
| Real estate term owner occupied - AQR special mention             | 484                    | 484                            | —                    |
| Real estate term owner occupied - AQR substandard                 | 672                    | 672                            | —                    |
| Real estate term non-owner occupied - AQR special mention         | 786                    | 786                            | —                    |
| Real estate term non-owner occupied - AQR substandard             | 955                    | 955                            | —                    |
| Real estate term other - AQR substandard                          | 1,292                  | 1,571                          | —                    |
| Consumer secured by 1st deeds of trust - AQR pass                 | 88                     | 88                             | —                    |
| Consumer other - AQR substandard                                  | 65                     | 65                             | —                    |
| Subtotal  | \$8,565                | \$8,989                        | \$—                  |
| With an allowance recorded  |                        |                                |                      |
| Consumer secured by 1st deeds of trust - AQR substandard          | \$186                  | \$186                          | \$11                 |
| Subtotal  | \$186                  | \$186                          | \$11                 |
| Commercial - AQR pass   | \$181                  | \$181                          | \$—                  |
| Commercial - AQR special mention                                  | 314                    | 314                            | —                    |
| Commercial - AQR substandard                                      | 343                    | 488                            | —                    |
| Real estate construction one-to-four family - AQR special mention | 353                    | 353                            | —                    |
| Real estate construction other - AQR pass                         | 1,686                  | 1,686                          | —                    |
| Real estate construction other - AQR special mention              | 834                    | 834                            | —                    |
| Real estate term owner occupied - AQR pass                        | 512                    | 512                            | —                    |
| Real estate term owner occupied - AQR special mention             | 484                    | 484                            | —                    |
| Real estate term owner occupied - AQR substandard                 | 672                    | 672                            | —                    |
| Real estate term non-owner occupied - AQR special mention         | 786                    | 786                            | —                    |
| Real estate term non-owner occupied - AQR substandard             | 955                    | 955                            | —                    |
| Real estate term other - AQR substandard                          | 1,292                  | 1,571                          | —                    |
| Consumer secured by 1st deeds of trust - AQR pass                 | 88                     | 88                             | —                    |
| Consumer secured by 1st deeds of trust - AQR substandard          | 186                    | 186                            | 11                   |
| Consumer other - AQR substandard                                  | 65                     | 65                             | —                    |
| Total   | \$8,751                | \$9,175                        | \$11                 |

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

The following table summarizes our average recorded investment and interest income recognized on impaired loans for the three month periods ended June 30, 2014 and 2013, respectively:

| Three Months Ended June 30,                                       | 2014                        |                            | 2013                        |                            |
|---|-----------------------------|----------------------------|-----------------------------|----------------------------|
| (In Thousands)  | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded                                |                             |                            |                             |                            |
| Commercial - AQR pass   | \$63                        | \$1                        | \$184                       | \$8                        |
| Commercial - AQR special mention                                  | 351                         | 9                          | 333                         | 4                          |
| Commercial - AQR substandard                                      | 2,546                       | 4                          | 837                         | 7                          |
| Real estate construction one-to-four family - AQR special mention | —                           | —                          | 470                         | —                          |
| Real estate construction other - AQR pass                         | —                           | —                          | 2,373                       | —                          |
| Real estate term owner occupied- AQR pass                         | 508                         | 15                         | 519                         | 29                         |
| Real estate term owner occupied- AQR special mention              | 363                         | 4                          | 942                         | 13                         |
| Real estate term owner occupied- AQR substandard                  | 1,414                       | 14                         | 286                         | —                          |
| Real estate term non-owner occupied- AQR pass                     | 614                         | 36                         | —                           | —                          |
| Real estate term non-owner occupied- AQR special mention          | 3,234                       | 25                         | 1,203                       | 49                         |
| Real estate term non-owner occupied- AQR substandard              | 2,055                       | —                          | 1,002                       | 5                          |
| Real estate term other - AQR special mention                      | 1,161                       | 47                         | —                           | —                          |
| Real estate term other - AQR substandard                          | 153                         | 4                          | 1,479                       | 6                          |
| Consumer secured by 1st deeds of trust - AQR pass                 | 85                          | —                          | 91                          | 1                          |
| Consumer secured by 1st deeds of trust - AQR substandard          | 379                         | —                          | —                           | —                          |
| Consumer other - AQR substandard                                  | 55                          | —                          | 229                         | 2                          |
| Subtotal  | \$12,981                    | \$159                      | \$9,948                     | \$124                      |
| With an allowance recorded  |                             |                            |                             |                            |
| Commercial - AQR substandard                                      | \$—                         | \$—                        | \$125                       | \$—                        |
| Real estate construction one-to-four family - AQR substandard     | —                           | —                          | 758                         | —                          |
| Consumer secured by 1st deeds of trust - AQR substandard          | 351                         | —                          | 195                         | —                          |
| Subtotal  | \$351                       | \$—                        | \$1,078                     | \$—                        |

| Total   |                             |                            |                             |                            |
|---|-----------------------------|----------------------------|-----------------------------|----------------------------|
|   |                             |                            |                             |                            |
| Commercial - AQR pass   | \$63                        | \$1                        | \$184                       | \$8                        |
| Commercial - AQR special mention                                  | 351                         | 9                          | 333                         | 4                          |
| Commercial - AQR substandard                                      | 2,546                       | 4                          | 962                         | 7                          |
| Real estate construction one-to-four family - AQR special mention | —                           | —                          | 470                         | —                          |
| Real estate construction one-to-four family - AQR substandard     | —                           | —                          | 758                         | —                          |
| Real estate construction other - AQR pass                         | —                           | —                          | 2,373                       | —                          |
| Real estate term owner-occupied - AQR pass                        | 508                         | 15                         | 519                         | 29                         |
| Real estate term owner-occupied - AQR special mention             | 363                         | 4                          | 942                         | 13                         |
| Real estate term owner-occupied - AQR substandard                 | 1,414                       | 14                         | 286                         | —                          |
| Real estate term non-owner occupied - AQR pass                    | 614                         | 36                         | —                           | —                          |
| Real estate term non-owner occupied - AQR special mention         | 3,234                       | 25                         | 1,203                       | 49                         |
| Real estate term non-owner occupied - AQR substandard             | 2,055                       | —                          | 1,002                       | 5                          |
| Real estate term other - AQR special mention                      | 1,161                       | 47                         | —                           | —                          |
| Real estate term other - AQR substandard                          | 153                         | 4                          | 1,479                       | 6                          |
| Consumer secured by 1st deeds of trust - AQR pass                 | 85                          | —                          | 91                          | 1                          |
| Consumer secured by 1st deeds of trust - AQR substandard          | 730                         | —                          | 195                         | —                          |
| Consumer other - AQR substandard                                  | 55                          | —                          | 229                         | 2                          |
| Total Impaired Loans  | \$13,332                    | \$159                      | \$11,026                    | \$124                      |
| Six Months Ended June 30,   | 2014                        |                            | 2013                        |                            |
| (In Thousands)  | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded                                |                             |                            |                             |                            |
| Commercial - AQR pass   | \$32                        | \$1                        | \$184                       | \$8                        |
| Commercial - AQR special mention                                  | 242                         | 10                         | 296                         | 15                         |
| Commercial - AQR substandard                                      | 1,476                       | 8                          | 903                         | 21                         |
| Real estate construction one-to-four family - AQR special mention | 176                         | 6                          | 470                         | —                          |
| Real estate construction other - AQR pass                         | —                           | —                          | 2,498                       | —                          |
| Real estate construction other - AQR special mention              | 409                         | 29                         | —                           | —                          |
| Real estate term owner occupied- AQR pass                         | 509                         | 27                         | 521                         | 23                         |
| Real estate term owner occupied- AQR special mention              | 322                         | 9                          | 943                         | 33                         |
| Real estate term owner occupied- AQR substandard                  | 1,143                       | 27                         | 144                         | 11                         |
| Real estate term non-owner occupied- AQR pass                     | 616                         | 55                         | —                           | —                          |
| Real estate term non-owner occupied- AQR special mention          | 2,113                       | 40                         | 1,216                       | 58                         |
| Real estate term non-owner occupied- AQR substandard              | 1,033                       | —                          | 1,193                       | 38                         |
| Real estate term other - AQR special mention                      | 584                         | 47                         | —                           | —                          |
| Real estate term other - AQR substandard                          | 154                         | 7                          | 1,544                       | 13                         |
| Consumer secured by 1st deeds of trust - AQR pass                 | 86                          | 2                          | 91                          | 2                          |
| Consumer secured by 1st deeds of trust - AQR special mention      | —                           | —                          | 43                          | 1                          |
| Consumer secured by 1st deeds of trust - AQR substandard          | 190                         | —                          | —                           | —                          |
| Consumer other - AQR substandard                                  | 58                          | —                          | 231                         | 3                          |
| Subtotal  | \$9,143                     | \$268                      | \$10,277                    | \$226                      |

## With an allowance recorded

|   |         |       |          |       |
|---|---------|-------|----------|-------|
| Commercial - AQR special mention                                  | \$92    | \$6   | \$—      | \$—   |
| Commercial - AQR substandard                                      | 298     | —     | 218      | —     |
| Commercial - AQR loss   | —       | —     | 93       | —     |
| Real estate construction one-to-four family - AQR substandard     | —       | —     | 770      | —     |
| Consumer secured by 1st deeds of trust - AQR substandard          | 268     | —     | 197      | —     |
| Subtotal  | \$658   | \$6   | \$1,278  | \$—   |
| Total   |         |       |          |       |
| Commercial - AQR pass   | \$32    | \$1   | \$184    | \$8   |
| Commercial - AQR special mention                                  | 334     | 16    | 296      | 15    |
| Commercial - AQR substandard                                      | 1,774   | 8     | 1,121    | 21    |
| Commercial - AQR loss   | —       | —     | 93       | —     |
| Real estate construction one-to-four family - AQR special mention | 176     | 6     | 470      | —     |
| Real estate construction one-to-four family - AQR substandard     | —       | —     | 770      | —     |
| Real estate construction other - AQR pass                         | —       | —     | 2,498    | —     |
| Real estate construction other - AQR special mention              | 409     | 29    | —        | —     |
| Real estate term owner-occupied - AQR pass                        | 509     | 27    | 521      | 23    |
| Real estate term owner-occupied - AQR special mention             | 322     | 9     | 943      | 33    |
| Real estate term owner-occupied - AQR substandard                 | 1,143   | 27    | 144      | 11    |
| Real estate term non-owner occupied - AQR pass                    | 616     | 55    | —        | —     |
| Real estate term non-owner occupied - AQR special mention         | 2,113   | 40    | 1,216    | 58    |
| Real estate term non-owner occupied - AQR substandard             | 1,033   | —     | 1,193    | 38    |
| Real estate term other - AQR special mention                      | 584     | 47    | —        | —     |
| Real estate term other - AQR substandard                          | 154     | 7     | 1,544    | 13    |
| Consumer secured by 1st deeds of trust - AQR pass                 | 86      | 2     | 91       | 2     |
| Consumer secured by 1st deeds of trust - AQR special mention      | —       | —     | 43       | 1     |
| Consumer secured by 1st deeds of trust - AQR substandard          | 458     | —     | 197      | —     |
| Consumer other - AQR substandard                                  | 58      | —     | 231      | 3     |
| Total Impaired Loans  | \$9,801 | \$274 | \$11,555 | \$226 |

As of June 30, 2014, loans accounted for under ASC 310-30 are as follows:  
(In Thousands)

|   |          |
|---|----------|
| Contractually required principal payments     | \$7,473  |
| Nonaccretable difference                      | (3,654 ) |
| Fair value of purchased credit impaired loans | \$3,819  |

Loans classified as troubled debt restructurings (“TDR”) totaled \$8.7 million and \$7.9 million at June 30, 2014 and December 31, 2013, respectively. A TDR is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Company is granting the borrower a concession that it would not grant otherwise. The Company has granted a variety of concessions to borrowers in the form of loan modifications. The modifications granted can generally be described in the following categories:

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

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

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

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

AQR pass graded loans included above in the impaired loan data are loans classified as TDRs. By definition, TDRs are considered impaired loans. All of the Company's TDRs are included in impaired loans.

