# BANK OF MARIN

# 2003 ANNUAL REPORT

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## DIRECTORS AND EXECUTIVE OFFICERS

Judith O'Connell Allen, *Community volunteer, Chairman, Bank of Marin*
James E. Deitz, *President, Marin Business Services*
W. Robert Griswold, Jr., *President and CEO, Bank of Marin*
Ray Hoffman, III, *Proprietor, Hoffman Development Co.*
* Nancy R. Boatright, *Vice President & Corp.Sec., Bank of Marin*
Norma J. Howard, *Business consultant*
J. Patrick Hunt, *Partner, Hunt Investments*
H. C. Jackson, *Retired merchant*
James D. Kirsner, *Business consultant*
* Larry Klaustermeier, *Sr. Exec. Vice President & CCO, Bank of Marin*
* M. Thomas LeMasters, *Exec. Vice President & CFO, Bank of Marin*
* Patrick J. London, *Exec. Vice President & Director of Investment Advisory & Trust Services, Bank of Marin*
Stuart D. Lum, *Partner, Veracast Communications*
Joseph D. Martino, *Retired banker*
James L. Placak, *Sales Representative, CIGNA*
Joel Sklar, MD, *Partner, Cardiology Assoc. of Marin & San Francisco*
Brian M. Sobel, *Partner, Sobel Communications*
* Alexandra E. Souza, *Exec.Vice President & CAO, Bank of Marin*
J. Dietrich Stroeh, *Partner, CSW/Stuber-Stroeh Engineering Group*

* These executive officers are not also directors.

This annual report serves as the annual disclosure statement for the purposes of part 350 of the Federal Deposit Insurance Corporation rules. It has not been reviewed or confirmed for accuracy or relevance by the FDIC.

## BANK STAFF

Mary Adams
Diane Akers
Dino Alessio
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Terry Aman
Michele Anderson
Natalie Andryushina
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Sabrina Arnaud-Randall
Cathy Atkinson
Tamara Austin
Boualay Bala
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Susan Beaver
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Vanessa Camacho
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Barbara Dougherty
Mary Jayne Elmore
Florette Eugene
Brandee Everett
Susan Farac
Coy Ferini
Richard Fisher
Craig Fox
Hung Fung
Karen Garbarino
Elizabeth Greene
Judy Grider
Vicki Gruber
Sal Gutierrez
Victoria Gutierrez
Dina Hadzikadunic
Leslie Harrell
Bryan Heagy
Leslie Heggli
Viviana Henao
Dean Higgins
Debbie Higgins
Helen Hoffmann
Josh Iversen
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Tracy Jerves
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Catherine Karklyn
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Lisa Kleinecke
Tori Kuciej
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Trini Lopez
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Molly Manisay
Connie Marelich
Joan Marino
Scott Martini
Stephanie McLeod
Kenny Meligan
Mary Melville
Victor Mencarelli
Bob Meyer
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Eric Nelson
Linda Nolt
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Jon O'Halloran
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Connie Pedersen
John Pedone
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Marie Reick
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Mike Roney
Stephen Ross
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Saroj Sachdev
Holly Schmidt
Ellie Shattuck
Mari Soria
Renee Sullivan
Nancy Sutherland
Jamie Thigpen
Allison Thornton
Kim To
Barbara Tolin
Cindy Toscanini
Ray Vallerga
Patty Varela
Joe Villaluna
Danielle Wu
Vita Yumanova
Jacky Zingarelli

## BANK OFFICERS

Kate Albaugh, *Asst. Vice President*
Sue Anderson, *Vice President*
Marshall Appleton, *Asst. Vice President*
Gisela Bigden-Fisher, *Vice President*
Bo Boero, *Asst. Vice President*
Michael Burke, *Vice President*
Fabia Butler, *Asst. Vice President*
Michael Callan, *Vice President*
Joan Capurro, *Vice President*
Jennifer Casper, *Asst. Vice President*
Sal Catinella, *Vice President*
Douglas Caulfield. *Vice President*
Judi Cole, *Vice President*
Chris Colliver, *Asst. Vice President*
Phyllis Cope, *Vice President*
Robert Davisson, *Vice President*
Emily DiLaura, *Vice President*
Pat Feingold, *Vice President*
Holly Ford, *Vice President*
Sharon Fox, *Vice President*
Faith Giosso, *Asst. Vice President*
Kevin Gish, *Asst. Vice President*
Robert Gotelli, *Asst. Vice President*
Jeff Graham, *Asst. Vice President*
Janet Hayward, *Vice President*
Karen Hegarty, *Vice President*
Wayne Hoffer, *Vice President*
Fran Hoke, *Asst. Vice President*
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Donald Jarvis, *Vice President*
Nancy Jones, *Vice President*
Steve Kambur, *Vice President*
James King, *Vice President*
Carol Kneis, *Vice President*
David Kough, *Vice President*
Mae Lacourse, *Vice President*
Carrie Lee, *Asst. Vice President*
Thomas Leong, *Asst. Vice President*
John Luce, *Vice President*
Marguerite Matthews, *Vice President*
Lynn McHale, *Asst. Vice President*
Bill Montgomery, *Vice President*
Frank Murray, *Sr. Vice President*
Patti O'Brien, *Asst. Vice President*
Elizabeth O'Farrell, *Sr. Vice President*
Peter Pelham, *Vice President*
Frank Perachiotti, Jr., *Vice President*
Carole Reif, *Vice President*
Elizabeth Reizman, *Sr. Vice President*
Lucy Rezendes, *Vice President*
Dan Rheiner, *Vice President*
Robert Rowen, *Asst. Vice President*
David Schmidt, *Vice President*
Dave Schrader, *Asst. Vice President*
Liza Silva, *Vice President*
Linda Steidle, *Vice President*
Rich Ugarte, *Vice President*
Sherry Wallace, *Vice President*
Jackie Williams, *Vice President*
Bonnie Wilson, *Asst. Vice President*
Nicole Young, *Asst. Vice President*
Keith Zimmerman, *Sr. Vice President*

**MESSAGE TO OUR SHAREHOLDERS:**

Bank of Marin was founded on the principals of providing outstanding service to our customers, a competitive return to our shareholders, a satisfying work environment for our employees, and of being a contributing member of the communities we serve. Consistency in all these areas has been a big part of our success. Our ongoing challenge is to grow in a way that is consistent with these goals. We are pleased to report another year of consistent growth in deposits, loans and earnings, as well as of enhanced service to our customers and to our communities.

We were able to achieve strong financial results in 2003 even though our economy did not experience the recovery many had expected earlier in the year. The decision of the Federal Reserve Open Market Committee to cut overnight rates by a further 25 basis points in late June brought interest rates to levels not seen in 40 years. Now eight months later most of us are still waiting for results, hoping for job growth in California and nationally, and for a reduction in available office space locally. We did see some increase in loan demand late in 2003, and we remain hopeful that 2004 will bring an improving economy and a return to more normal interest rate levels.

In 2003 deposits grew faster than loans, reversing the trend of the previous year. As a result, our loan to deposit ratio declined, hurting our net interest margin, because we invested excess deposits in short term, lower earning investments. Despite that, our net interest income increased by $2.1 million or 8.4%. We were also able to grow our non-interest income by $0.6 million or 27.7% and importantly, limit growth in non-interest expenses to $0.7 million or 4.0%, while growing our total assets by 19.2%. The bottom line was an increase in net income of $1.2 million or 19.7% compared to 2002.

We experienced only modest charge-offs during the year (0.06%) and ended the year with no non-performing loans or loans 90 days past due, evidence that the credit quality of our portfolio remains high. Our strong earnings and the shift in our asset mix increased our total risk based capital ratio to 10.92%, indicating, when combined with our historical levels of current year earnings, that we have the necessary capital to support our growth. These factors together with our growing reputation for "legendary customer service" and a strong commitment to our communities, give us confidence that the Bank's future remains bright.

Strong leadership by boards of directors and senior management is important, especially at this time when corporate boards are under particular scrutiny to ensure good corporate governance. Your board of directors and the Bank's senior management are committed to the highest standards of ethical conduct, as outlined in our recently formalized Code of Ethical Conduct.

Again this year, we want to take this opportunity to express our appreciation to our talented team of dedicated and committed community bankers. Our success would not be possible without them and you, our loyal customers and shareholders.

*/s/ Judith O'Connell Allen*

Judith O'Connell Allen
Chairman of the Board

*/s/ W. Robert Griswold, Jr.*

W. Robert Griswold, Jr.
President & Chief Executive Officer

## BUSINESS OF THE BANK

### General

Bank of Marin (the 'Bank') was incorporated in August 1989, received its charter from the California Superintendent of Banks (now the California Department of Financial Institutions) and commenced operations in January 1990. The Bank is an insured bank under the Federal Deposit Insurance Act and, like most state chartered banks of its size in California, is not a member of the Federal Reserve System.

### Market Area and Customer Base

The Bank's market area stretches from southern Sonoma County south to the Golden Gate Bridge and lies between the Pacific Ocean on the west and San Pablo Bay to the east. Of this larger market area the Bank has designated the communities of San Rafael, Corte Madera, Greenbrae, Larkspur, Kentfield, Ross, San Anselmo, Tiburon, Belvedere, Mill Valley, Sausalito, Terra Linda, Bel Marin Keys, Novato and Petaluma as its primary market areas. The Bank's customer base is made up of business and personal banking relationships from the communities near the nine branch office locations.

### Loans

The Bank offers a broad range of commercial and retail lending programs including commercial loans, construction financing, consumer loans, and home equity loans and lines of credit. The Bank also offers a proprietary Visa credit card to its customers, including a Business Visa program for business and professional customers. For reporting purposes these programs are consolidated into the general categories of commercial loans, real estate loans and personal loans. At December 31, 2003, these broad categories totaled $450.9 million, and accounted for approximately 24%, 60% and 16%, respectively, of the loan portfolio.