The following table presents newly restructured loans hat occurred during the six months ended June 30, 2014:

| (In Thousands)   | Accrual Status | Nonaccrual Status | Total Modifications |
|--|----------------|-------------------|---------------------|
| <b>New Troubled Debt Restructurings</b>                  |                |                   |                     |
| Commercial - AQR special mention                         | \$112          | \$—               | \$112               |
| Real estate owner occupied - AQR substandard             | —              | 248               | 248                 |
| Real estate non-owner occupied - AQR special mention     | 2,153          | —                 | 2,153               |
| Real estate non-owner occupied - AQR substandard         | —              | 1,150             | 1,150               |
| Real estate other - AQR substandard                      | 255            | —                 | 255                 |
| Consumer secured by 1st deeds of trust - AQR substandard | —              | 128               | 128                 |
| Subtotal   | \$2,520        | \$1,526           | \$4,046             |
| Existing Troubled Debt Restructurings                    | 4,694          | —                 | 4,694               |
| <b>Total</b>   | <b>\$7,214</b> | <b>\$1,526</b>    | <b>\$8,740</b>      |

The following table presents newly restructured loans that occurred during the six months ended June 30, 2014 by concession (terms modified):

| (In Thousands)   | Number of Contracts | June 30, 2014     |                   | Payment Modification | Combination Modification | Total Modifications |
|--|---------------------|-------------------|-------------------|----------------------|--------------------------|---------------------|
|  |                     | Rate Modification | Term Modification |                      |                          |                     |
| Pre-Modification Outstanding Recorded Investment:        |                     |                   |                   |                      |                          |                     |
| Commercial - AQR special mention                         | 1                   | \$—               | \$—               | \$113                | \$—                      | \$113               |
| Real estate owner occupied - AQR substandard             | 2                   | —                 | —                 | —                    | 248                      | 248                 |
| Real estate non-owner occupied - AQR special mention     | 3                   | —                 | —                 | —                    | 2,154                    | 2,154               |
| Real estate non-owner occupied - AQR substandard         | 3                   | —                 | —                 | —                    | 1,150                    | 1,150               |
| Real estate other - AQR substandard                      | 1                   | —                 | 255               | —                    | —                        | 255                 |
| Consumer secured by 1st deeds of trust - AQR substandard | 1                   | —                 | —                 | —                    | 128                      | 128                 |
| <b>Total</b>   | <b>11</b>           | <b>\$—</b>        | <b>\$255</b>      | <b>\$113</b>         | <b>\$3,680</b>           | <b>\$4,048</b>      |
| Post-Modification Outstanding Recorded Investment:       |                     |                   |                   |                      |                          |                     |
| Commercial - AQR special mention                         | 1                   | \$—               | \$—               | \$112                | \$—                      | \$112               |
| Real estate owner occupied - AQR substandard             | 2                   | —                 | —                 | —                    | 248                      | 248                 |
| Real estate non-owner occupied - AQR special mention     | 3                   | —                 | —                 | —                    | 2,153                    | 2,153               |
| Real estate non-owner occupied - AQR substandard         | 3                   | —                 | —                 | —                    | 1,150                    | 1,150               |
| Real estate other - AQR substandard                      | 1                   | —                 | 255               | —                    | —                        | 255                 |
| Consumer secured by 1st deeds of trust - AQR substandard | 1                   | —                 | —                 | —                    | 128                      | 128                 |
| <b>Total</b>   | <b>11</b>           | <b>\$—</b>        | <b>\$255</b>      | <b>\$112</b>         | <b>\$3,679</b>           | <b>\$4,046</b>      |

The Company had no commitments to extend additional credit to borrowers whose terms have been modified in TDRs. There were no charge offs in the six months ended June 30, 2014 on loans that were later classified as TDRs. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the Allowance. There were no TDRs with specific impairment at June 30, 2014 and December 31, 2013, respectively. The following table presents TDRs that occurred during the last twelve months that subsequently defaulted, for the periods ending June 30, 2014 and 2013, respectively:

| (In Thousands)  | June 30, 2014       |                     | June 30, 2013       |                     |
|---|---------------------|---------------------|---------------------|---------------------|
|   | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| Troubled Debt Restructurings that Subsequently Defaulted:         |                     |                     |                     |                     |
| Real estate construction one-to-four family - AQR special mention | 1                   | \$353               | —                   | \$—                 |
| <b>Total</b>  | <b>1</b>            | <b>\$353</b>        | <b>—</b>            | <b>\$—</b>          |

At June 30, 2014, the Company had one TDR that subsequently defaulted within the twelve month period ending June 30, 2014. At June 30, 2014 this restructured loan that defaulted is not past due and is accruing interest. At December 31, 2013, the Company had no TDRs that subsequently defaulted within the twelve month period ending



December 31, 2013.

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## 8. Allowance for Loan Losses

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

| Three Months Ended June 30,           | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deed of trust | Consumer other | Unallocated | Total    |
|---------------------------------------|------------|---|--------------------------------|---------------------------------|-------------------------------------|------------------------|---------------------------------------|----------------|-------------|----------|
| 2014                                  |            |   |                                |                                 |                                     |                        |                                       |                |             |          |
| Balance, beginning of period          | \$5,657    | \$513                                       | \$623                          | \$1,407                         | \$4,293                             | \$655                  | \$313                                 | \$384          | \$2,187     | \$16,032 |
| Charge-Offs                           | —          | —   | —                              | —                               | —                                   | —                      | (39)                                  | (24)           | —           | (63)     |
| Recoveries                            | 576        | 613   | —                              | —                               | —                                   | —                      | —                                     | 10             | —           | 1,199    |
| Provision (benefit)                   | (1,099)    | (556)                                       | 207                            | (23)                            | (169)                               | (13)                   | (2)                                   | —              | 519         | (1,136)  |
| Balance, end of period                | \$5,134    | \$570                                       | \$830                          | \$1,384                         | \$4,124                             | \$642                  | \$272                                 | \$370          | \$2,706     | \$16,032 |
| Balance, end of period:               |            |   |                                |                                 |                                     |                        |                                       |                |             |          |
| Individually evaluated for impairment | \$—        | \$—   | \$—                            | \$—                             | \$—                                 | \$—                    | \$14                                  | \$—            | \$—         | \$14     |
| Balance, end of period:               |            |   |                                |                                 |                                     |                        |                                       |                |             |          |
| Collectively evaluated for impairment | \$5,134    | \$570                                       | \$830                          | \$1,384                         | \$4,124                             | \$642                  | \$258                                 | \$370          | \$2,706     | \$16,018 |
| 2013                                  |            |   |                                |                                 |                                     |                        |                                       |                |             |          |
| Balance, beginning of period          | \$6,917    | \$726                                       | \$571                          | \$1,434                         | \$4,442                             | \$655                  | \$351                                 | \$402          | \$1,143     | \$16,641 |
| Charge-Offs                           | (355)      | —   | —                              | —                               | —                                   | —                      | —                                     | —              | —           | (355)    |
| Recoveries                            | 143        | 18  | 78                             | —                               | —                                   | —                      | —                                     | 3              | —           | 242      |
| Provision (benefit)                   | (325)      | 109   | (342)                          | (104)                           | (615)                               | (58)                   | (19)                                  | (20)           | 1,374       | —        |
| Balance, end of period                | \$6,380    | \$853                                       | \$307                          | \$1,330                         | \$3,827                             | \$597                  | \$332                                 | \$385          | \$2,517     | \$16,528 |
| Balance, end of period:               |            |   |                                |                                 |                                     |                        |                                       |                |             |          |
| Individually evaluated for impairment | \$54       | \$215                                       | \$—                            | \$—                             | \$—                                 | \$—                    | \$18                                  | \$—            | \$—         | \$287    |
| Balance, end of period:               |            |   |                                |                                 |                                     |                        |                                       |                |             |          |
| Collectively evaluated for impairment | \$6,326    | \$638                                       | \$307                          | \$1,330                         | \$3,827                             | \$597                  | \$314                                 | \$385          | \$2,517     | \$16,241 |

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| Six Months Ended<br>June 30,             | Commercial | Real estate<br>construction<br>one-to-four<br>family | Real<br>estate<br>construction<br>other | Real<br>estate<br>term<br>owner<br>occupied | Real<br>estate<br>term<br>non-owner<br>occupied | Real<br>estate<br>term<br>other | Consumer<br>secured<br>by 1st<br>deed of<br>trust | Consumer<br>other | Unallocated | Total    |
|--|------------|--|---|---|---|---------------------------------|---|-------------------|-------------|----------|
| 2014                                     |            |  |   |   |   |                                 |   |                   |             |          |
| Balance, beginning<br>of period          | \$5,779    | \$557  | \$539                                   | \$1,583                                     | \$4,297   | \$537                           | \$322   | \$390             | \$2,278     | \$16,282 |
| Charge-Offs                              | (320 )     | —  | —                                       | —   | —   | —                               | (39 )   | (33 )             | —           | (392 )   |
| Recoveries                               | 630        | 625  | —                                       | —   | —   | —                               | —   | 23                | —           | 1,278    |
| Provision (benefit)                      | (955 )     | (612 )   | 291                                     | (199 )                                      | (173 )  | 105                             | (11 )   | (10 )             | 428         | (1,136 ) |
| Balance, end of<br>period                | \$5,134    | \$570  | \$830                                   | \$1,384                                     | \$4,124   | \$642                           | \$272   | \$370             | \$2,706     | \$16,032 |
| Balance, end of period:                  |            |  |   |   |   |                                 |   |                   |             |          |
| Individually evaluated<br>for impairment | \$—        | \$—  | \$—                                     | \$—   | \$—   | \$—                             | \$14  | \$—               | \$—         | \$14     |
| Balance, end of period:                  |            |  |   |   |   |                                 |   |                   |             |          |
| Collectively evaluated<br>for impairment | \$5,134    | \$570  | \$830                                   | \$1,384                                     | \$4,124   | \$642                           | \$258   | \$370             | \$2,706     | \$16,018 |
| 2013                                     |            |  |   |   |   |                                 |   |                   |             |          |
| Balance, beginning<br>of period          | \$6,308    | \$1,029  | \$326                                   | \$1,441                                     | \$4,065   | \$539                           | \$344   | \$388             | \$1,968     | \$16,408 |
| Charge-Offs                              | (355 )     | —  | —                                       | —   | —   | —                               | —   | (14 )             | —           | (369 )   |
| Recoveries                               | 219        | 36   | 78                                      | —   | —   | —                               | —   | 6                 | —           | 339      |
| Provision (benefit)                      | 208        | (212 )   | (97 )                                   | (111 )                                      | (238 )  | 58                              | (12 )   | 5                 | 549         | 150      |
| Balance, end of<br>period                | \$6,380    | \$853  | \$307                                   | \$1,330                                     | \$3,827   | \$597                           | \$332   | \$385             | \$2,517     | \$16,528 |
| Balance, end of period:                  |            |  |   |   |   |                                 |   |                   |             |          |
| Individually evaluated<br>for impairment | \$54       | \$215  | \$—                                     | \$—   | \$—   | \$—                             | \$18  | \$—               | \$—         | \$287    |
| Balance, end of period:                  |            |  |   |   |   |                                 |   |                   |             |          |
| Collectively evaluated<br>for impairment | \$6,326    | \$638  | \$307                                   | \$1,330                                     | \$3,827   | \$597                           | \$314   | \$385             | \$2,517     | \$16,241 |

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

| (In Thousands)          | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deed of trust | Consumer other | Total     |
|-------------------------|------------|---|--------------------------------|---------------------------------|-------------------------------------|------------------------|---------------------------------------|----------------|-----------|
| June 30, 2014           |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Balance, end of period  | \$339,011  | \$40,178                                    | \$49,901                       | \$112,519                       | \$284,824                           | \$37,893               | \$33,219                              | \$33,704       | \$931,249 |
| Balance, end of period: |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Individually evaluated  |            |   |                                |                                 |                                     |                        |                                       |                |           |
| for impairment          | \$1,192    | \$353                                       | \$803                          | \$1,607                         | \$1,592                             | \$152                  | \$599                                 | \$53           | \$6,351   |
| Balance, end of period: |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Collectively evaluated  |            |   |                                |                                 |                                     |                        |                                       |                |           |
| for impairment          | \$337,819  | \$39,825                                    | \$49,098                       | \$110,912                       | \$283,232                           | \$37,741               | \$32,620                              | \$33,651       | \$924,898 |
| December 31, 2013       |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Balance, end of period  | \$300,338  | \$30,161                                    | \$32,599                       | \$91,098                        | \$255,324                           | \$29,976               | \$16,483                              | \$18,058       | \$774,037 |
| Balance, end of period: |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Individually evaluated  |            |   |                                |                                 |                                     |                        |                                       |                |           |
| for impairment          | \$838      | \$353                                       | \$2,520                        | \$1,668                         | \$1,741                             | \$1,292                | \$274                                 | \$65           | \$8,751   |
| Balance, end of period: |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Collectively evaluated  |            |   |                                |                                 |                                     |                        |                                       |                |           |
| for impairment          | \$299,500  | \$29,808                                    | \$30,079                       | \$89,430                        | \$253,583                           | \$28,684               | \$16,209                              | \$17,993       | \$765,286 |

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

| (In Thousands)                         | Total | Commercial | Real estate construction 1-4 family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deeds of trust | Consumer other | Unallocated |
|--|-------|------------|-------------------------------------|--------------------------------|---------------------------------|-------------------------------------|------------------------|--|----------------|-------------|
| June 30, 2014                          |       |            |                                     |                                |                                 |                                     |                        |  |                |             |
| Individually evaluated for impairment  |       |            |                                     |                                |                                 |                                     |                        |  |                |             |
| AQR Special Mention                    | \$—   | \$—        | \$—                                 | \$—                            | \$—                             | \$—                                 | \$—                    | \$—                                    | \$—            | \$—         |
| AQR Substandard                        | 14    | —          | —                                   | —                              | —                               | —                                   | —                      | 14                                     | —              | —           |
| Collectively evaluated for impairment: |       |            |                                     |                                |                                 |                                     |                        |  |                |             |

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|   |          |         |       |       |         |         |       |       |       |         |
|---|----------|---------|-------|-------|---------|---------|-------|-------|-------|---------|
| AQR Pass                                  | 12,924   | 4,989   | 570   | 830   | 1,178   | 4,117   | 637   | 248   | 355   | —       |
| AQR Special<br>Mention                    | 362      | 135     | —     | —     | 206     | 6       | 5     | 9     | 1     | —       |
| AQR Substandard                           | 26       | 10      | —     | —     | —       | 1       | —     | 1     | 14    | —       |
| Unallocated                               | 2,706    | —       | —     | —     | —       | —       | —     | —     | —     | 2,706   |
|   | \$16,032 | \$5,134 | \$570 | \$830 | \$1,384 | \$4,124 | \$642 | \$272 | \$370 | \$2,706 |
| December 31, 2013                         |          |         |       |       |         |         |       |       |       |         |
| Individually evaluated for<br>impairment: |          |         |       |       |         |         |       |       |       |         |
| AQR Substandard                           | \$11     | \$—     | \$—   | \$—   | \$—     | \$—     | \$—   | \$11  | \$—   | \$—     |
| Collectively evaluated for<br>impairment: |          |         |       |       |         |         |       |       |       |         |
| AQR Pass                                  | 13,325   | 5,482   | 527   | 537   | 1,381   | 4,225   | 537   | 274   | 362   | —       |
| AQR Special<br>Mention                    | 586      | 278     | 30    | 2     | 202     | 30      | —     | 36    | 8     | —       |
| AQR Substandard                           | 82       | 19      | —     | —     | —       | 42      | —     | 1     | 20    | —       |
| Unallocated                               | 2,278    | —       | —     | —     | —       | —       | —     | —     | —     | 2,278   |
|   | \$16,282 | \$5,779 | \$557 | \$539 | \$1,583 | \$4,297 | \$537 | \$322 | \$390 | \$2,278 |

## 9. Purchased Receivables

We purchase accounts receivable from our business customers and provide them with short-term working capital. We provide this service to our customers in Alaska and in Washington and the greater west coast through Northrim Funding Services. Our purchased receivable activity is guided by policies that outline risk management, documentation, and approval limits. The policies are reviewed and approved annually by the Board of Directors. Purchased receivables are carried at their principal amount outstanding, net of a reserve for anticipated losses that have not yet been identified, and have a maturity of less than one year. Purchased receivable balances are charged against this reserve when management believes that collection of principal is unlikely. Management evaluates the adequacy of the reserve for purchased receivable losses based on historical loss experience by segment and class of receivable and its assessment of current economic conditions. As of June 30, 2014, the Company has one segment and class of purchased receivables. There was one purchased receivable with a balance of \$243,000 past due at June 30, 2014 and none past due at December 31, 2013, respectively, and there were no restructured purchased receivables at June 30, 2014 or December 31, 2013.

Income on purchased receivables is accrued and recognized on the principal amount outstanding using an effective interest method except when management believes doubt exists as to the collectability of the income or principal. As of June 30, 2014, the Company is accruing income on all purchased receivable balances outstanding except one with a balance of \$243,000.

The following table summarizes the components of net purchased receivables for the periods indicated:

| (In Thousands)                          | June 30, 2014 | December 31, 2013 |
|---|---------------|-------------------|
| Purchased receivables                   | \$17,623      | \$16,298          |
| Reserve for purchased receivable losses | (243          | )(273             |
| Total                                   | \$17,380      | \$16,025          |

The following table sets forth information regarding changes in the purchased receivable reserve for the three and six-month periods ending June 30, 2014 and 2013, respectively:

| (In Thousands)                    | Three Months Ended June 30, |       | Six Months Ended June 30, |       |
|-----------------------------------|-----------------------------|-------|---------------------------|-------|
|                                   | 2014                        | 2013  | 2014                      | 2013  |
| Balance at beginning of period    | \$236                       | \$407 | \$273                     | \$323 |
| Charge-offs                       | (239                        | )—    | (239                      | )—    |
| Recoveries                        | 3                           | —     | 3                         | —     |
| Charge-offs net of recoveries     | (236                        | )—    | (236                      | )—    |
| Reserve for purchased receivables | 243                         | (115  | )206                      | (31   |
| Balance at end of period          | \$243                       | \$292 | \$243                     | \$292 |

The Company recorded one partial charge-off for \$214,000 and one full charge-off for \$25,000 in the first six months of 2014 and had did not record any charge-offs in the first six months of 2013. The remaining purchased receivables related to these relationships are past due and are not currently performing.

## 10. Goodwill and Intangible Assets

The Company acquired Alaska Pacific on April 1, 2014. The Company did not record goodwill related to the acquisition of Alaska Pacific on April 1, 2014. The Company recorded a core deposit intangible of \$623,000 related to deposits acquired from Alaska Pacific that will be amortized over its estimated useful life of ten years using an accelerated method. See Note 3 above for further discussion of this transaction.

The Company performs goodwill impairment testing annually in accordance with the policy described in Note 1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2013. There was no indication of impairment as of June 30, 2014. The Company continues to monitor the Company's goodwill for potential impairment on an ongoing basis. No assurance can be given that there will not be an impairment charge to earnings during 2014 for goodwill impairment, if, for example,



our stock price declines and trades at a significant discount to its book value, although there are many qualitative and quantitative factors that we analyze in determining the impairment of goodwill.

#### 11. Deposit Activities

Total deposits at June 30, 2014 and December 31, 2013 were \$1.1 billion and \$1.0 billion, respectively. The only deposit category with stated maturity dates is certificates of deposit. At June 30, 2014, the Company had \$110.9 million in certificates of deposit as compared to certificates of deposit of \$86.2 million at December 31, 2013. At June 30, 2014, \$75.2 million, or 68%, of the Company's certificates of deposits are scheduled to mature over the next 12 months as compared to \$55.4 million, or 64%, of total certificates of deposit at December 31, 2013.

#### 12. Derivatives

The Company enters into commercial loan interest rate swap agreements in order to provide commercial loan customers the ability to convert from variable to fixed interest rates. Under these agreements, the Company enters into a variable-rate loan agreement with a customer in addition to a swap agreement that effectively converts the customer's variable rate loan into a fixed rate. The Company then simultaneously enters into a corresponding swap agreement with a third party financial institution ("counterparty") in order to offset its exposure on the fixed component of the customer's interest rate swap. The Company has an agreement with its counterparty that contains a provision that provides that if the Company fails to maintain its status as a well-capitalized institution, then the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreement. This agreement also requires that the Company and the counterparty collateralize any fair value shortfalls that exceed \$250,000 with eligible collateral, which includes cash and securities backed with the full faith and credit of the federal government. Similarly, the Company could be required to settle its obligations under the agreement if specific regulatory events occur, such as if the Company were issued a prompt corrective action directive or a cease and desist order, or if certain regulatory ratios fall below specified levels.

The interest rate swap agreements with our customers and the counterparty are not designated as hedging instruments under the Derivatives and Hedging topic of the FASB ASC 815, rather they are accounted for as free standing derivatives with changes in fair value reported in income. The Company had interest rate swaps with an aggregate notional amount of \$24.7 million and \$25.8 million at June 30, 2014 and December 31, 2013, respectively. At June 30, 2014, the notional amount of interest rate swaps is made up of two swaps totaling \$12.4 million variable to fixed rate swap to a commercial loan customer and two swaps totaling \$12.4 million fixed to variable rate swap with a counterparty. Changes in fair value from these four interest rate swaps offset each other in the second quarter of 2014. The Company did not recognize any fee income related to interest rate swaps in either of the six month periods ending June 30, 2014 and 2013, respectively. Interest rate swap income is recorded in other income on the Consolidated Statements of Income.

The following table presents the fair value of derivatives not designated as hedging instruments at June 30, 2014 and December 31, 2013:

| (In thousands)          | Asset Derivatives      | June 30, 2014          | December 31, 2013 |
|-------------------------|------------------------|------------------------|-------------------|
|                         |                        | Balance Sheet Location | Fair Value        |
| Interest rate contracts | Other assets           | \$16                   | \$186             |
| (In thousands)          | Liability Derivatives  |                        |                   |
|                         |                        | June 30, 2014          | December 31, 2013 |
|                         | Balance Sheet Location | Fair Value             | Fair Value        |
| Interest rate contracts | Other Liabilities      | \$16                   | \$186             |



### 13. Stock Incentive Plan

The Company adopted the 2014 Stock Option Plan (“2014 Plan”) following shareholder approval of the 2014 Plan at the 2014 Annual Meeting. Subsequent to the adoption of the 2014 Plan, no additional grants may be issued under the prior plans. The 2014 Plan provides for grants of up to 350,000 shares.