The interest rates on most commercial loans are tied to the Wall Street Journal prevailing prime rate and change as rate changes are reported. A majority of these loans have a term of one year or less.

Real estate loans include commercial real estate loans, consumer loans and lines of credit secured by real property, and construction financing. Commercial real estate loans are generally written for ten years with fixed rates for the first 5 years and then adjusting to an indexed spread for the remaining 5 years. Consumer real estate secured loans include equity lines of credit and installment loans for various consumer purposes. Generally, equity lines are for a term of ten years or less and are secured by first or second deeds of trust on residential properties and bear interest at a floating rate tied to the Wall Street Journal prevailing prime rate. Usually, home equity installment loans are for a term of 15 years or less and have a fixed rate of interest.

The Bank offers construction financing to developers of single family residences and commercial real estate properties. Construction loans are typically repaid through permanent financing by the Bank or from other financial institutions. Usually these loans have terms of twelve to eighteen months, have fixed rates of interest or floating rates tied to the Wall Street Journal prevailing prime rate, and are secured by first deeds of trust.

### Deposits

The Bank offers a variety of checking and savings accounts, and a number of time deposit alternatives, including interest bearing and non-interest bearing personal and business checking accounts and time certificates of deposit. We offer direct deposit of payroll, social security and pension checks. Our ATM system is tied into both the STAR and PLUS networks, and we offer a proprietary Visa check card.

We attract deposits from individuals, merchants, small to medium sized businesses and professionals who live and/or work in our market areas. More than 90% of our deposits come from Marin and Sonoma Counties. Approximately half of the Bank's deposits are from businesses and half are from individuals. The Bank as a matter of policy does not accept brokered deposits.

### Investment Advisory & Trust Services

In 1998, the Bank began to offer investment advisory and personal trust services. The services include customized portfolio management of individual stocks, bonds and cash; professional management of all trust assets including real estate and other specialty assets; tax reporting, safekeeping and accounting of assets; estate settlement and administration of all areas of living, testamentary and charitable trusts.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion of the Bank's financial condition and results of operations for each of the three years ended December 31, 2003 should be read in conjunction with the Bank's financial statements and related notes thereto, located on pages 34 to 47 of this Annual Report. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances. In April 2003, the Board of Directors declared a 5% stock dividend, equal to the dividend declared in April of 2002. Per share information with respect to earnings and book value has been restated to reflect the stock dividends.

### Critical Accounting Policy

Management has considered the accounting principles upon which the Bank's financial reporting depends and has determined the allowance for loan losses to be the Bank's most critical accounting policy. The allowance for loan losses is discussed in further detail beginning on page 27 of this Annual Report. The Bank formally assesses the adequacy of the allowance for loan losses on a quarterly basis. Determination of the adequacy is based on ongoing assessments of the probable risk in the outstanding loan portfolio. These assessments include the periodic re-grading of loans based on changes in their individual credit characteristics including delinquency, seasoning, recent financial performance of the borrower, economic factors, changes in the interest rate environment, and other factors as warranted. Loans are initially graded when originated. They are re-graded as they are renewed, when there is a new loan to the same borrower, when identified facts demonstrate heightened risk of nonpayment, or if they become delinquent. Re-grading of larger problem loans occurs at least quarterly. Confirmation of the quality of the grading process is obtained by independent credit reviews conducted by consultants specifically hired for this purpose and by various bank regulatory agencies.

The Bank's method for assessing the appropriateness of the allowance includes specific allowances for identified problem loans, an allowance factor for pools of credits, and allowances for changing environmental factors (e.g. portfolio trends, concentration of credit, growth, economic factors, etc.). Allowances for identified problem loans are based on specific analysis of individual credits. Loss estimation factors for loan pools are based on analysis of local economic factors applicable to each loan pool. Due to our minimal historic losses, loss estimation factors are based only in part on the previous historical loss experience for each pool. Allowances for changing environmental factors are management's best estimate of the probable impact these changes have had on the loan portfolio as a whole.

## RESULTS OF OPERATIONS

### Overview

The 2003 financial performance for Bank of Marin produced record levels of deposits, loans, and net income. Total deposits reached $584,116,000 in 2003, an increase of $98,087,000 or 20.2% from the prior year. Total loans finished the year at $450,881,000 compared to $410,155,000 in 2002, representing an increase of $40,726,000 or 9.9%. Net income for 2003 was $7,473,000 or $2.38 per share (diluted) compared with $6,242,000 or $2.06 per share (diluted) in 2002. The year over year change in net income represents an improvement of 19.7%.

The Bank's return on average assets (ROA) and return on average equity (ROE) improved over the prior year. In 2003 the Bank's ROA and ROE were, respectively, 1.28% and 14.46% compared to 1.26% and 14.12% in 2002. Management continues to balance the desire to increase the return ratios to those of its peers with the desire to increase the Bank's deposit penetration in Marin and Sonoma Counties. For the twelve month period from June 2002 to June 2003 (the latest date for which the information is available), the Bank's market share of total Marin County deposits increased from 7.36% to 8.11%.

Net interest income was a principal source of the earnings improvement for the year, as it reached $27,656,000, an increase of $2,134,000 or 8.4% over 2002. The interest income component of net interest income was up 3.4% to $32,825,000, and is the result of the increase in the size of the Bank's loan portfolio. Total interest expense of $5,169,000 was down from 2002 by $1,059,000 or 17.0%. While the Bank's deposit portfolio showed strong growth, total interest expense was down significantly, as market interest rates and the Bank's rates declined throughout the year.

The Bank provided $686,000 to the allowance for loan losses in 2003, and net charge-offs were $263,000. This compares to a provision of $577,000 and net charge-offs of $122,000 in 2002. At year-end 2003 and 2002, the allowance for loan losses as a percentage of total loans was 1.21% and 1.23%, respectively.

Non-interest income is comprised of service charges on deposit accounts, Investment Advisory & Trust Services (IA&TS) revenue, and other income. In 2003, total non-interest income was $2,960,000, which is an improvement of $642,000 or 27.7% over 2002. Service charges on deposit accounts increased to $1,021,000 versus $840,000 one year ago. IA&TS revenue grew to $815,000, an increase of $145,000, and other income finished the year at $1,125,000 compared to $809,000 in the prior year.

Non-interest expenses increased from $17,125,000 in 2002 to $17,817,000 in 2003, a $693,000 or 4.0% increase and were largely due to the growth in the operations of the Bank. From 2001 to 2002, non-interest expenses increased by over 18.0%. The significant year over year increase in 2002 was due to the costs associated with branch expansion that occurred in the second half of 2001.

Assets of the Bank totaled $642,607,000 at December 31, 2003, an increase of $103,582,000 or 19.2% from 2002 ending balances. The Bank ended 2003 with a total capital to risk weighted asset ratio of 10.92%, well above the regulatory minimum of 8.0%.

## Summary of Quarterly Results of Operations

Table 1 sets forth the results of operations for the four quarters of 2002 and 2003.

**Table 1 Summarized Statement of Operations**

| | 2002 Quarters Ended | | | | 2003 Quarters Ended | | | |
|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Mar. 31 | June 30 | Sept. 30 | Dec. 31 | Mar. 31 | June 30 | Sept. 30 | Dec. 31 |
| Interest income | $7,425 | $7,817 | $8,111 | $8,397 | $8,115 | $8,340 | $8,213 | $8,156 |
| Interet expense | 1,526 | 1,540 | 1,624 | 1,538 | 1,405 | 1,285 | 1,239 | 1,239 |
| Net interest income | 5,899 | 6,277 | 6,487 | 6,859 | 6,710 | 7,055 | 6,974 | 6,917 |
| Provision for loan losses | 150 | 175 | 150 | 102 | 167 | 205 | 174 | 139 |
| Net interest income after provision for loan losses | 5,749 | 6,102 | 6,337 | 6,757 | 6,543 | 6,850 | 6,800 | 6,778 |
| Non-interest income | 508 | 557 | 608 | 645 | 668 | 679 | 796 | 816 |
| Non-interest expense | 4,213 | 4,203 | 4,287 | 4,421 | 4,580 | 4,492 | 4,482 | 4,263 |
| Income before provision for income taxes | 2,044 | 2,456 | 2,658 | 2,981 | 2,631 | 3,037 | 3,114 | 3,331 |
| Provision for income taxes | 766 | 939 | 1,027 | 1,165 | 1,020 | 1,179 | 1,194 | 1,247 |
| Net income | $1,278 | $1,517 | $1,631 | $1,816 | $1,611 | $1,858 | $1,920 | $2,084 |
| Net income per common share | | | | | | | | |
| Basic | $ 0.45 | $ 0.53 | $ 0.56 | $ 0.63 | $ 0.55 | $ 0.64 | $ 0.65 | $ 0.71 |
| Diluted | $ 0.43 | $ 0.50 | $ 0.53 | $ 0.59 | $ 0.52 | $ 0.59 | $ 0.61 | $ 0.65 |

## Net Interest Income

Net interest income is the difference between the interest earned on earning assets, such as loans and investments, and the interest expense on interest bearing liabilities used to fund those assets, primarily deposits. Net interest income is the Bank’s largest (90.3%) source of income.

Net interest income is impacted by changes in general market interest rates and by changes in the amounts and composition of interest earning assets and interest bearing liabilities. Comparisons of net interest income are frequently made using net interest margin and net interest rate spread. Net interest margin is expressed as net interest income divided by average earning assets. Net interest rate spread is the difference between the average rate earned on total interest earning assets and the average rate incurred on total interest bearing liabilities. Both of these measures are reported on a taxable equivalent basis. Net interest margin is the higher of the two because it reflects interest income earned on assets funded with non-interest bearing liabilities, which includes demand deposits and stockholders’ equity.