**Stock Options:** Under the 2014 Plan and previous plans, certain key employees have been granted the option to purchase set amounts of common stock at the market price on the day the option was granted. Optionees, at their own discretion, may cover the cost of exercise through the exchange at the then fair value of already owned shares of the Company’s stock. Options are granted for a 10-year period and vest on a pro-rata basis over the initial three years from grant.

The Company measures the fair value of each stock option at the date of grant using the Black-Scholes option pricing model. For the quarters ended June 30, 2014 and 2013, the Company recognized \$16,000 and \$17,000, respectively, in stock option compensation expense as a component of salaries and other personnel expense. For the six months ended June 30, 2014 and 2013, the Company recognized \$32,000 and \$34,000, respectively, in stock option compensation expense as a component of salaries and other personnel expense.

Proceeds from the exercise of stock options in the three months ended June 30, 2014 and 2013, were \$64,000 and \$70,000, respectively. The Company withheld \$0 and \$70,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options in the three months ended June 30, 2014 and 2013, respectively. Proceeds from the exercise of stock options in the six months ended June 30, 2014 and 2013, were \$64,000 and \$118,000, respectively. The Company withheld \$0, and \$124,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options in the six months ended June 30, 2014 and 2013, respectively.

There were no stock options granted in the second quarter of 2014.

**Restricted Stock Units:** The Company grants restricted stock units to certain key employees periodically. Recipients of restricted stock units do not pay any cash consideration to the Company for the shares and receive all dividends with respect to such shares when the shares vest. Restricted stock units cliff vest at the end of a three-year time period. For the three months ended June 30, 2014 and 2013, the Company recognized \$66,000 and \$98,000, respectively, in restricted stock unit compensation expense as a component of salaries and other personnel expense. For the six months ended June 30, 2014 and 2013, the Company recognized \$157,000 and \$193,000, respectively, in restricted stock unit compensation expense as a component of salaries and other personnel expense.

There were no restricted stock units granted in the second quarter of 2014.

### 14. Fair Value of Assets and Liabilities

The Company groups its assets and liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are: Level 1: Valuation is based upon quoted prices for identical instruments traded in active exchange markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

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

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

The following methods and assumptions were used to estimate fair value disclosures. All financial instruments are held for other than trading purposes. Cash, due from banks and deposits in other banks: Due to the short term nature of these instruments, the carrying amounts reported in the balance sheet represent their fair values.

Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. Investments in Federal Home Loan Bank stock are recorded at cost, which also represents fair value. Loans held for sale: Due to the short term nature of these instruments, the carrying amounts reported in the balance sheet represent their fair values.

Loans: Fair values were generally determined by discounting both principal and interest cash flows on pools of loans expected to be collected using a discount rate for similar instruments with adjustments that the Company believes a market participant would consider in determining fair value. The Company estimates the cash flows expected to be collected using internal credit risk, interest rate and prepayment risk models that incorporate the Corporation's best estimate of current key assumptions, such as default rates, loss severity and prepayment speeds for the life of the loan. The carrying value of loans is presented net of the Allowance (see Note 8). Impaired loans are carried at fair value. Specific valuation allowances are included in the Allowance.

Purchased receivables: Fair values for purchased receivables are based on their carrying amounts due to their short duration and repricing frequency. Generally, purchased receivables have a duration of less than one year.

Mortgage servicing rights: MSR are measured at fair value on a recurring basis. These assets are classified as Level 3 as quoted prices are not available and the Company uses a model derived valuation methodology to estimate the fair value of MSR obtained from an independent financial advisor on an annual basis. The annual valuation is reviewed on a quarterly basis for significant changes in assumptions and current market rates. The model pools loans into tranches of homogeneous characteristics and performs a present value analysis of the expected future cash flows. The tranches are created by individual loan characteristics such as note rate, product type, and the remittance schedule. Applicable current market rate assumptions are utilized for discounting the future cash flows.

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

Deposits: The fair value for deposits with stated maturities was determined by discounting contractual cash flows using current market rates for instruments with similar maturities. For deposits with no stated maturities, the carrying value was considered to approximate fair value and does not take into account the significant value of the cost advantage and stability of the Company's long-term relationships with depositors.

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

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

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

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

Interest Rate Contracts: Interest rate swap contracts are valued in a model, which uses as its basis a discounted cash flow technique incorporating credit valuation adjustments to reflect nonperformance risk in the measurement of fair value. Although the Bank has determined that the majority of inputs used to value its interest rate swap derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of December 31, 2014, the Bank has assessed the significance of the impact of these adjustments on the overall valuation of its interest rate swap positions and has determined that they are not significant to the overall valuation of its interest rate swap derivatives. As a result, the Bank has classified its interest rate swap derivative valuations in Level 2 of the fair value hierarchy.

Assets subject to nonrecurring adjustment to fair value: The Company is also required to measure certain assets such as equity method investments, goodwill, intangible assets, impaired loans, and other real estate owned ("OREO") at fair

value on a nonrecurring basis in accordance with GAAP. Any nonrecurring adjustments to fair value usually result from the write down of individual assets.

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

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

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

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

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

| (In Thousands)                                   | June 30, 2014   |             | December 31, 2013 |             |
|--|-----------------|-------------|-------------------|-------------|
|  | Carrying Amount | Fair Value  | Carrying Amount   | Fair Value  |
| <b>Financial assets:</b>                         |                 |             |                   |             |
| <b>Level 1 inputs:</b>                           |                 |             |                   |             |
| Cash, due from banks and deposits in other banks | \$97,883        | \$97,883    | \$99,091          | \$99,091    |
| Investment securities                            | 27,078          | 27,078      | 20,487            | 20,487      |
| <b>Level 2 inputs:</b>                           |                 |             |                   |             |
| Investment securities                            | 186,500         | 186,645     | 232,305           | 232,458     |
| Accrued interest receivable                      | 3,136           | 3,136       | 2,729             | 2,729       |
| Interest rate contracts                          | 16              | 16          | 186               | 186         |
| <b>Level 3 inputs:</b>                           |                 |             |                   |             |
| Loans and loans held for sale, net               | 924,966         | 930,807     | 765,035           | 769,570     |
| Purchased receivables, net                       | 17,380          | 17,380      | 16,025            | 16,025      |
| Mortgage servicing rights                        | 1,169           | 1,169       | —                 | —           |
| <b>Financial liabilities:</b>                    |                 |             |                   |             |
| <b>Level 2 inputs:</b>                           |                 |             |                   |             |
| Deposits   | \$1,130,266     | \$1,130,106 | \$1,003,723       | \$1,003,816 |
| Securities sold under repurchase agreements      | 19,776          | 19,776      | 21,143            | 21,143      |
| Borrowings                                       | 2,186           | 2,275       | 6,527             | 6,448       |
| Accrued interest payable                         | 118             | 118         | 52                | 52          |
| Interest rate contracts                          | 16              | 16          | 186               | 186         |
| <b>Level 3 inputs:</b>                           |                 |             |                   |             |
| Junior subordinated debentures                   | 18,558          | 16,420      | 18,558            | 15,456      |
| <b>Unrecognized financial instruments:</b>       |                 |             |                   |             |
| Commitments to extend credit <sup>(1)</sup>      | \$219,979       | \$2,200     | \$187,931         | \$1,879     |
| Standby letters of credit <sup>(1)</sup>         | 6,232           | 62          | 6,463             | 65          |

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

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

| (In Thousands)                                  | Total     | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) |
|---|-----------|--|---|---|
| June 30, 2014                                   |           |  |   |   |
| Assets:   |           |  |   |   |
| Available for sale securities                   |           |  |   |   |
| U.S. Treasury and government sponsored entities | \$147,893 | \$15,564   | \$132,329   | \$—   |
| Municipal securities                            | 15,887    | —  | 15,887  | —   |
| U.S. Agency mortgage-backed securities          | 1,154     | —  | 1,154   | —   |
| Corporate bonds                                 | 39,806    | 8,355  | 31,451  | —   |
| Preferred stock                                 | 3,159     | 3,159  | —   | —   |
| Total available for sale securities             | \$207,899 | \$27,078   | \$180,821   | \$—   |
| Other assets (interest rate contracts and MSR)  | \$1,185   | \$—  | \$16  | \$1,169   |
| Liabilities:                                    |           |  |   |   |
| Other liabilities (interest rate contracts)     | \$16      | \$—  | \$16  | \$—   |
| December 31, 2013                               |           |  |   |   |
| Assets:   |           |  |   |   |
| Available for sale securities                   |           |  |   |   |
| U.S. Treasury and government sponsored entities | \$168,702 | \$5,538  | \$163,164   | \$—   |
| Municipal securities                            | 20,149    | 419  | 19,730  | —   |
| U.S. Agency mortgage-backed securities          | 25        | —  | 25  | —   |
| Corporate bonds                                 | 56,778    | 11,496   | 45,282  | —   |
| Preferred stock                                 | 3,034     | 3,034  | —   | —   |
| Total available for sale securities             | \$248,688 | \$20,487   | \$228,201   | \$—   |
| Other assets (interest rate contracts)          | \$186     | \$—  | \$186   | \$—   |
| Liabilities:                                    |           |  |   |   |
| Other liabilities (interest rate contracts)     | \$186     | \$—  | \$186   | \$—   |

As of and for the six months ending June 30, 2014 and 2013, no impairment or valuation adjustment was recognized for assets recognized at fair value on a nonrecurring basis, except for certain assets as shown in the following table. For loans measured for impairment, the Company classifies fair value measurements using observable inputs, such as external appraisals, as Level 2 valuations in the fair value hierarchy, and unobservable inputs, such as in-house evaluations, as Level 3 valuations in the fair value hierarchy.

| (In Thousands)                | Total   | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) | Total<br>(gains)<br>losses |
|-------------------------------|---------|--|---|---|----------------------------|
| June 30, 2014                 |         |  |   |   |                            |
| Loans measured for impairment | \$349   | \$—  | \$—   | \$349   | \$2                        |
| Other real estate owned       | 227     | —  | —   | 227   | 45                         |
| Total                         | \$576   | \$—  | \$—   | \$576   | \$47                       |
| June 30, 2013                 |         |  |   |   |                            |
| Loans measured for impairment | \$1,057 | \$—  | \$745   | \$312   | (\$371 )                   |
| Other real estate owned       | 426     | —  | —   | 426   | 88                         |
| Total                         | \$1,483 | \$—  | \$745   | \$738   | (\$283 )                   |

#### 15. Subsequent Event

On August 7, 2014 the Company announced the signing of a definitive agreement for Northrim Bank to acquire an additional 76.5% of RML in a cash transaction for a purchase price of approximately \$29.8 million. As a result of this transaction, Northrim Bank will own 100% of RML through its wholly-owned subsidiary, Northrim Capital Investment Company. The terms of the transaction call for Northrim Bank to pay approximately \$29.8 million in cash with \$22.4 million paid at closing and approximately \$7.4 million paid over a five year period, depending upon the profitability of RML. The initial cash payment for 76.5% of RML is 126% of the book value for that portion of RML at June 30, 2014.