Table 2, Distribution of Average Statements of Condition and Analysis of Net Interest Income, compares interest income and interest earning assets with interest expense and interest bearing liabilities for the three years 2001 through 2003. The table also indicates net interest income, net interest margin and net interest rate spread for each year.

**Table 2 Distribution of Average Statements of Condition and Analysis of Net Interest Income**

| (Dollars in thousands) | 2001 Average Balance | 2001 Interest Income/ Expense(1) | 2001 Yield/ Rate(1) | 2002 Average Balance | 2002 Interest Income/ Expense(1) | 2002 Yield/ Rate(1) | 2003 Average Balance | 2003 Interest Income/ Expense(1) | 2003 Yield/ Rate(1) |
|---|---|---|---|---|---|---|---|---|---|
| Assets | | | | | | | | | |
| Federal funds sold | $ 19,627 | 731 | 3.72% | $ 13,237 | 204 | 1.54% | $ 23,312 | 243 | 1.04% |
| Interest-earning deposits | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| Investment securities | | | | | | | | | |
| U. S. Treasury securities | 22,471 | 1,403 | 6.25 | 17,522 | 1,101 | 6.28 | 11,459 | 518 | 4.52 |
| U. S. government agencies | 17,647 | 1,556 | 8.82 | 21,769 | 1,009 | 4.64 | 32,672 | 1,018 | 3.11 |
| Other | 12,208 | 701 | 5.74 | 15,201 | 848 | 5.58 | 12,303 | 791 | 6.43 |
| Municipal bonds | 22,802 | 1,030 | 6.24 | 24,281 | 1,027 | 6.02 | 23,991 | 954 | 5.72 |
| Loans and bankers' acceptances.(2) | 291,717 | 25,020 | 8.58 | 366,408 | 27,561 | 7.52 | 434,908 | 29,301 | 6.74 |
| Total interest-earning assets | 386,472 | 30,441 | 7.98 | 458,418 | 31,750 | 7.02 | 538,645 | 32,825 | 6.17 |
| Cash and due from banks | 22,358 | | | 29,877 | | | 33,056 | | |
| Bank premises and equipment | 2,887 | | | 4,196 | | | 4,361 | | |
| Interest receivable and other assets | 2,043 | | | 2,090 | | | 5,513 | | |
| Total Assets | $413,760 | | | $494,581 | | | $581,575 | | |
| Liabilities and Stockholders' Equity | | | | | | | | | |
| Interest-bearing transaction accounts | $ 35,638 | 270 | 0.76 | $ 43,188 | 309 | 0.72 | $ 51,664 | 207 | 0.40 |
| Savings accounts | 140,092 | 4,149 | 2.96 | 182,532 | 2,953 | 1.62 | 226,288 | 2,426 | 1.07 |
| Time accounts | 98,512 | 4,565 | 4.63 | 105,409 | 2,960 | 2.81 | 110,740 | 2,534 | 2.29 |
| Funds purchased | 16 | 1 | 6.78 | 333 | 6 | 1.86 | 91 | 2 | 1.71 |
| Total interest-bearing liabilities | 274,258 | 8,985 | 3.28 | 331,462 | 6,228 | 1.88 | 388,783 | 5,169 | 1.33 |
| Demand accounts | 98,599 | | | 115,983 | | | 138,214 | | |
| Interest payable | 3,030 | | | 2,922 | | | 2,890 | | |
| Stockholders' equity | 37,873 | | | 44,214 | | | 51,688 | | |
| Total Liabilities and Stockholders' Equity | $413,760 | | | $494,581 | | | $581,575 | | |
| Net Interest Income | | $21,456 | | | $25,522 | | | $27,656 | |
| Net Interest Margin | | | 5.65% | | | 5.66% | | | 5.21% |
| Net Interest Spread | | | 4.70% | | | 5.14% | | | 4.84% |

(1) Yields and interest income are presented on a taxable equivalent basis using the Federal statutory rate of 34 percent.
(2) Average balances on loans outstanding include all non-performing loans. The amortized portion of net loan origination fees (costs) is included in interest income on loans, representing an adjustment to the yield.

In 2003, the Bank's net interest income increased by $2,134,000 or 8.4% over 2002, and by $4,066,000 or 19.0% in 2002 over 2001. These increases are attributable to growth in average earning assets of $80,227,000 in 2003 and $71,946,000 in 2002. The Bank's 2003 year-end loan to deposit ratio was 77.2%. The Bank's yield on interest earning assets declined in 2003 by 85 basis points to 6.17%, and the yield on its loan portfolio declined from 7.52% in 2002 to 6.74% in 2003. The yield on the Bank's Federal funds sold dropped from 1.54% in 2002 to 1.04% in 2003. These decreases in yield are the result of interest rate reductions implemented by the Federal Reserve Board by reducing the Federal funds interest rate (the interest rate banks charge each other for short term borrowings), and the time required for these rate changes to impact market rates of interest. In the last two years there was a fifty basis point reduction in the Federal funds rate in 2002, and a twenty-five basis point reduction in 2003.

The yield on the Bank's portfolio of Treasury Securities, and Agency Securities declined from prior year levels to 4.52% and 3.11%, respectively. The Bank's Treasury and Agency Securities generally have an average life of less than three years and will mature or be called more quickly than other securities in the Bank's portfolio. Therefore, their yield is significantly impacted by market rates of interest. The yield on Municipal Securities decreased from 6.02% in 2002 to 5.72% in 2003, while the yield on other securities increased during the same period. Other Securities is largely comprised of corporate bonds, and the yield on these instruments improved during the year from 5.58% to 6.43%.

While the yield the Bank realized on interest earning assets decreased, deposit rates also declined in 2003. The rate paid on interest bearing liabilities declined from 1.88% in 2002 to 1.33% in 2003. This is primarily the result of the aforementioned changes in market interest rates originating from actions taken by the Federal Reserve in 2002 and 2003. In 2003, the Bank achieved a net interest margin (NIM) of 5.21%, down from the NIM of 5.66% experienced in 2002. The combination of a lower loan to deposit ratio in 2003, and the decline in market rates of interest contributed to this change.

In 2002 the Bank's net interest margin increased by one basis point when compared to 2001. While market rates of interest changed substantially in 2001 and 2002, the increase in the Bank's loan to deposit ratio from 79.2% in 2001 to 84.4% in 2002 aided in maintaining the Bank's NIM.

Table 3, Analysis of Changes in Net Interest Income, separates the change in the Bank's net interest income into two components: (1) volume - change caused by increases or decreases in the average asset and liability balances outstanding, and (2) yield/rate - changes in average yields on earning assets and average rates for interest bearing liabilities. Table 3 shows the impact on income of balance sheet changes and the changes in market interest rate levels which occurred during 2002 and 2003. The increase in net interest income during both years is primarily the result of growth in average earning assets, a change in the mix of average earning assets, and the decline in the rate paid on interest bearing liabilities.

**Table 3 Analysis of Changes in Net Interest Income**

| | Year ended December 31, 2002 compared to 2001 | | | Year ended December 31, 2003 compared to 2002 | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Volume | Yield/ Rate* | Total | Volume | Yield/ Rate* | Total |
| Assets | | | | | | |
| Federal funds sold | $ (238) | $ (289) | $ (527) | $ 156 | $ (117) | $ 39 |
| Interest-earning deposits | -- | -- | -- | -- | -- | -- |
| Investment securities | | | | | | |
| U. S. Treasury securities | (309) | 7 | (302) | (381) | (202) | (583) |
| U. S. government agencies | 363 | (910) | (547) | 506 | (497) | 9 |
| Other | 172 | (25) | 147 | (162) | 105 | (57) |
| Municipal bonds | -- | (3) | (3) | (17) | (56) | (73) |
| Loans and bankers' acceptances | 6,406 | (3,865) | 2,541 | 5,153 | (3,413) | 1,740 |
| Total interest-earning assets | 6,394 | (5,085) | 1,309 | 5,255 | (4,180) | 1,075 |
| Liabilities | | | | | | |
| Interest-bearing transaction acct. | 57 | (17) | 40 | 61 | (163) | (102) |
| Savings accounts | 1,257 | (2,453) | (1,196) | 708 | (1,235) | (527) |
| Time accounts | 320 | (1,924) | (1,604) | 150 | (576) | (426) |
| Funds purchased | 21 | (16) | 5 | (4) | 0 | (4) |
| Total interest-bearing liabilities | 1,655 | (4,410) | (2,755) | 915 | (1,974) | (1,059) |
| Net Interest Income | $4,739 | $ (675) | $4,064 | $4,340 | $ (2,206) | $2,134 |

* Variances due to changes in both yield/rate and volume (mix) are allocated to yield/rate.

## Provision for Loan Losses

The Bank provides as an expense an amount to bring the allowance for loan losses to a level to provide adequate coverage for probable loan losses. The adequacy of the allowance for loan losses is evaluated based on several factors, including growth of the loan portfolio, analysis of probable losses in the portfolio and recent loss experience. Actual losses on loans are charged against the allowance and the allowance is increased through the provision charged to expense. The Bank's provision for loan losses in 2003 was $686,000 versus $577,000 for 2002 and $619,000 in 2001. Net charge-offs for 2003 totaled $263,000 compared with $122,000 in 2002 and $43,000 in 2001. Table 4, Non-performing Loans at December 31, shows the total non-performing assets at December 31 for the last five years.

**Table 4 Non-performing Loans at December 31**

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Non accrual loans | $ 90,000 | $ -- | $ -- | $ -- | $ -- |
| Accruing loans past due 90 days or more | -- | -- | -- | -- | -- |
| Other real estate owned | -- | -- | -- | -- | -- |
| Total non-performing assets | $ 90,000 | $ -- | $ -- | $ -- | $ -- |

Loans are placed on nonaccrual when management believes that there is serious doubt as to the collection of principal or interest, or when they become contractually past-due by 90 days or more with respect to principal or interest, except for loans that are both well secured and in the process of collection. When loans are placed on nonaccrual status, any accrued but uncollected interest is reversed from current income, and additional income is recorded only as payments are received.

**Non-interest Income**

Most of the growth in non-interest income to $2,960,000, up from $2,318,000 in 2002 and $1,873,000 in 2001, is attributable to the growth in the operations of the Bank.

Service charges on deposits in 2003 and in 2002 increased by $180,000 and $133,000 respectively. These increases are generally due to growth in the number of accounts in the Bank. The Bank's IA&TS has shown similar results. IA&TS revenue in 2003 was $815,000, an increase over the prior year of $145,000. This increase is primarily the result of growth in assets under management. IA&TS revenue showed a $144,000 increase over 2001. The increase in "other" income is primarily from growth in other services associated with an expanding customer base.

**Non-interest Expense**

Table 5, Significant Components of Non-Interest Expense, summarizes the amounts and changes in dollars and percentages. As with non-interest income, much of the increase in non-interest expense is attributable to the growth in the operations of the Bank. In 2003 non-interest expense increased 4.0% while average loans and deposits increased 18.7% and 17.8%, respectively. In 2002 non-interest expense increased 19.4%, while average loans and deposits increased 25.6% and 20.0%, respectively.

**Table 5 Significant Components of Non-Interest Expense**

| (Dollars in Thousands) | Year ended December 31, 2001 | 2002 | 2003 | 2002 compared to 2001 Amount Increase | 2002 compared to 2001 Percent Increase | 2003 compared to 2002 Amount Increase (Decrease) | 2003 compared to 2002 Percent Increase (Decrease) |
|---|---|---|---|---|---|---|---|
| Salaries and related benefits | $8,835 | $10,446 | $10,767 | $1,611 | 18.2% | $321 | 3.1% |
| Occupancy and equipment | 2,041 | 2,483 | 2,668 | 442 | 21.7 | 185 | 7.5 |
| Legal fees | 78 | 93 | 54 | 15 | 19.2 | (39) | (41.9) |
| Other professional fees | 365 | 437 | 468 | 72 | 19.7 | 31 | 7.1 |
| Data processing fees | 796 | 952 | 1,039 | 156 | 19.6 | 87 | 9.1 |
| Other | 2,313 | 2,714 | 2,821 | 401 | 17.3 | 107 | 3.9 |
| Total | $14,428 | $17,125 | $17,817 | $2,697 | 18.7% | $692 | 4.0% |

In 2003 salaries and benefits costs increased by $321,000 or 3.1% primarily due to annual merit pay increases. The number of full-time equivalent (FTE) employees increased slightly to 161, up from 2002's level of 159. In 2003 there were expenses of $917,000 for the Bank's Employee Stock Ownership and Savings Plan (ESOP), and $885,000 for staff and officer incentive bonus plans. The increase in ESOP expense for 2003 was $38,000 or 4.3%. The increase in salary and ESOP costs were offset by a decrease in incentive bonus plan expense which decreased by $293,000 or 24.9% from 2002.

In comparing 2002 with 2001, salaries and benefits costs increased by 18.2%. The number of full-time equivalent (FTE) employees increased by seven from December 31, 2001 to 159 at December 31, 2002. In 2002 there were expenses of $879,000 for the Bank's Employee Stock Ownership and Savings Plan and $1,178,000 for staff and officer incentive bonus plans. The year over year increase in salaries and benefits was due to branch expansion in 2001. The larger expenses for incentive compensation were due to the Bank's strong loan and deposit growth, and improved profitability.

The 2003 increase of $185,000 in occupancy and equipment costs is largely due to annual increases in branch operating leases. This year over year increase represents a decline when compared to the increase experienced in the prior year. In 2002, the Bank incurred an increase of $442,000, which was largely due to increases in branch operating leases and the amortization of improvements associated with two new branch offices. Additionally, the Bank incurred costs associated with the remodel of a branch office, and software improvements in the Bank's central operations department.

In 2003, data processing costs were $1,039,000, an increase over 2002 of $87,000 or 9.1%. This increase is largely attributable to the growth in the operations of the Bank. In 2002, data processing expense increased by $156,000, and like 2003, is attributable to the increase in the growth in the operations of the Bank.

Other non-interest expenses of $2,821,000 represent a $107,000 or 3.9% increase over 2002. Generally, this increase is due to the growth in activity of the Bank. In 2002, other non-interest expenses increased by $481,000 or 21.5%. These increases were due to the growth in activity of the Bank, and the expansion of the Bank's branch offices that took place in the second half of 2001.

The Bank's efficiency ratio (non-interest expense divided by the sum of non-interest income and net interest income) improved over the prior year and finished at 58.1% in 2003. Last year, the Bank's efficiency ratio was 61.5%.

## FINANCIAL CONDITION

### Investment Securities

The Bank maintains an investment securities portfolio to provide liquidity and earnings on funds that have not been loaned. Management determines the maturities and the types of securities to be purchased based on the need for liquidity to fund loans and the desire to attain a high investment yield. Table 6 shows the makeup of the securities portfolio at December 31, 2002 and 2003.

**Table 6 Securities Investments**

| Type and Maturity Grouping | December 31, 2002 | | | | December 31, 2003 | | | |
|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Principal Amount | Book Value* | Market Value | Average Yield | Principal Value | Book Value* | Market Value | Average Yield |
| Held to maturity | | | | | | | | |
| U.S. Treasury | | | | | | | | |
| Total | $ -- | $ -- | $ -- | --% | $ -- | $ -- | $ -- | --% |
| Other U.S. Government | | | | | | | | |
| Total | -- | -- | -- | -- | -- | -- | -- | -- |
| State and municipal | | | | | | | | |
| Due within 1 year | 1,075 | 1,078 | 1,101 | 4.57 | 7,320 | 7,367 | 7,359 | 2.94 |
| Due after 1 but within 5 years | 17,570 | 17,998 | 18,994 | 4.05 | 13,795 | 14,028 | 14,797 | 4.13 |
| Due after 5 but within 10 years | 1,575 | 1,583 | 1,716 | 4.75 | 6,705 | 7,205 | 7,244 | 3.39 |
| Due after 10 years | 1,890 | 1,939 | 2,033 | 4.69 | 1,890 | 1,899 | 1,960 | 4.69 |
| Total | 22,110 | 22,598 | 23,844 | 4.18 | 29,710 | 30,499 | 31,360 | 3.71 |
| Corporate Bonds | | | | | | | | |
| Due within 1 year | 2,000 | 2,034 | 2,052 | 3.54 | -- | -- | -- | -- |
| Due after 1 but within 5 years | 10,500 | 10,580 | 11,461 | 6.71 | 11,500 | 11,691 | 12,380 | 6.05 |
| Due after 5 but within 10 years | -- | -- | -- | -- | -- | -- | -- | -- |
| Due after 10 years | -- | -- | -- | -- | -- | -- | -- | -- |
| Total | 12,500 | 12,614 | 13,513 | 6.20 | 11,500 | 11,691 | 12,380 | 6.05 |
| Total held to maturity | 34,610 | 35,212 | 37,357 | 4.90 | 41,210 | 42,190 | 43,740 | 4.36 |
| Available for sale | | | | | | | | |
| U.S. Treasury | | | | | | | | |
| Due within 1 year | 9,000 | 9,080 | 9,280 | 6.03 | 5,500 | 5,514 | 5,572 | 3.09 |
| Due after 1 but within 5 years | 3,000 | 3,027 | 3,296 | 6.71 | 7,500 | 7,802 | 7,879 | 2.43 |
| Due after 5 but within 10 years | -- | -- | -- | -- | -- | -- | -- | -- |
| Due after 10 years | -- | -- | -- | -- | -- | -- | -- | -- |
| Total | 12,000 | 12,107 | 12,576 | 6.20 | 13,000 | 13,316 | 13,451 | 2.71 |
| Other U. S. Goverment | | | | | | | | |
| Due within 1 year | -- | -- | -- | -- | 26,794 | 27,258 | 27,572 | 4.69 |
| Due after 1 but within 5 years | 13,500 | 13,601 | 14,012 | 4.34 | 28,407 | 28,798 | 28,919 | 3.04 |
| Due after 5 but within 10 years | 2,258 | 2,268 | 2,337 | 6.11 | 10,000 | 10,012 | 9,852 | 4.15 |
| Due after 10 years | -- | -- | -- | -- | 716 | 713 | 742 | 6.13 |
| Total | 15,758 | 15,869 | 16,349 | 4.57 | 65,917 | 66,781 | 67,085 | 3.92 |
| Total available for sale | 27,758 | 27,976 | 28,925 | 5.28 | 78,917 | 80,097 | 80,536 | 3.72 |
| Total | $62,368 | $63,188 | $66,282 | 5.07% | $120,127 | $122,287 | $124,276 | 3.94% |

* Book value reflects cost, adjusted for accumulated amortization and accretion. No securities are less than investment grade.