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

This discussion should be read in conjunction with the unaudited consolidated financial statements of Northrim Bancorp, Inc. (the "Company") and the notes thereto presented elsewhere in this report and with the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

### Note Regarding Forward Looking-Statements

This quarterly report on Form 10-Q includes "forward-looking statements," as that term is defined for purposes of Section 21D of the Securities Exchange Act, as amended, which are not historical facts. These forward-looking statements describe management's expectations about future events and developments such as future operating results, growth in loans and deposits, continued success of the Company's style of banking, and the strength of the local economy. All statements other than statements of historical fact, including statements regarding industry prospects and future results of operations or financial position, made in this report are forward-looking. We use words such as "anticipate," "believe," "expect," "intend" and similar expressions in part to help identify forward-looking statements. Forward-looking statements reflect management's current plans and expectations and are inherently uncertain. Our actual results may differ significantly from management's expectations, and those variations may be both material and adverse. Forward-looking statements are subject to various risks and uncertainties that may cause our actual results to differ materially and adversely from our expectations as indicated in the forward-looking statements. These risks and uncertainties include: the general condition of, and changes in, the Alaska economy; factors that impact our net interest margin; our ability to maintain asset quality and expand our market share or net interest margin; and expected cost savings, synergies and other related benefits of our recently completed merger with Alaska Pacific might not be realized within the expected timeframe and costs or difficulties relating to the integration might be greater than expected. Further, actual results may be affected by competition on price and other factors with other financial institutions; customer acceptance of new products and services; the regulatory environment in which we operate; and general trends in the local, regional and national banking industry and economy. Many of these risks, as well as other risks that may have a material adverse impact on our operations and business, are identified in Part II. Item 1A Risk Factors of this report, and in our other filings with the Securities and Exchange Commission. However, you should be aware that these factors are not an exhaustive list, and you should not assume these are the only factors that may cause our actual results to differ from our expectations. In addition, you should note that we do not intend to update any of the forward-looking statements or the uncertainties that may adversely impact those statements, other than as required by law.

### Critical Accounting Policies

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

The accounting policies that involve significant estimates and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities, are considered critical accounting policies. The Company's critical accounting policies include those that address the accounting for the allowance for loan losses



("Allowance"), valuation of goodwill and other intangible assets, and the valuation of other real estate owned. These critical accounting policies are further described in Item 7, Management's Discussion and Analysis, and in Note 1, Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements in the Company's Form 10-K for the year ended December 31, 2013. Management has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements.

#### Update on Economic Conditions

"All sectors of the Alaska economy remain stable with only moderate reductions in the government sector," said Joseph Beedle, Northrim Bank's President. "Fisheries, tourism, transportation, health services, construction, and the ever important resource extraction industries continue to produce moderate growth. We believe the 2013 oil tax legislation is vitally important to the economy of Alaska."

Northrim Bank sponsors the Alaskanomics blog to provide news, analysis and commentary on Alaska's economy. Join the conversation at Alaskanomics.com or for more information on the Alaska economy, visit: [www.northrim.com](http://www.northrim.com) and click on the "About Alaska" tab. Information from our website is not incorporated into, and does not form a part of, this press release.

#### Highlights and Summary of Performance - Second Quarter of 2014

Diluted earnings per share in the second quarter of 2014 were \$0.63, compared to \$0.53 per diluted share in the quarter ended June 30, 2013.

Total revenues, which include net interest income plus other operating income, were \$17.5 million in the second quarter of 2014, a 20% increase from total revenues of \$14.6 million in the second quarter a year ago.

Net interest income increased to \$13.4 million in the second quarter of 2014, compared to \$10.9 million in the quarter ended June 30, 2013.

Other operating income, which includes revenues from Residential Mortgage, LLC, our mortgage affiliate, and other financial services affiliates, service charges, and electronic banking, were 23.4% of total revenues in the second quarter of 2014, as compared to 25.3% in the second quarter a year ago.

Northrim paid a quarterly cash dividend of \$0.17 per share in June of 2014, up 13% from the \$0.15 per share dividend paid a year ago. The dividend provides a yield of approximately 2.7% at current market share prices.

Tangible book value was \$21.73 per share at June 30, 2014 as compared to \$20.86 per share at December 31, 2013.

Tangible book value is a non-GAAP ratio that represents total shareholders' equity less goodwill and intangible assets divided by the number of shares outstanding. Although we believe this non-GAAP financial measure is frequently used by stakeholders in the evaluation of a company, there are limitations, it is not required to be uniformly applied, and it is not audited. The most comparable GAAP measure of book value consists of total shareholders' equity divided by the number of shares outstanding. Book value per share was \$22.97 at June 30, 2014, compared to \$22.07 at December 31, 2013.

Average portfolio loans increased 21% to \$924.9 million for the second quarter of 2014 as compared to \$763.4 million for the fourth quarter of, 2013, reflecting the addition of the loans acquired from Alaska Pacific.

The Company remains well-capitalized with Tier 1 Capital to Risk Adjusted Assets at June 30, 2014, of 14.26%, compared to 15.35% at December 31, 2013. The decrease in Tier 1 Capital to Risk Adjusted Assets at June 30, 2014 is a result of the acquisition of \$167.2 million in assets from Alaska Pacific.

Tangible common equity to tangible assets was 11.02% at June 30, 2014, compared to 11.30% December 31, 2013.

Tangible common equity to tangible assets is a non-GAAP ratio that represents total equity less goodwill and intangible assets divided by total assets less goodwill and intangible assets. Although we believe this non-GAAP financial measure is frequently used by stakeholders in the evaluation of a company, there are limitations, it is not required to be uniformly applied, and it is not audited. The most comparable GAAP measure of equity to assets consists of total equity divided by total assets. Total equity to total assets was 11.57% at June 30, 2014 as compared to 11.88% at December 31, 2013.

On April 1, 2014, the Company completed the acquisition of Alaska Pacific Bancshares, Inc. ("Alaska Pacific") in a stock and cash transaction valued at \$14.6 million. The transaction value includes \$6.4 million in cash, the issuance of 290,212 shares of common stock issued by the Company, and \$717,000 in proceeds from the exercise of warrants for Alaska Pacific common stock. With the completion of this acquisition, the Company now has 15 branch locations that serve 75% of Alaska's population.

The Company reported net income and diluted earnings per share of \$4.4 million and \$0.63, respectively, for the second quarter of 2014 compared to net income and diluted earnings per share of \$3.5 million and \$0.53, respectively, for the second quarter of 2013. The Company reported net income and diluted earnings per share of \$7.0 million and \$1.04, respectively, year to date as of June 30, 2014 compared to net income and diluted earnings per share of \$6.2 million and \$0.94, respectively, for the same period in 2013. The increase in net income for both of these periods as compared to the same periods in 2013 was primarily

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the result of a benefit for loan losses recorded due to \$1.1 million in net recoveries recorded in the second quarter of 2014. Additionally, contributions from the acquisition of Alaska Pacific at the beginning of the second quarter of 2014 had a positive impact on net income. Lastly, gains on sale of securities increased in the second quarter of 2014 and the first six months of 2014 as compared to the first quarter of 2014 and the first six months of 2013.

The Company's total assets increased by 12% at June 30, 2014 as compared to December 31, 2013, primarily due to the assets acquired from Alaska Pacific on April 1, 2014. Increases in portfolio loans, other assets, and net premises and equipment were partially offset by a decrease in investment securities available for sale. Net loans increased to \$925.0 million at June 30, 2014 as compared to \$765.0 million at December 31, 2013, which includes \$138.4 million in loans acquired from Alaska Pacific.

#### Credit Quality

Nonperforming assets: Nonperforming assets at June 30, 2014 increased \$4.0 million, or 95% to \$8.2 million as compared to \$4.2 million at December 31, 2013. Nonaccrual loans increased \$1.3 million to \$3.1 million and OREO increased \$2.5 million to \$4.9 million at June 30, 2014 as compared to \$1.8 million and \$2.4 million at December 31, 2013, respectively. Nonperforming purchased receivables increased from zero at December 31, 2013 to \$243,000 at June 30, 2014.

The following table summarizes total OREO activity for the three and six month periods ending June 30, 2014 and 2013:

|   | Three Months Ended June 30, |         | Six Months Ended June 30, |         |
|---|-----------------------------|---------|---------------------------|---------|
|   | 2014                        | 2013    | 2014                      | 2013    |
|   | (In Thousands)              |         |                           |         |
| Balance, beginning of the period                  | \$3,443                     | \$4,516 | \$2,402                   | \$4,543 |
| Transfers from loans                              | 21                          | 204     | 1,158                     | 365     |
| Transfers from premises and equipment             | —                           | —       | 904                       | —       |
| Acquired from Alaska Pacific                      | 1,709                       | —       | 1,709                     | —       |
| Proceeds from the sale of other real estate owned | (305)                       | (433)   | (1,599)                   | (634)   |
| Gain on sale of other real estate owned, net      | 74                          | 108     | 368                       | 129     |
| Deferred gain on sale of other real estate owned  | —                           | (15)    | —                         | (23)    |
| Impairment on other real estate owned             | (45)                        | (87)    | (45)                      | (87)    |
| Balance at end of period                          | \$4,897                     | \$4,293 | \$4,897                   | \$4,293 |

The Company transferred land valued at \$904,000 from premises and equipment to OREO in the first quarter of 2014 and listed the land for sale. The Company purchased this property in 2006 with the intension of using it for a future branch location. The Company delayed construction at this location during the economic downturn that began in 2008. The resulting unprecedented disruption in the banking industry and general uncertainty about the local, national, and global economies lingered for several years and further delayed construction. In the first quarter of 2014, the Company determined that this location is no longer suitable for a branch location based on our current analysis of the market and our branch network.

The Company acquired six OREO properties valued at \$1.7 million from Alaska Pacific. The OREO properties acquired consist of two commercial properties valued at \$1.5 million, one piece of developed land valued at \$130,000, and 3 lots valued at \$112,000.

Potential problem loans: Potential problem loans are loans which are currently performing that have developed negative indications that the borrower may not be able to comply with present payment terms and which may later be included in nonaccrual, past due, or impaired loans. At June 30, 2014, management had identified potential problem loans of \$9.1 million as compared to potential problem loans of \$8.2 million at December 31, 2013.

Troubled debt restructurings ("TDRs"): TDRs are those loans for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower, have been granted due to the borrower's weakened financial condition. Interest on TDRs will be accrued at the restructured rates when it is anticipated that no loss of original principal will occur, and the interest can be collected, which is generally after a period of six months. The Company had \$7.2 million in loans classified as TDRs that were performing and \$1.5 million in TDRs included in nonaccrual loans at June 30, 2014 for a total of \$8.7 million. At December 31, 2013 there were \$6.6 million in loans classified as

TDRs that were performing and \$1.3 million in TDRs included

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in nonaccrual loans for a total of \$7.9 million. The increase in TDRs at June 30, 2014 compared to December 31, 2013 is due to the acquisition of several TDRs from Alaska Pacific. See Note 6 of the Notes to Consolidated Financial Statements included in Item 1 of this report for further discussion of TDRs.

## RESULTS OF OPERATIONS

### Income Statement

#### Net Income

Net income attributable to Northrim BanCorp for the second quarter of 2014 increased \$873,000, or 25%, to \$4.4 million as compared to \$3.5 million for the same period in 2013. Net income attributable to Northrim BanCorp for the six months ended June 30, 2014 increased \$857,000 to \$7.0 million as compared to \$6.2 million for the same period in 2013. The increases in both periods were primarily due to increases in net interest income and a decrease in the provision for loan losses. These increases were partially offset by increases in other operating expense and the provision for income taxes.

#### Net Interest Income / Net Interest Margin

Net interest income for the second quarter of 2014 increased \$2.5 million, or 23%, to \$13.4 million as compared to \$10.9 million for the second quarter in 2013. Net interest income increased \$3.2 million, or 15%, to \$24.6 million in the first six months of 2014 as compared to \$21.5 million for the same period in 2013. The increases for both of these periods mainly arose from increases in interest income on loans. The increase in interest income on loans were primarily due to increased average loan balances, which were partially offset by lower rates on loans. The Company's net interest income as a percentage of average interest-earning assets on a tax equivalent basis increased by 9 and 3 basis points to 4.43% and 4.36% for the three and six month periods ending June 30, 2014, respectively, as compared to the same periods in 2013.