The Bank's investment securities portfolio, consisting primarily of U.S. Treasuries, other U.S. government agencies, state and municipal securities, and corporate bonds, increased $58,588,000 or (91.3%) in 2003. U.S. Treasuries, representing 11.0% of the portfolio increased by $875,000. U.S. government agency securities made up 54.6% of the portfolio and increased by $50,735,000. State and municipal securities increased by $7,901,000 and represent 24.9% of the portfolio, and corporate bonds totaling $11,691,000 or 9.5% of the portfolio, decreased by $923,000 in 2003. The weighted average maturity of the portfolio at December 31, 2003 was approximately 24 months.

## Loans

The Bank seeks to maintain a loan portfolio that is well balanced in terms of borrowers, collateral and maturities. Of the Bank's outstanding loans at December 31, 2003, 24% are commercial loans, 60% are secured by real estate and 16% are to consumers. For the most part, this mix is not significantly changed from prior years. The Bank's commercial real estate loan portfolio is composed primarily of term loans for which the primary source of repayment is cash flow from net operating income. Table 7 shows an analysis of loans by type.

**Table 7 Loans Outstanding by Type at December 31**

| (Dollars in thousands) | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Commercial loans | $ 46,706 | $ 54,030 | $ 68,517 | $ 85,192 | $ 105,847 |
| Real estate | | | | | |
| Commercial | 123,434 | 146,695 | 161,136 | 187,384 | 196,703 |
| Construction | 12,459 | 17,284 | 27,305 | 41,736 | 44,471 |
| Residential | 17,717 | 24,114 | 28,363 | 29,824 | 28,052 |
| Installment | 17,649 | 22,825 | 40,928 | 66,019 | 75,808 |
| Total loans | 217,965 | 264,948 | 326,249 | 410,155 | 450,881 |
| Allowance for loan losses | 3,376 | 4,213 | 4,580 | 5,035 | 5,458 |
| Net loans | $214,589 | $260,735 | $321,669 | $405,120 | $445,423 |

Table 8 shows that both the fixed and variable rate portion of the portfolio in 2003 remained relatively unchanged when compared to 2002. In 2003, the Bank's fixed rate loans were 41.1% of the portfolio, and the variable portion was 58.9%. The large majority of the variable rate loans are tied to independent indices (such as the Wall Street Journal prime rate or the Treasury Constant Maturities) and the remainder adjusts with changes in the Bank's reference rate. Many of the fixed rate loans with an original term of more than five years have provisions for the fixed rates to reset, or convert to a variable rate, after five years.

**Table 8 Loan Portfolio Maturity Distribution and Interest Rate Sensitivity**

| | December 31, 2002 | | | | December 31, 2003 | | | |
|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Fixed Rate | Variable Rate | Total | Percent | Fixed Rate | Variable Rate | Total | Percent |
| Due within 1 year | $34,938 | $65,669 | $100,607 | 24.5% | $28,498 | $96,309 | $124,807 | 27.7% |
| Due after 1 but within 5 years | 69,123 | 47,407 | 116,530 | 28.4 | 89,142 | 45,672 | 134,814 | 29.9 |
| Due after 5 years | 56,719 | 136,299 | 193,018 | 47.1 | 67,620 | 123,640 | 191,260 | 42.4 |
| Total | $160,780 | $249,375 | $410,155 | 100.0% | $185,260 | $265,621 | $450,881 | 100.0% |
| Percentage | 39.2% | 60.8% | 100.0% | | 41.1% | 58.9% | 100.0% | |

Note: The "Due within 1 year" data includes demand loans, overdrafts and past due loans.

## Allowance for Loan Losses

Credit risk is inherent in the business of lending. As a result, the Bank maintains an allowance for loan losses to absorb losses inherent in the Bank's loan portfolio. This is maintained through periodic charges to earnings. These charges are shown in the Statement of Operations as provision for loan losses. All specifically identifiable and quantifiable losses are immediately charged off against the allowance. The balance of the Bank's allowance for loan losses is an estimate of the remaining losses inherent in the portfolio.

The allowance for loan losses to total loans at December 31, 2003 was 1.21% versus 1.23% at the end of 2002. At December 31, 2001, the allowance for loan losses to total loans was 1.40%. Based on the current conditions of the loan portfolio, management believes that the $5,457,635 allowance for loan losses at December 31, 2003 is adequate to absorb losses inherent in the Bank's loan portfolio. No assurance can be given, however, that adverse economic conditions or other circumstances will not result in increased losses in the portfolio. Table 9 shows the activity in the allowance for loan losses for each of the years ended December 31. At December 31, 2003 and 2002 the Bank had no loans that were past due 90 days or otherwise nonperforming.

**Table 9 Allowance for Loan Losses at December 31**

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Beginning balance | $3,024,158 | $3,179,195 | $4,003,275 | $4,579,744 | $5,034,653 |
| Provision charged to expense | 770,187 | 986,156 | 619,178 | 577,157 | 685,485 |
| Loans charged off | (691,678) | (214,990) | (52,596) | (194,562) | (376,544) |
| Loan loss recoveries | 76,528 | 52,914 | 9,887 | 72,314 | 114,041 |
| Ending balance | $3,179,195 | $4,003,275 | $4,579,744 | $5,034,653 | $5,457,635 |
| Total loans outstanding at end of year, before deducting allowance for loan losses | $217,964,245 | $264,948,338 | $326,249,033 | $410,154,831 | $450,880,626 |
| Average total loans outstanding during year | $200,268,739 | $232,760,803 | $291,716,706 | $366,407,696 | $434,908,002 |
| Ratio of allowance for loan losses to total loans at end of year | 1.46% | 1.51% | 1.40% | 1.23% | 1.21% |

## The Components of the Allowance for Loan Losses

As stated previously in "Critical Accounting Policy," the overall allowance consists of a specific allowance, an allowance factor, and an allowance for changing environmental factors. The first component, the specific allowance, results from the analysis of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. Through management's ongoing loan grading process, individual loans are identified that have conditions that indicate the borrower may be unable to pay all amounts due under the contractual terms. These loans are evaluated individually by management and specified allowances for loan losses established where applicable.

The second component, the allowance factor, is an estimate of the probable losses that have occurred across the major loan categories in the Bank's loan portfolio. This analysis is based on loan grades by pool and current general economic and business conditions. This analysis covers the Bank's entire loan portfolio but excludes any loans that were analyzed individually for specific allowances as discussed above. The total amount allocated for this component is determined by applying loss estimation factors to outstanding loans.

The third component of the allowance for credit losses is an economic component that is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by portfolio trends, concentration of credit, growth, economic trends, etc.

There are limitations to any credit risk grading process. The volume of loans makes it impractical to re-grade every loan every quarter. Therefore, it is possible that some currently performing loans not recently graded will not be as strong as their last grading and an insufficient portion of the allowance will have been allocated to them. Grading and loan review often must be done without knowing whether all relevant facts are at hand. Troubled borrowers may deliberately or inadvertently omit important information from reports or conversations with lending officers regarding their financial condition and the diminished strength of repayment sources.

At December 31, 2003 the allowance for loan losses was $5,458,000 consisting of a specific allowance of $1,110,000, an allowance factor of $3,643,000, and an economic allowance of $705,000. At December 31, 2002 the allowance for loan losses was $5,035,000 consisting of a specific allowance of $1,093,000, an allowance factor of $3,325,000, and an economic allowance of $617,000.

Table 10 shows the allocation of the allowance by loan type as well as showing the percentage of total loans in each of the same loan types.

**Table 10 Allocation of Allowance for Loan Losses**

| | December 31, 2002 | | December 31, 2003 | |
|---|---|---|---|---|
| | Allocation of allowance balance | Loans as percent of total loans | Allocation of allowance balance | Loans as percent of total loans |
| Commercial | $1,584,000 | 20.9% | $2,288,000 | 23.4% |
| Construction | 872,000 | 10.2 | 734,000 | 9.8 |
| Real estate | 1,577,000 | 45.9 | 1,319,000 | 44.2 |
| Installment | 1,002,000 | 23.0 | 1,117,000 | 22.6 |
| Total allowance for loan losses | $5,035,000 | | $5,458,000 | |
| Total percent | | 100.0% | | 100.0% |

## Deposits

Deposits are used to fund the Bank's interest earning assets. The Bank does not accept brokered deposits and has only a nominal amount of public funds. Tables 11 and 12 show the relative composition of the Bank's average deposits for the years 2001, 2002 and 2003, and the maturity groupings for the Bank's time deposits of $100,000 or more.

**Table 11 Distribution of Average Deposits**

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2001 | | 2002 | | 2003 | |
| (Dollars in thousands) | Amount | Percent | Amount | Percent | Amount | Percent |
| Demand | $98,599 | 26.4% | $115,983 | 25.9% | $138,214 | 26.2% |
| Interest checking | 35,638 | 9.6 | 43,188 | 9.7 | 51,664 | 9.8 |
| Savings | 47,791 | 12.8 | 70,502 | 15.7 | 84,161 | 16.0 |
| Money market | 92,300 | 24.8 | 112,030 | 25.1 | 142,128 | 27.0 |
| Time deposits | | | | | | |
| Less than $100,000 | 42,116 | 11.3 | 40,762 | 9.1 | 39,756 | 7.5 |
| $100,000 or more | 56,396 | 15.1 | 64,647 | 14.5 | 70,984 | 13.5 |
| Total time deposits | 98,512 | 26.4 | 105,409 | 23.6 | 110,740 | 21.0 |
| Total Deposits | $372,840 | 100.0% | $447,112 | 100.0% | $526,907 | 100.0% |

Note: Refer to Table 2 for the average amount of and the average rate paid on each deposit category.