Average loans, the largest category of interest-earning assets, increased by \$190.4 million, or 26% to \$935.7 million in the three-month period ending June 30, 2014, and increased \$125.6 million, or 17% to \$856.7 million in the six-month period ending June 30, 2014, as compared to the same periods in 2013, respectively. Total interest income from loans increased \$2.3 million for the second quarter of 2014 and increased \$2.9 million during the six-month period ending June 30, 2014 as compared to the same periods in 2013, respectively, mainly due to increased average balances. Average balances increased across all loan types as a result of the acquisition of Alaska Pacific.

Additionally, average commercial and real estate construction balances from the Company's legacy operations also increased in the second quarter and first six months of 2014 as compared to the same periods a year ago. These increases were only partially offset by the decrease in interest income from loans due to decreased yields.

Average investments increased 5% both for the three and six-month periods ending June 30, 2014 as compared to the same periods in 2013. Interest income from investments increased 15% and 11%, respectively, for these same periods due to increased average balances and increased average yields.

Average interest-bearing liabilities increased \$138.5 million, or 21%, to \$791.6 million during the second quarter of 2014 and increased \$85.7 million, or 13%, to \$735 million during the first six months of 2014 as compared to \$653.1 million and \$649.3 million, respectively, for the same periods in 2013. These increases were primarily the result of increased average interest-bearing deposit balances acquired from Alaska Pacific.

The average cost of interest-bearing liabilities decreased \$27,000, or 5%, and \$117,000, or 11%, for the three and six-month periods ending June 30, 2014, respectively, as compared to the same periods in 2013 primarily due to declining market rates across all deposit types. Additionally, the Company paid off the outstanding balance on a borrowing to purchase its main office facility. This borrowing had an interest rate of 5.95% and was paid off in January 2014.

## Components of Net Interest Margin

The following table compares average balances and rates as well as net tax equivalent margins on earning assets for the three and six-month periods ending June 30, 2014 and 2013:

| (Dollars in<br>Thousands)  | Three Months Ended June 30, |             |           |       | Interest income/<br>expense |          |         |        | Average Yields/Costs<br>Tax Equivalent <sup>3</sup> |        |          |
|--|-----------------------------|-------------|-----------|-------|-----------------------------|----------|---------|--------|---|--------|----------|
|  | Average Balances            |             | Change    |       | Change                      |          | Change  |        |   |        |          |
|  | 2014                        | 2013        | \$        | %     | 2014                        | 2013     | \$      | %      | 2014  | 2013   | %        |
| Loans <sup>1,2</sup>   | \$935,708                   | \$745,357   | \$190,351 | 26 %  | \$13,082                    | \$10,734 | \$2,348 | 22 %   | 5.63 %  | 5.81 % | (0.18) % |
| Short-term<br>investments  | 48,466                      | 49,767      | (1,301)   | (3) % | 41                          | 46       | (5)     | (11) % | 0.33 %  | 0.37 % | (0.04) % |
| Long-term<br>investments   | 243,096                     | 227,775     | 15,321    | 7 %   | 772                         | 660      | 112     | 17 %   | 1.39 %  | 1.32 % | 0.07 %   |
| Total investments  | 291,562                     | 277,542     | 14,020    | 5 %   | 813                         | 706      | 107     | 15 %   | 1.22 %  | 1.15 % | 0.07 %   |
| Interest-earning<br>assets   | 1,227,270                   | 1,022,899   | 204,371   | 20 %  | 13,895                      | 11,440   | 2,455   | 21 %   | 4.58 %  | 4.54 % | 0.04 %   |
| Nonearning assets  | 116,450                     | 123,021     | (6,571)   | (5) % |                             |          |         |        |   |        |          |
| Total  | \$1,343,720                 | \$1,145,920 | \$197,800 | 17 %  |                             |          |         |        |   |        |          |
| Interest-bearing<br>deposits   | \$748,537                   | \$610,784   | \$137,753 | 23 %  | \$348                       | \$312    | \$36    | 12 %   | 0.19 %  | 0.20 % | (0.01) % |
| Borrowings   | 43,063                      | 42,296      | 767       | 2 %   | 136                         | 199      | (63)    | (32) % | 1.23 %  | 1.88 % | (0.65) % |
| Total<br>interest-bearing<br>liabilities                               | 791,600                     | 653,080     | 138,520   | 21 %  | 484                         | 511      | (27)    | (5) %  | 0.24 %  | 0.31 % | (0.07) % |
| Demand deposits<br>and other<br>noninterest<br>-bearing<br>liabilities | 395,841                     | 353,097     | 42,744    | 12 %  |                             |          |         |        |   |        |          |
| Equity   | 156,279                     | 139,743     | 16,536    | 12 %  |                             |          |         |        |   |        |          |
| Total  | \$1,343,720                 | \$1,145,920 | \$197,800 | 17 %  |                             |          |         |        |   |        |          |
| Net interest income  |                             |             |           |       | \$13,411                    | \$10,929 | \$2,482 | 23 %   |   |        |          |
| Net tax equivalent margin on interest earning assets <sup>3</sup>      |                             |             |           |       |                             |          |         |        | 4.43 %  | 4.34 % | 0.09 %   |

<sup>1</sup>Interest income includes loan fees. Loan fees recognized during the period and included in the yield calculation totaled \$717,000 and \$783,000 in the second quarter of 2014 and 2013, respectively.

<sup>2</sup>Nonaccrual loans are included with a zero effective yield. Average nonaccrual loans included in the computation of the average loans were \$3.8 million and \$4.2 million in the second quarter of 2014 and 2013 respectively.

<sup>3</sup>Tax-equivalent net interest margin is a non-GAAP performance measurement in which interest income on non-taxable investments and loans is presented on a tax-equivalent basis using a combined federal and state statutory rate of 41.11% in both 2014 and 2013. Net interest margin was 4.38% and 4.29%, respectively, for the second quarter of 2014 and 2013.

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| (Dollars in<br>Thousands)  | Six Months Ended June 30, |             |           |      |                             |          |          |         |   |        |         |        |   |
|--|---------------------------|-------------|-----------|------|-----------------------------|----------|----------|---------|---|--------|---------|--------|---|
|  | Average Balances          |             |           |      | Interest income/<br>expense |          |          |         | Average Yields/Costs<br>Tax Equivalent <sup>3</sup> |        |         |        |   |
|  | 2014                      | 2013        | Change    | %    | 2014                        | 2013     | Change   | %       | 2014  | 2013   | Change  | %      |   |
| Loans <sup>1,2</sup>   | \$856,734                 | \$731,156   | \$125,578 | 17   | % \$23,953                  | \$21,076 | \$2,877  | 14      | % 5.66  | % 5.84 | %(0.18) | %      |   |
| Short-term<br>investments  | 53,275                    | 61,742      | (8,467)   | (14) | % 90                        | 108      | (18)     | (17)    | % 0.34  | % 0.35 | %(0.01) | %      |   |
| Long-term<br>investments   | 243,200                   | 221,004     | 22,196    | 10   | % 1,525                     | 1,348    | 177      | 13      | % 1.39  | % 1.39 | —       | %      |   |
| Total investments  | 296,475                   | 282,746     | 13,729    | 5    | % 1,615                     | 1,456    | 159      | 11      | % 1.21  | % 1.17 | % 0.04  | %      |   |
| Interest-earning<br>assets   | 1,153,209                 | 1,013,902   | 139,307   | 14   | % 25,568                    | 22,532   | 3,036    | 13      | % 4.52  | % 4.54 | %(0.02) | %      |   |
| Nonearning assets  | 109,046                   | 116,333     | (7,287)   | (6)  | %                           |          |          |         |   |        |         |        |   |
| Total  | \$1,262,255               | \$1,130,235 | \$132,020 | 12   | %                           |          |          |         |   |        |         |        |   |
| Interest-bearing<br>deposits   | \$692,212                 | \$607,050   | \$85,162  | 14   | % \$634                     | \$650    | (\$16)   | (2)     | % 0.18  | % 0.22 | %(0.04) | %      |   |
| Borrowings   | 42,752                    | 42,233      | 519       | 1    | % 290                       | 391      | (101)    | (26)    | % 1.34  | % 1.85 | %(0.51) | %      |   |
| Total<br>interest-bearing<br>liabilities                               | 734,964                   | 649,283     | 85,681    | 13   | % 924                       | 1,041    | (117)    | (11)    | % 0.25  | % 0.32 | %(0.07) | %      |   |
| Demand deposits<br>and other<br>noninterest<br>-bearing<br>liabilities | 376,051                   | 342,129     | 33,922    | 10   | %                           |          |          |         |   |        |         |        |   |
| Equity   | 151,240                   | 138,823     | 12,417    | 9    | %                           |          |          |         |   |        |         |        |   |
| Total  | \$1,262,255               | \$1,130,235 | \$132,020 | 12   | %                           |          |          |         |   |        |         |        |   |
| Net interest income  |                           |             |           |      |                             | \$24,644 | \$21,491 | \$3,153 | 15  | %      |         |        |   |
| Net tax equivalent margin on interest earning assets <sup>3</sup>      |                           |             |           |      |                             |          |          |         |   | 4.36   | % 4.33  | % 0.03 | % |

<sup>1</sup>Interest income includes loan fees. Loan fees recognized during the period and included in the yield calculation totaled \$1.4 million and \$1.5 million in the six months ended June 30, 2014 and 2013, respectively.

<sup>2</sup>Nonaccrual loans are included with a zero effective yield. Average nonaccrual loans included in the computation of the average loans were \$2.9 million and \$4.3 million in the six months ended June 30, 2014 and 2013, respectively.

<sup>3</sup>Tax-equivalent net interest margin is a non-GAAP performance measurement in which interest income on non-taxable investments and loans is presented on a tax-equivalent basis using a combined federal and state statutory rate of 41.11% in both 2014 and 2013. Net interest margin was 4.31% and 4.27%, respectively, for the second quarter of 2014 and 2013.

The following tables sets forth the changes in consolidated net interest income attributable to changes in volume and to changes in interest rates for the three and six-month periods ending June 30, 2014 and 2013. Changes attributable to the combined effect of volume and interest rate have been allocated proportionately to the changes due to volume and the changes due to interest rates:

| (In Thousands)   | Three months ended June 30, 2014 vs. 2013 |      |       |
|------------------|---|------|-------|
|                  | Volume                                    | Rate | Total |
| Interest Income: |   |      |       |



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|                           |         |        |           |   |
|---------------------------|---------|--------|-----------|---|
| Loans                     | \$2,687 | (\$339 | ) \$2,348 |   |
| Short-term investments    | (1      | )(4    | )(5       | ) |
| Long-term investments     | 62      | 50     | 112       |   |
| Total interest income     | \$2,748 | (\$293 | ) \$2,455 |   |
| Interest Expense:         |         |        |           |   |
| Interest-bearing deposits | \$46    | (\$10  | ) \$36    |   |
| Borrowings                | 4       | (67    | )(63      | ) |
| Total interest expense    | \$50    | (\$77  | ) (\$27   | ) |

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| (In Thousands)            | Six months ended June 30, 2014 vs. 2013 |          |          |
|---------------------------|---|----------|----------|
|                           | Increase (decrease) due to              |          | Total    |
|                           | Volume                                  | Rate     |          |
| <b>Interest Income:</b>   |   |          |          |
| Loans                     | \$2,263                                 | \$614    | \$2,877  |
| Short-term investments    | (11                                     | )(7      | )(18     |
| Long-term investments     | 62                                      | 115      | 177      |
| Total interest income     | \$2,314                                 | \$722    | \$3,036  |
| <b>Interest Expense:</b>  |   |          |          |
| Interest-bearing deposits | (\$5                                    | )( \$11  | )( \$16  |
| Borrowings                | (11                                     | )(90     | )(101    |
| Total interest expense    | (\$16                                   | )( \$101 | )( \$117 |

#### Provision for Loan Losses

The provision for loan losses was negative \$1.1 million and zero for the second quarters of 2014 and 2013, respectively, and negative \$1.1 million and positive \$150,000 for the six-month periods ending June 30, 2014 and 2013, respectively. The decrease in the provision for loan losses in both periods is primarily the result of net recoveries. At June 30, 2014, the Allowance was \$16.0 million, or 1.73% of total loans as compared to \$16.3 million, or 2.11% of total loans at December 31, 2013. Nonperforming loans compared to total portfolio loans increased to 0.33% at June 30, 2014 from 0.24% at December 31, 2013, and the Allowance compared to nonperforming loans decreased to 521% at June 30, 2014 from 897% at December 31, 2013. See additional analysis of the Allowance in the Balance Sheet Overview section.