**Table 12 Maturities of Time Deposits of $100,000 or more at December 31**

| | December 31, | | |
|---|---|---|---|
| (Dollars in thousands) | 2001 | 2002 | 2003 |
| Three months or less | $36,425 | $31,542 | $39,276 |
| Over three months through six months | 8,141 | 8,840 | 6,470 |
| Over six months through twelve months | 8,707 | 11,330 | 8,535 |
| Over twelve months | 5,795 | 27,371 | 17,239 |
| Total | $59,068 | $79,083 | $71,520 |

## Commitments

The following is a summary of the Bank's contractual commitments associated with operating lease obligations as of December 31, 2003.

**Table 13 Contractual Obligations at December 31**

| | Payments due by period | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | < 1 year | 1-3 years | 3-5 years | >5 years | Total |
| Operating leases | $1,342 | $2,241 | $1,793 | $1,982 | $7,358 |

The contract amount of loan commitments not reflected on the statement of condition was $153,695,000 at December 31, 2003 and $135,558,000 at December 31, 2002.

## Capital Adequacy

As discussed in Note 13 of the Notes to Financial Statements, the Bank's capital ratios are above regulatory guidelines to be considered "well capitalized." In 2003, the Bank's risk based capital ratio improved from 10.61% to 10.92%. This is due to a change in mix of risk weighted assets. Management expects the ratios to increase modestly in 2004.

## Liquidity

The goal of liquidity management is to provide adequate funds to meet both loan demand and unexpected deposit withdrawals. This goal is accomplished by maintaining an appropriate level of liquid assets, consistent with core deposit growth, and informal lines of credit to purchase funds from correspondent banks.

At year-end 2003, the Bank had approximately $105.1 million in cash, Federal funds sold and securities maturing within one year. The remainder of the securities portfolio provides additional liquidity. Taken together, these liquid assets equaled 19.1% of total assets at December 31, 2003, compared to 22.8% of total assets at December 31, 2002.

The combination of 20.2% deposit growth and 9.9% loan growth during the year, resulted in a year-end loan to deposit ratio of 77.2% compared to 84.4% at December 31, 2002.

Management monitors the Bank's liquidity position daily, balancing loan fundings / payments with changes in deposit activity and overnight investments. The Bank's emphasis on local deposits at competitive rates, combined with its 8.6% average equity capital base, provides a very stable funding base. The Bank also has an informal line of credit of over $20 million to purchase Federal funds. The Bank is a member of the Federal Home Loan Bank of San Francisco (FHLB), and has an available line of credit at an interest rate that is determined daily. Borrowings under the line are limited to eligible collateral.

The Bank had undisbursed loan commitments of $153.7 million, including $78.3 million under lines of credit (these commitments are contingent upon customers maintaining specific credit standards), $40.7 million under revolving home equity lines, and $22.6 million under undisbursed construction loans. These commitments, to the extent used, are expected to be funded through repayment of existing loans and normal deposit growth.

## Market Risk Management

The objective for managing the assets and the liabilities of the Bank is to maximize net income while at the same time, maintaining a high quality portfolio of loans and investments and assuming only limited interest rate risk. The Loan and Investment Committee of the Board has overall responsibility for interest rate risk management policies. The Committee establishes and monitors guidelines to control the sensitivity of net interest income (NII) and regulatory Tier 1 capital (Capital) to changes in interest rates.

Activities in asset and liability management include, but are not limited to, lending, accepting deposits and investing in securities. Interest rate risk is the primary market risk associated with asset and liability management. Sensitivity of NII and Capital to interest rate changes arises when yields on loans and investments change in a different time frame or amount from that of rates on deposits. To mitigate interest rate risk, the structure of the statement of condition is managed with the objective of correlating the movements of interest rates on loans and investments with those of deposits. The asset and liability policy sets limits on the acceptable amount of change to NII and Capital in changing interest rate environments. The Bank uses simulation models to forecast NII and Capital.

Simulation of NII and Capital under various scenarios of increasing or decreasing interest rates is the primary tool used to measure interest rate risk. Using licensed software developed for this purpose, management is able to estimate the potential impact of changing rates. A simplified statement of condition is prepared as a starting point, using as inputs, actual loans, investments and deposits.

In the simulation of NII and Capital under various interest rate scenarios, the simplified statement of condition is processed against at least six interest rate change scenarios. In addition to a flat rate scenario, which assumes interest rates are unchanged, the six scenarios include three 100 basis point increases and three 100 basis point decreases. Each of these scenarios assumes that the change in interest rates is immediate and remains at the new levels.

Table 14 summarizes the effect on NII and Capital due to changing interest rates as measured against the flat rate scenario.

**Table 14 Effect of Interest Rate Change on Net Interest Income and Capital**

| Changes in Interest Rates (in basis points) | Estimated change in NII (as percent of flat NII) at December 31, 2002 | 2003 | Estimated change in capital (as percent of flat capital) at December 31, 2002 | 2003 |
|---|---|---|---|---|
| up 300 | 6.5% | 5.4% | 3.9% | 3.3% |
| up 200 | 4.4% | 3.6% | 2.6% | 2.2% |
| up 100 | 2.2% | 1.8% | 1.3% | 1.1% |
| unchanged | 0.0% | 0.0% | 0.0% | 0.0% |
| down 100 | (2.7%) | (2.5%) | (1.6%) | (1.4%) |
| down 200 | -- | -- | -- | -- |
| down 300 | -- | -- | -- | -- |

The results in the table indicate that the Bank was modestly asset sensitive since NII increased under the increasing interest rate scenarios. The results are also well within the policy guidelines established by the Committee. Further, the results do not assume nor incorporate any action(s) which management might take to minimize any negative consequences of interest rate changes. Therefore, they are not intended to portray likely results but rather estimates of the impact of interest rate risk.

As with any simulation model or other method of measuring interest rate risk, certain limitations are inherent in the process. For example, although certain of the Bank's assets and liabilities may have similar maturities or repricing time frames, they may react differently to changes in market interest rates. In addition, the changes in interest rates on certain categories of either the Bank's assets or liabilities may precede or lag changes in market interest rates.

Also, the actual rates and timing of prepayments on loans and investment securities could vary significantly from the assumptions used in the various scenarios. Further, changes in US Treasury rates accompanied by a change in the shape of the yield curve could produce different results from those presented in the table. Accordingly, the results presented should not be relied upon as indicative of actual results in the event of changing market interest rates.

Interest rate sensitivity is a function of the repricing characteristics of the Bank's assets and liabilities. One aspect is the time frame within which the interest earning assets and interest bearing liabilities are subject to change in interest rates at repricing or maturity. An analysis of the repricing time frames is called a "gap" analysis because it shows the gap between the amounts of assets and liabilities repricing in each of several periods of time. Another aspect is the relative magnitude of the repricing for each category of interest earning asset and interest bearing liability given various changes in market rates. Gap analysis gives no indication of the relative magnitude of repricing. Interest rate sensitivity management focuses on the maturity of assets and liabilities and their repricing during periods of change in market rates. Interest rate sensitivity gaps are calculated as the difference between the amounts of assets and liabilities that are subject to repricing during various time periods.

Table 15 shows the Bank's repricing gaps as of December 31, 2003. Interest bearing transaction and savings accounts, which may be repriced at will, have been excluded from the table. Historically, the magnitude of the their repricing has been minimal and their inclusion would cause the Bank to appear to be liability sensitive. Due to the limitations of gap analysis, as described above, the Bank does not generally use it in managing interest rate risk. Instead the Bank relies on the more sophisticated simulation model described above as its primary tool in measuring and managing interest rate risk.

**Table 15 Interest Rate Sensitivity**

| (Dollars in thousands) | Maturing or Repricing 1-30 Days | 31-90 Days | 91-180 Days | 181-365 Days | Over one year | Total |
|---|---|---|---|---|---|---|
| **At December 31, 2003** | | | | | | |
| Interest Bearing Liabilities | | | | | | |
| Money market | $319,615 | $ -- | $ -- | $ -- | $ -- | $ 319,615 |
| Time deposits less than $100,000 | -- | 13,075 | 6,246 | 6,246 | 7,293 | 32,860 |
| Time deposits $100,000 or more | -- | 39,176 | 12,320 | 3,080 | 16,945 | 71,521 |
| Total | 319,615 | 52,251 | 18,566 | 9,326 | 24,238 | 423,996 |
| Interest Earning Assets | | | | | | |
| Funds sold | $16,900 | $ 5 | $ -- | $ -- | $ -- | $ 16,900 |
| Investment securities | -- | 2,875 | 4,412 | 8,823 | 106,616 | 122,726 |
| Loans | 133,498 | 20,234 | 9,026 | 16,763 | 265,902 | 445,423 |
| Total | 150,398 | 23,114 | 13,438 | 25,586 | $372,518 | $585,054 |
| Sensitivity for period | (169,217) | (29,137) | (5,128) | 16,260 | | |
| Sensitivity - cumulative | $(169,217) | $(198,354) | $(203,482) | $(187,222) | | |

## CODE OF ETHICS

The Bank has adopted a Code of Ethics for the Chief Executive Officer, the Chief Financial Officer and all senior financial officers as referred to in the Sarbanes-Oxley Act of 2002. A copy of the Code of Ethics may be obtained by written request to Corporate Secretary, Bank of Marin, P. O. Box 2039, Novato, CA 94948.

## FORWARD-LOOKING STATEMENTS

This discussion of financial results contains certain forward-looking statements about the Bank, including descriptions of plans or objectives of management for future operations, products or services, and forecasts of its revenues, earnings or other measures of economic performance. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include the words “believe,” “expect,” “intend,” “estimate” or words of similar meaning, or future or conditional verbs such as “will,” “would,” “should,” “could” or “may.”