### Other Operating Income

Other operating income for the three-month period ending June 30, 2014, increased \$404,000, or 11%, to \$4.1 million as compared to the same period in 2013. This increase is primarily the result of an increase of \$246,000 in employee benefit plan income due to revenue contributions from Enroll Alaska and increased revenue from Northrim Benefits Group's existing book of business, an increase in gain on sale of securities of \$249,000, and an increase in other income of \$240,000. The increase in other income is primarily the result of a \$158,000 bargain purchase gain on the acquisition of Alaska Pacific and an increase in loan servicing fees of \$93,000 due to the servicing portfolio purchased from Alaska Pacific. These increases were partially offset by a decrease of \$183,000 in equity in earnings from RML, the Company's mortgage affiliate, due to a decrease in refinance activity and a decrease of \$284,000 in purchased receivable income, due to decreased purchased receivable balances.

Other operating income for the six-month period ending June 30, 2014 was essentially flat as compared to the same period in 2013. The following are the significant changes in individual items that make up other operating income: a decrease of \$556,000 in equity in earnings from RML, the Company's mortgage affiliate, due to a decrease in refinance activity and a decrease of \$505,000 in purchased receivable income, due to decreased purchased receivable activity; an increase of \$553,000 in employee benefit plan income due to revenue contributions from Enroll Alaska and increased revenue from Northrim Benefits Group's existing book of business, an increase in gain on sale of securities of \$128,000, and an increase in other income of \$296,000. The increase in other income is primarily the result of the bargain purchase gain and new loan servicing fees noted above and also a \$52,000 increase in the Company's share of net income from its wealth management affiliate, Pacific Wealth Advisors, LLC, due in part to an increase in its assets under management increase.

### Other Operating Expense

Other operating expense for the second quarter of 2014 increased \$2.6 million, or 27%, to \$12.0 million as compared to the same period in 2013, reflecting the acquisition of the Alaska Pacific operations and one time merger costs. Salaries and other personnel expense, reserve for purchased receivables, occupancy expense, and professional and outside services expense increased \$1.3 million, \$358,000, \$254,000, and \$101,000, respectively, in the second quarter of 2014 as compared to the second quarter of 2013. Salaries and other personnel expense increased due to an increase in average full time equivalent employees by 51 from 252 at the end of 2013 to 303 at June 30, 2014, the hiring of new employees at higher salary levels, and increases in salaries of existing employees. The reserve for purchased receivables increased due to an increase in charge-offs and nonperforming purchased receivables. Occupancy expense increased due to the acquisition of Alaska Pacific which increased the number of bank branches maintained by the Company. Professional and outside services expense increased due to legal, advisory, and system conversion costs related to the acquisition of Alaska Pacific.

Additionally, the Company recognized increases in its reserve for purchased receivables and amortization of low income housing tax credit investments. These expenses increased \$358,000 and \$83,000, respectively, in the second quarter of 2014 as compared to the second quarter of 2013. The reserve for purchased receivables increased due to charge offs incurred during the second quarter of 2014. Amortization of low income housing tax investments increased in 2014 as compared to 2013 due to an increase in the Company's investment in and allocated tax credits from low income housing tax credit partnerships (see further discussion in "Income Taxes" below).

Other operating expense for the first six months of 2014 increased \$3.2 million, or 17%, to \$22.3 million as compared to the same period in 2013. Salaries and other personnel expense, professional and outside services expense, occupancy expense, and reserve for purchased receivables increased \$1.4 million, \$476,000, \$243,000, and \$237,000, respectively. The reasons for these changes in these expense items are the same as discussed above for the second quarter.

The Company incurred significant expenses in connection with the acquisition and integration of Alaska Pacific that are not capitalizable. Classification of expenses as merger-related is done based on the nature of the expense. Expenses that are necessary in the normal course of business, such as salaries and benefits, occupancy, and systems related costs related to the day-to-day operations of the locations acquired in the transaction since April 1, 2014, are not classified as merger-related expenses. The following table presents the merger-related expenses by major category for the six month periods ending June 30, 2014 and 2013:

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| (In Thousands)                    | 2014  | 2013 |
|-----------------------------------|-------|------|
| Professional and outside services | \$452 | \$—  |
| Other operating expenses          | 199   | —    |
| Total                             | \$651 | \$—  |

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#### Income Taxes

The provision for income taxes for the three and six-month periods ending June 30, 2014 increased \$604,000 and \$469,000, or 37% and 17%, as compared to the same periods in 2013 primarily due to an increase in net income before the provision for income taxes. Additionally, the Company estimates that \$319,000 in merger related costs included in pre-tax income for the six-month period ending June 30, 2014 are not deductible for tax purposes. The impact of this increase in non-deductible costs on the provision for income taxes was only partially offset by an increase in tax credits from the Company's investments in low income housing tax credit partnerships. The effective tax rate for the six-month periods ending June 30, 2014 and 2013 was 31% and 30%, respectively.

#### FINANCIAL CONDITION

##### Balance Sheet Overview

##### Investment Securities

Investment securities at June 30, 2014 decreased \$40.8 million, or 16%, to \$210.1 million from \$250.9 million at December 31, 2013. This decrease was primarily due to sales, maturities, and security calls of available for sale securities, which were only partially offset by purchases. The Company used proceeds from the net decrease in investment securities to fund loan growth in the first six months of 2014.

##### Loans and Lending Activities

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

Portfolio loans increased by \$156.8 million, or 20%, to \$926.8 million at June 30, 2014 from \$770.0 million at December 31, 2013. On April 1, 2014, the Company acquired \$138.4 million in loans from Alaska Pacific. The remainder of the increase represents organic growth in commercial and real estate construction loans.

The following table details loan balances by loan type as of the dates indicated:

| (In Thousands)   | June 30, 2014 |                  | December 31, 2013 |                  |    |
|--|---------------|------------------|-------------------|------------------|----|
|  | Dollar Amount | Percent of Total | Dollar Amount     | Percent of Total |    |
| Commercial   | \$339,011     | 36.6             | % \$300,338       | 39.0             | %  |
| Real estate construction one-to-four family              | 40,178        | 4.3              | % 30,161          | 3.9              | %  |
| Real estate construction other                           | 49,901        | 5.4              | % 32,599          | 4.2              | %  |
| Real estate term owner occupied                          | 112,519       | 12.1             | % 91,098          | 11.8             | %  |
| Real estate term non-owner occupied                      | 284,824       | 30.7             | % 255,324         | 33.2             | %  |
| Real estate term other                                   | 37,893        | 4.1              | % 29,976          | 3.9              | %  |
| Consumer secured by 1st deeds of trust                   | 33,219        | 3.6              | % 16,483          | 2.1              | %  |
| Consumer other   | 33,704        | 3.6              | % 18,058          | 2.3              | %  |
| Subtotal   | \$931,249     |                  | \$774,037         |                  |    |
| Less: Unearned origination fee, net of origination costs | (4,440)       | )(0.5            | )% (4,021         | )(0.5            | )% |
| Total loans  | \$926,809     |                  | \$770,016         |                  |    |

The following table provides details on the acquired loan portfolio after fair value adjustments as of June 30, 2014, and also details the rest of the Company's portfolio loans compared to December 31, 2013:

| (In Thousands)   | June 30, 2014 |               |           | December 31, 2013 |
|--|---------------|---------------|-----------|-------------------|
|  | NRIM Legacy   | AKPB Acquired | NRIM      | NRIM              |
| Commercial   | \$302,824     | \$36,187      | \$339,011 | \$300,338         |
| Real estate construction one-to-four family              | 33,867        | 6,311         | 40,178    | 30,161            |
| Real estate construction other                           | 49,624        | 277           | 49,901    | 32,599            |
| Real estate term owner occupied                          | 81,181        | 31,338        | 112,519   | 91,098            |
| Real estate term non-owner occupied                      | 258,543       | 26,281        | 284,824   | 255,324           |
| Real estate term other                                   | 35,360        | 2,533         | 37,893    | 29,976            |
| Consumer secured by 1st deeds of trust                   | 15,734        | 17,485        | 33,219    | 16,483            |
| Consumer other   | 18,434        | 15,270        | 33,704    | 18,058            |
| Subtotal   | \$795,567     | \$135,682     | \$931,249 | \$774,037         |
| Less: Unearned origination fee, net of origination costs | (3,988)       | )(452         | )(4,440   | )(4,021           |
| Total loans  | \$791,579     | \$135,230     | \$926,809 | \$770,016         |

#### Analysis of Allowance for Loan Losses

The Company maintains an Allowance to reflect losses inherent in the loan portfolio. The Allowance is increased by provisions for loan losses and loan recoveries and decreased by loan charge-offs. The size of the Allowance is determined through quarterly assessments of probable estimated losses in the loan portfolio.

Our methodology for making such assessments and determining the adequacy of the Allowance includes the following key elements:

A specific allocation for impaired loans. Management determined the fair value of the majority of these loans based on the underlying collateral values. This analysis is based upon a specific analysis for each impaired loan, including external appraisals on loans secured by real property, management's assessment of the current market, recent payment history, and an evaluation of other sources of repayment. In-house evaluations of fair value are used in the impairment analysis in some situations. Inputs to the in-house evaluation process include information about sales of comparable properties in the appropriate markets and changes



in tax assessed values. The Company obtains appraisals on real and personal property that secure its loans during the loan origination process in accordance with regulatory guidance and its loan policy. The Company obtains updated appraisals on loans secured by real or personal property based upon its assessment of changes in the current market or particular projects or properties, information from other current appraisals, and other sources of information. Appraisals may be adjusted downward by the Company based on its evaluation of the facts and circumstances on a case by case basis. External appraisals may be discounted when management believes that the absorption period used in the appraisal is unrealistic, when expected liquidation costs exceed those included in the appraisal, or when management's evaluation of deteriorating market conditions warrants an adjustment. Additionally, the Company may also adjust appraisals in the above circumstances between appraisal dates. The Company uses the information provided in these updated appraisals along with its evaluation of all other information available on a particular property as it assesses the collateral coverage on its performing and nonperforming loans and the impact that may have on the adequacy of its Allowance. The specific allowance for impaired loans, as well as the overall Allowance, may increase based on the Company's assessment of updated appraisals. When the Company determines that a loss has occurred on an impaired loan, a charge-off equal to the difference between carrying value and fair value is recorded. If a specific allowance is deemed necessary for a loan, and then that loan is partially charged off, the loan remains classified as a nonperforming loan after the charge-off is recognized. Loans measured for impairment based on collateral value and all other loans measured for impairment are accounted for in the same way. As of June 30, 2014 and December 31, 2013, 22% and 60% of nonperforming loans, which totaled \$3.1 million and \$1.8 million, respectively, had partially charged-off balances.

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

The Company has the following loan segments: commercial, real estate construction one-to-four family, real estate construction other, real estate term owner occupied, real estate term non-owner occupied, real estate term other, consumer secured by 1st deeds of trust, and other consumer loans. The Company has five loan classes: pass, special mention, substandard, doubtful, and loss.