Forward-looking statements are based on management’s current expectations regarding economic, legislative, and regulatory issues that may impact the Bank’s earnings in future periods. A number of factors - many of which are beyond the Bank’s control - could cause future results to vary materially from current management expectations. Such factors include, but are not limited to, general economic conditions, changes in interest rates, deposit flows, real estate values and competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation; and other economic, competitive, governmental, regulatory and technological factors affecting the Bank’s operations, pricing, products and services. These and other important factors are detailed in various Federal Deposit Insurance Corporation filings made periodically by the Bank, copies of which are available from the Bank at no charge. Forward-looking statements speak only as of the date they are made. The Bank does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
Bank of Marin
Corte Madera, California

We have audited the accompanying statement of condition of Bank of Marin (the Bank) as of December 31, 2002 and 2003, and the related statements of operations, stockholders' equity, cash flows and comprehensive income for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits. The financial statements of Bank of Marin for the year ended December 31, 2001 were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated January 11, 2002.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the 2002 and 2003 financial statements present fairly, in all material respects, the financial position of the Bank as of December 31, 2002 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed above, the financial statements of Bank of Marin for the year ended December 31, 2001 were audited by other auditors who have ceased operations. As described in Notes 1 and 12, those financial statements have been restated to reflect a stock dividend declared in 2002. We audited the adjustments described in Notes 1 and 12 that were applied to restate the 2001 financial statements. Our audit procedures with respect to the restatement for the stock dividend included i) reading the minutes of the Board of Directors approving the stock dividend and ii) testing the mathematical accuracy of the recalculations made to reflect the stock dividend. In our opinion, such adjustments have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 2001 financial statements of the Bank of Marin other than with respect to such adjustments and, accordingly, we do not express an opinion or any form of assurance on the 2001 financial statements taken as a whole.

*/s/ Deloitte & Touche LLP*

San Francisco, California
January 21, 2004

## STATEMENT OF CONDITION

| | December 31, 2002 | December 31, 2003 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 29,168,902 | $ 36,025,596 |
| Federal funds sold | 29,500,000 | 16,900,000 |
| Cash and cash equivalents | 58,668,902 | 52,925,596 |
| | | |
| Investment securities | | |
| Held to maturity | 35,211,907 | 42,189,876 |
| Available for sale (at fair market value, cost $27,976,102 in 2002 and $80,097,198 in 2003) | 28,925,824 | 80,535,801 |
| Total investment securities | 64,137,731 | 122,725,677 |
| | | |
| Loans, net of allowance for loan losses of $5,034,653 in 2002 and $5,457,635 in 2003 | 405,120,178 | 445,422,991 |
| Bank premises and equipment, net | 4,550,638 | 4,508,222 |
| Interest receivable and other assets | 6,547,658 | 17,024,125 |
| Total assets | $ 539,025,107 | $ 642,606,611 |
| | | |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Deposits | | |
| Non-interest bearing | $ 130,175,862 | $ 160,121,639 |
| Interest bearing | | |
| Transaction accounts | 48,009,450 | 63,800,859 |
| Savings | 193,174,691 | 255,813,637 |
| Time | 114,669,148 | 104,379,545 |
| Total deposits | 486,029,151 | 584,115,680 |
| | | |
| Interest payable and other liabilities | 5,879,345 | 2,914,390 |
| Total liabilities | 491,908,496 | 587,030,070 |
| | | |
| Commitments and contingencies | --- | --- |
| | | |
| Stockholders' Equity | | |
| Common stock | | |
| Authorized - 5,000,000 shares | | |
| Issued and outstanding - 2,757,393 shares in 2002 and 2,954,054 shares in 2003 | 31,968,501 | 37,366,841 |
| Retained earnings | 14,661,771 | 17,955,310 |
| Accumulated other comprehensive income | 550,839 | 254,390 |
| Unearned ESOP shares | (64,500) | 0 |
| Total stockholders' equity | 47,116,611 | 55,576,541 |
| | | |
| Total liabilities and stockholders' equity | $ 539,025,107 | $ 642,606,611 |

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

## STATEMENT OF OPERATIONS

| | Years ended December 31, | | |
|---|---|---|---|
| | 2001 | 2002 | 2003 |
| Interest income | | | |
| Interest and fees on loans | $25,020,149 | $27,561,435 | $29,301,148 |
| Interest on investment securities | | | |
| U. S. Treasury securities | 1,403,337 | 1,101,094 | 518,211 |
| Securities of U. S. government agencies | 1,555,743 | 1,009,325 | 1,017,279 |
| Obligations of state and political subdivisions (tax exempt) | 1,029,382 | 1,026,651 | 954,015 |
| Corporate debt securities and other | 701,129 | 847,787 | 791,392 |
| Interest on Federal funds sold | 731,018 | 204,413 | 242,845 |
| Total interest income | 30,440,758 | 31,750,705 | 32,824,890 |
| Interest expense | | | |
| Interest on interest bearing transaction accounts | 269,520 | 309,178 | 206,962 |
| Interest on savings deposits | 4,149,443 | 2,953,352 | 2,425,951 |
| Interest on time deposits | 4,564,430 | 2,959,503 | 2,534,383 |
| Interest on borrowed funds | 1,115 | 6,179 | 1,556 |
| Total interest expense | 8,984,508 | 6,228,212 | 5,168,852 |
| Net interest income | 21,456,250 | 25,522,493 | 27,656,001 |
| Provision for loan losses | 619,178 | 577,157 | 685,485 |
| Net interest income after provision for loan losses | 20,837,072 | 24,945,336 | 26,970,516 |
| Non-interest income | | | |
| Service charges on deposit accounts | 706,962 | 840,274 | 1,020,514 |
| Investment advisory and trust services | 525,815 | 669,571 | 814,619 |
| Other | 639,729 | 808,523 | 1,124,834 |
| Total non-interest income | 1,872,506 | 2,318,368 | 2,959,967 |
| Non-interest expense | | | |
| Salaries and related benefits | 8,834,722 | 10,446,216 | 10,766,645 |
| Occupancy | 1,330,995 | 1,600,647 | 1,676,038 |
| Depreciation and amortization | 710,007 | 882,155 | 992,438 |
| Data processing | 795,574 | 952,424 | 1,038,898 |
| Other | 2,757,132 | 3,243,237 | 3,343,346 |
| Total non-interest expense | 14,428,430 | 17,124,679 | 17,817,365 |
| Income before provision for income taxes | 8,281,148 | 10,139,025 | 12,113,155 |
| Provision for income taxes | 3,133,000 | 3,897,000 | 4,640,000 |
| Net income | $ 5,148,148 | $ 6,242,025 | $ 7,473,155 |
| Net income per common share | | | |
| Basic | $ 1.81 | $ 2.17 | $ 2.55 |
| Diluted | $ 1.76 | $ 2.06 | $ 2.38 |

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

## STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

| | Common Stock | | Retained | Accumulated other Comprehensive Income (Loss) | Unearned ESOP shares | |
|---|---|---|---|---|---|---|
| | Shares | Amount | Earnings | | | Total |
| Balance at Dec. 31, 2000 | 2,434,698 | $24,925,554 | $9,238,885 | $336,236 | $(148,538) | $34,352,137 |
| Stock options exercised | 26,240 | 361,590 | --- | --- | --- | 361,590 |
| Stock issued on 5% stock dividend declared Apr. 12 | 121,497 | 2,535,642 | (2,549,380) | --- | --- | (13,738) |
| Stock issued in payment of director fees | 8,314 | 180,574 | --- | --- | --- | 180,574 |
| Change in unearned ESOP shares | --- | --- | --- | --- | 98,538 | 98,538 |
| Other comprehensive income | --- | --- | --- | 473,641 | --- | 473,641 |
| Net income | --- | --- | 5,148,148 | --- | --- | 5,148,148 |
| Balance at Dec. 31, 2001 | 2,590,749 | $28,003,360 | $11,837,653 | $809,877 | $(50,000) | $40,600,890 |
| Stock options exercised | 27,160 | 316,856 | --- | --- | --- | 316,856 |
| Stock issued on 5% stock dividend declared Apr. 11 | 129,956 | 3,404,847 | (3,417,907) | --- | --- | (13,060) |
| Stock issued in payment of director fees | 9,528 | 243,438 | --- | --- | --- | 243,438 |
| Change in unearned ESOP shares | --- | --- | --- | --- | (14,500) | (14,500) |
| Other comprehensive income | --- | --- | --- | (259,038) | --- | (259,038) |
| Net income | --- | --- | 6,242,025 | --- | --- | 6,242,025 |
| Balance at Dec. 31, 2002 | 2,757,393 | $31,968,501 | $14,661,771 | $550,839 | $(64,500) | $47,116,611 |
| Stock options exercised | 48,958 | 954,517 | --- | --- | --- | 954,517 |
| Stock issued on 5% stock dividend declared Apr. 10 | 138,461 | 4,162,349 | (4,179,616) | --- | --- | (17,267) |
| Stock issued in payment of director fees | 9,242 | 281,474 | --- | --- | --- | 281,474 |
| Change in unearned ESOP shares | --- | --- | --- | --- | 64,500 | 64,500 |
| Other comprehensive income | --- | --- | --- | (296,449) | --- | (296,449) |
| Net income | --- | --- | 7,473,155 | --- | --- | 7,473,155 |
| Balance at Dec. 31, 2003 | 2,954,054 | $37,366,841 | $17,955,310 | $254,390 | $0 | $55,576,541 |