After the portfolio has been disaggregated into segments and classes, the Company calculates a general reserve for each segment and class based on the average year loss history for each segment and class using a five year look-back period.

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

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

At June 30, 2014, the unallocated portion of the Allowance as a percentage of the total Allowance was 17%. The unallocated portion of the Allowance as a percentage of the total Allowance was 14% at December 31, 2013. Further discussion of the enhancement to the Company's Allowance methodology can be found in Item 7 in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

**Allowance related to acquired loans:** In accordance with generally accepted accounting principles, loans purchased from Alaska Pacific on April 1, 2014 were recorded at their fair value at the acquisition date. Credit discounts were included in the determination of fair value; therefore, an allowance for loan losses was not recorded at the acquisition



date. Purchased credit impaired loans were evaluated on a loan by loan basis and the valuation allowance for these loans was netted against the carrying value.

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

| (In Thousands)                              | Three Months Ended June 30, |          | Six Months Ended June 30, |          |
|---|-----------------------------|----------|---------------------------|----------|
|   | 2014                        | 2013     | 2014                      | 2013     |
| Balance at beginning of period              | \$16,032                    | \$16,641 | \$16,282                  | \$16,408 |
| Charge-offs:                                |                             |          |                           |          |
| Commercial                                  | —                           | 355      | 320                       | 355      |
| Consumer secured by 1st deeds of trust      | 39                          | —        | 39                        | —        |
| Consumer other                              | 24                          | —        | 33                        | 14       |
| Total charge-offs                           | 63                          | 355      | 392                       | 369      |
| Recoveries:                                 |                             |          |                           |          |
| Commercial                                  | 576                         | 143      | 630                       | 219      |
| Real estate construction one-to-four family | 613                         | 18       | 625                       | 36       |
| Real estate construction other              | —                           | 78       | —                         | 78       |
| Consumer other                              | 10                          | 3        | 23                        | 6        |
| Total recoveries                            | 1,199                       | 242      | 1,278                     | 339      |
| Net, (recoveries) charge-offs               | (1,136)                     | ) 113    | (886)                     | ) 30     |
| Provision (benefit) for loan losses         | (1,136)                     | ) —      | (1,136)                   | ) 150    |
| Balance at end of period                    | \$16,032                    | \$16,528 | \$16,032                  | \$16,528 |

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

#### Deposits

Deposits are the Company's primary source of funds. Total deposits increased \$126.5 million to \$1.1 billion at June 30, 2014, from \$1.0 billion at December 31, 2013. On April 1, 2014, the Company acquired \$151.4 million in deposits from Alaska Pacific.

The following table provides details on the deposits after fair value adjustments as of June 30, 2014:

| (In Thousands)          | 30-Jun-14   |               |             | 31-Dec-13   |
|-------------------------|-------------|---------------|-------------|-------------|
|                         | NRIM Legacy | AKPB Acquired | NRIIM       | NRIM        |
| Demand deposits         | \$351,681   | \$37,047      | \$388,728   | \$363,969   |
| Interest-bearing demand | 138,984     | 35,663        | 174,647     | 143,703     |
| Savings deposits        | 96,553      | 23,565        | 120,118     | 94,518      |
| Alaska CDs              | 115,081     | —             | 115,081     | 112,702     |
| Money market deposits   | 191,351     | 29,460        | 220,811     | 202,606     |
| Time deposits           | 83,863      | 27,018        | 110,881     | 86,225      |
| Total deposits          | \$977,513   | \$152,753     | \$1,130,266 | \$1,003,723 |

Noninterest-bearing demand deposits increased \$24.8 million to \$388.7 million at June 30, 2014, from \$363.9 million at December 31, 2013. The Company's mix of deposits continues to contribute to a low cost of funds with balances in transaction accounts representing 90% and 91% of total deposits at June 30, 2014 and December 31, 2013, respectively. Savings account balances at June 30, 2014 were up 27% as compared to December 31, 2013. At June 30, 2014, noninterest-bearing demand deposits accounted for 34% of total deposits, interest-bearing demand accounts were 15%, savings deposits were 11%, money market

balances accounted for 20%, the Alaska CD accounted for 10% and time certificates were 10% of total deposits. There were no depositors with deposits representing 10% or more of total deposits at June 30, 2014 or December 31, 2013.

#### Borrowings

At June 30, 2014, the Company's maximum borrowing line from the FHLB was \$170.6 million, approximately 13% of the Company's assets. The Company has an outstanding FHLB advance of \$2.2 million as of June 30, 2014 and December 31, 2013, respectively, that was originated in the first quarter of 2013. FHLB advances are dependent on the availability of acceptable collateral such as marketable securities or real estate loans, although all FHLB advances are secured by a blanket pledge of the Company's assets. The \$2.2 million FHLB advance that the Company drew in the first quarter of 2013 was to match fund a \$2.2 million loan to one borrower for the construction of a low income housing project that qualifies for a long term fixed interest rate of 3.12%. This new FHLB borrowing has an eighteen year term with a 30 year amortization period, which mirrors the term of the construction loan made to the borrower. Additionally, as of June 30, 2014 the Company has an outstanding FHLB letter of credit of \$2 million which it acquired from Alaska Pacific.

The Company purchased its main office facility for \$12.9 million on July 1, 2008 through Northrim Building LLC, and assumed an existing loan secured by the building in an amount of \$5.1 million. At June 30, 2014 and December 31, 2013, the outstanding balance on this loan was zero and \$4.3 million, respectively. This borrowing had an interest rate of 5.95% and was paid off in January 2014.

At June 30, 2014 and December 31, 2013, the Company had no short-term (original maturity of one year or less) borrowings that exceeded 30% of shareholders' equity.

#### Liquidity and Capital Resources

The Company manages its liquidity through its Asset and Liability Committee. In addition to the \$97.9 million of cash and due from banks and interest bearing deposits in other banks and \$157.2 million in unpledged available for sale securities held at June 30, 2014, the Company had additional funding sources which include fed fund borrowing lines and advances available at the FHLB of Seattle and the Federal Reserve Bank of approximately \$205.0 million as of June 30, 2014.

At June, 2014, \$50.7 million in securities, or 24%, of the investment portfolio was pledged, as compared to \$46.8 million, or 19%, at December 31, 2013. As shown in the Consolidated Statements of Cash Flows, net cash used by operating activities was \$1.5 million for the first six months of 2014 primarily due to net purchases of loans held for sale and an increase in other assets related to the acquisition of Alaska Pacific. Net cash provided by investing activities was \$33.3 million for the same period, primarily due to the proceeds from sales and maturities of securities available for sale. Net cash used by financing activities was \$33.0 million, primarily due to an decrease in borrowings and deposits.

The Company issued 3,049 shares of its common stock through the exercise of stock options in the second quarter of 2014 and did not repurchase any shares of its common stock under the Company's publicly announced repurchase program. The Company issued 290,212 shares of its common stock as part of the purchase agreement to acquire Alaska Pacific on April 1, 2014. At June 30, 2014, the Company had 6,830,913 shares of its common stock outstanding.

#### Capital Requirements and Ratios

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

The requirements address both risk-based capital and leverage capital. At June 30, 2014, all capital ratios of the Company and the Bank exceeded the ratios required for a “well-capitalized” institution under regulatory guidelines.

The following table sets forth the actual capital ratios for the Company and the Bank as calculated under regulatory guidelines, compared to the regulatory minimum capital ratios and the regulatory minimum capital ratios needed to be eligible to qualify as a “well-capitalized” institution as of June 30, 2014.

|                           | Adequately-Capitalized | Well-Capitalized | Actual Ratio<br>Northrim<br>BanCorp, Inc. | Actual Ratio<br>Northrim<br>Bank |
|---------------------------|------------------------|------------------|---|----------------------------------|
| June 30, 2014             |                        |                  |   |                                  |
| Tier 1 risk-based capital | 4.00%                  | 6.00%            | 14.26%                                    | 13.37%                           |
| Total risk-based capital  | 8.00%                  | 10.00%           | 15.51%                                    | 14.62%                           |
| Leverage ratio            | 4.00%                  | 5.00%            | 12.55%                                    | 11.75%                           |
| December 31, 2013         |                        |                  |   |                                  |
| Tier 1 risk-based capital | 4.00%                  | 6.00%            | 15.35%                                    | 13.75%                           |
| Total risk-based capital  | 8.00%                  | 10.00%           | 16.61%                                    | 15.00%                           |
| Leverage ratio            | 4.00%                  | 5.00%            | 13.06%                                    | 11.68%                           |

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

The decrease in the capital ratios of the Company are a result of the acquisition of \$167.2 million in assets from Alaska Pacific. The Company paid \$6.4 million in cash and issued 290,212 shares of common stock with a value of \$7.4 million on April 1, 2014 for the purchase of Alaska Pacific.

#### Off-Balance Sheet Items

The Company is a party to financial instruments with off-balance sheet risk. Among the off-balance sheet items entered into in the ordinary course of business are commitments to extend credit and the issuance of letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized on the balance sheet. Certain commitments are collateralized. As of June 30, 2014 and December 31, 2013, the Company’s commitments to extend credit and to provide letters of credit which are not reflected on its balance sheet amounted to \$226.2 million and \$194.4 million, respectively. Since many of the commitments are expected to expire without being drawn upon, these total commitment amounts do not necessarily represent future cash requirements.

#### Capital Expenditures and Commitments

At June 30, 2014 the Company has capital commitments of \$4.2 million related to the planned improvements to the Company’s corporate office building. The Company expects these capital expenditures to be incurred in the second half of 2014.

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

Our assessment of market risk as of June 30, 2014 indicates that there are no material changes in the quantitative and qualitative disclosures from those in our Annual Report on Form 10-K for the year ended December 31, 2013.

#### ITEM 4. CONTROLS AND PROCEDURES

##### Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, we evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934). Our principal executive and financial officers supervised and participated in this evaluation. Based on this evaluation, our principal executive and financial officers each concluded that as of June 30, 2014, the disclosure controls and procedures are effective in timely alerting them to material information required to be included in the periodic reports to the Securities and Exchange Commission. The design of any system of controls is based in part upon various assumptions about the likelihood of future events, and there can be no assurance that any of our plans, products, services or procedures will succeed in achieving their intended goals under future conditions.

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

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15-d-15(f) of the Securities Exchange Act of 1934) that occurred during the quarterly period ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

#### PART II - OTHER INFORMATION

##### ITEM 1. LEGAL PROCEEDINGS

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

##### ITEM 1A. RISK FACTORS

For information regarding risk factors, please refer to Item 1A in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. These risk factors have not materially changed as of June 30, 2014.

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

(a)-(b) Not applicable

(c) There were no stock repurchases by the Company during the three months ending June 30, 2014.

##### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

##### ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

(a) Not applicable

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

ITEM 6. EXHIBITS

|         |   |
|---------|---|
| 31.1    | Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a)   |
| 31.2    | Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a)   |
| 32.1    | Certification of Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350 |
| 32.2    | Certification of Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350 |
| 101.INS | XBRL Instance Document  |
| 101.SCH | XBRL Schema Document  |
| 101.CAL | XBRL Calculation Linkbase Document  |
| 101.LAB | XBRL Labels Linkbase Document   |
| 101.PRE | XBRL Presentation Linkbase Document   |
| 101.DEF | XBRL Definition Linkbase Document   |

Notes to Exhibits List:

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

SIGNATURES

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

NORTHRIM BANCORP, INC.

August 8, 2014

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

August 8, 2014

By /s/ Latosha M. Frye  
Latosha M. Frye  
Senior Vice President, Chief Financial Officer  
(Principal Financial and Accounting Officer)