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

## STATEMENT OF CASH FLOWS

| | Years ended December 31, 2001 | 2002 | 2003 |
|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | |
| Net income | $ 5,148,148 | $ 6,242,025 | $ 7,473,155 |
| Adjustments to reconcile income to net cash provided by operating activities: | | | |
| Provision for loan losses | 619,178 | 577,157 | 685,485 |
| Compensation payable in common stock | 180,574 | 243,438 | 281,474 |
| Amortization and accretion of investments | 185,887 | 750,590 | 1,106,840 |
| Depreciation and amortization | 710,007 | 882,155 | 992,438 |
| Net change in operating assets and liabilities: | | | |
| Interest receivable | 143,061 | (131,217) | 19,153 |
| Interest payable | (148,972) | (19,483) | (81,501) |
| Other assets | (699,940) | (336,718) | (495,640) |
| Other liabilities | 265,026 | 2,609,514 | (2,604,284) |
| Total adjustments | 1,254,821 | 4,575,436 | (96,035) |
| Net cash provided by operating activities | 6,402,969 | 10,817,461 | 7,377,120 |
| **Cash Flows from Investing Activities:** | | | |
| Purchase of securities held-to-maturity | (11,805,458) | --- | (14,277,237) |
| Purchase of securities available-for-sale | (8,351,180) | (17,128,299) | (87,478,963) |
| Proceeds from maturity of: | | | |
| Securities held-to-maturity | 3,535,000 | 2,694,000 | 6,972,300 |
| Securities available-for-sale | 21,167,123 | 31,672,803 | 34,577,995 |
| Purchase of bank owned life insurance policies | --- | --- | (10,000,000) |
| Loans originated and principal collected | (61,300,695) | (83,905,798) | (40,988,742) |
| Additions to premises and equipment | (2,397,121 | (1,320,249) | (949,558) |
| Net cash used in investing activities | (59,152,331) | (67,987,543) | (112,144,205) |
| **Cash Flows from Financing Activities:** | | | |
| Net increase in deposits | 70,106,716 | 74,211,686 | 98,086,529 |
| Issuance of common stock | 361,590 | 316,856 | 954,517 |
| Other | (13,738) | (13,060) | (17,267) |
| Net cash provided by financing activities | 70,454,568 | 74,515,482 | 99,023,779 |
| Net increase (decrease) in cash and cash equivalents | 17,705,206 | 17,345,400 | (5,743,306) |
| Cash and cash equivalents at beginning of year | 23,618,296 | 41,323,502 | 58,668,902 |
| Cash and cash equivalents at end of year | $41,323,502 | $58,668,902 | $52,925,596 |

Cash paid for interest for the years ended December 31, 2001, 2002 and 2003 was $9,133,480, $6,247,695 and $5,250,353, respectively. Cash paid for income taxes for the years ended December 31, 2001, 2002 and 2003 was $3,280,000, $3,762,000 and $4,822,000, respectively.

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

## STATEMENT OF COMPREHENSIVE INCOME

| | Years ended December 31, 2001 | 2002 | 2003 |
|---|---|---|---|
| Net income | $5,148,148 | $6,242,025 | $7,473,155 |
| Cumulative effect of change in accounting principle (net of taxes of $269,000) | 385,109 | --- | --- |
| Net change in unrealized gain (loss) on available for sale securities (net of taxes of $78,000, ($188,000) and ($215,000) in the years 2001, 2002 and 2003) | 88,532 | (259,038) | (296,449) |
| Other comprehensive income (loss) | 473,641 | (259,038) | (296,449) |
| Comprehensive income | $5,621,789 | $5,982,987 | $7,176,706 |

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

## NOTES TO FINANCIAL STATEMENTS
December 31, 2003

### Note 1: Summary of Significant Accounting Policies

*Nature of Operations:* The Bank of Marin (the Bank) is a California state chartered bank. The Bank operates eight branches in Marin County and one in southern Sonoma County, California. The Bank's primary source of revenue is interest from providing loans to customers, who are predominately professionals, small and middle-market businesses, and middle and high-income individuals who work and/or reside in Marin and southern Sonoma counties. The accounting and reporting policies of the Bank conform with generally accepted accounting principles and general practice within the banking industry. A summary of the more significant policies follows.

*Investment Securities* are classified as "held to maturity," "trading securities" or "available for sale." Held to maturity securities are those that the Bank has the ability and intent to hold to maturity. Investments classified as held to maturity are reported at amortized cost; investments classified as trading securities are reported at fair value, with unrealized gains and losses included in earnings; and investments classified as available for sale are reported at fair value, with unrealized gains and losses, net of related tax, if any, reported as a separate component of comprehensive income.

*Loans* are stated at the principal amount outstanding net of deferred fees and the allowance for loan losses. Interest income is accrued daily using the simple interest method. Loans are placed on nonaccrual status when management believes that there is serious doubt as to the collection of principal or interest, or when they become contractually past-due by 90 days or more with respect to principal or interest, except for loans that are both well secured and in the process of collection. When loans are placed on nonaccrual status, any accrued but uncollected interest is reversed from current income, and additional income is recorded only as payments are received. Loan origination and commitment fees, offset by certain direct loan origination costs, are deferred and amortized as yield adjustments over the contractual lives of the related loans.

*Allowance for Loan Losses* is based upon estimates of loan losses and is maintained at a level considered adequate to provide for probable losses inherent in the loan portfolio. The allowance is increased by provisions charged to expense and reduced by net charge-offs. The Bank considers the Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, current economic conditions and other factors in periodic evaluations of the adequacy of the allowance balance. The allowance for loan losses is based on estimates, and ultimate losses may vary from current estimates.

The Bank’s method for assessing the appropriateness of the allowance includes specific allowances for identified problem loans, an allowance factor for pools of credits, and allowances for changing environmental factors (e.g., portfolio trends, concentration of credit, growth, economic factors, etc.) Allowances for identified problem loans are based on specific analysis of individual credits. Loss estimation factors for loan pools are based on analysis of local economic factors applicable to each loan pool. Due to our minimal historic losses, loss estimation factors are based only in part on the previous historical loss experience for each pool. Allowances for changing environmental factors are management’s best estimate of the probable impact these changes have had on the loan portfolio as a whole.

The Bank considers a loan as impaired when it is probable the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. For loans determined to be impaired, the extent of the impairment is measured based on the present value of expected future cash flows discounted at the loan's original effective interest rate. As a practical expedient, impairment may be measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through an allocation of the allowance for loan losses.

*Bank Premises and Equipment* consist of leasehold improvements, and furniture and equipment and are stated at cost, less accumulated depreciation and amortization. Depreciation is computed on a straight-line basis over the estimated useful lives of furniture and equipment, generally from three to ten years. Leasehold improvements are amortized over the terms of the leases or their estimated useful lives, whichever is shorter.

*Income Taxes* reported in the financial statements are computed based on an asset and liability approach. The Bank recognizes the amount of taxes payable or refundable for the current year, and deferred tax assets and liabilities for the future tax consequences that have been recognized in the financial statement or tax returns. The measurement of tax assets and liabilities is based on the provisions of enacted tax laws.

*Statements of Cash Flows* are prepared assuming that cash and cash equivalents includes cash and due from banks and federal funds sold, which have an original maturity of 90 days or less at the time of purchase.

*Earnings per share* are based upon the weighted average number of common shares outstanding during each year. The following table shows weighted average basic shares, potential common shares related to stock options, and weighted average diluted shares. Basic earnings per share are based upon the weighted average number of common shares outstanding during each period. Diluted earnings per share are based upon the weighted average number of common shares and potential common shares outstanding during each period.

| | December 31, 2001 | December 31, 2002 | December 31, 2003 |
|---|---|---|---|
| Weighted average basic shares outstanding | 2,838,875 | 2,882,801 | 2,928,641 |
| Add: Potential common shares related to stock options | 80,120 | 151,626 | 210,394 |
| Weighted average diluted shares outstanding | 2,918,995 | 3,034,427 | 3,139,035 |

The number of antidilutive shares not included in the calculation of diluted earnings per shares were 72,343, 24,076 and 11,577 at December 31, 2001, 2002 and 2003, respectively.

On April 10, 2003 the Board of Directors declared a 5% stock dividend payable May 5 to stockholders of record April 21, 2003. Earnings per share have been restated for all periods to reflect the stock dividend.

*Stock-Based Compensation* In December 2002 the Bank adopted the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 148 - Accounting for Stock-Based Compensation - Transition and Disclosure, which amends SFAS No. 123 - Accounting for Stock-Based Compensation. This Statement provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure requirements to require prominent disclosure about the method of accounting for stock-based employee compensation and the effect of the method used on reported results.

The Bank accounts for stock-based awards for its plans under APB Opinion No. 25, under which no compensation cost has been recognized. Had compensation cost for these plans been determined in accordance with SFAS 123, the Bank's net income and earnings per share would have been reduced to the pro forma amounts shown in the following table. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of options granted was $10.67, $11.87, and $12.85 for 2001, 2002 and 2003, respectively. The following weighted-average assumptions were used for grants in 2001, 2002 and 2003, respectively: risk-free interest rates of 5.00%, 4.00% and 4.00%, expected dividend yields of 0%, 0% and 0%, expected lives of 7, 8 and 8 years, expected volatility of 37.84%, 30.88% and 28.83%.

| | 2001 | 2002 | 2003 |
|---|---|---|---|
| Net income as reported | $5,148,148 | $6,242,025 | $7,473,155 |
| Stock-based compensation expense net of taxes | (751,029) | (909,812) | (959,337) |
| Pro forma net income | $4,397,119 | $5,332,213 | $6,513,818 |
| Earnings per share | | | |
| As reported (basic) | $1.81 | $2.17 | $2.55 |
| As reported (diluted) | 1.76 | 2.06 | 2.38 |
| Pro forma (basic) | 1.55 | 1.85 | 2.22 |
| Pro forma (diluted) | 1.51 | 1.76 | 2.08 |

*Comprehensive Income* for the Bank includes net income reported on the statement of operations and changes in the fair value of its available for sale investments reported as a component of stockholders' equity.

*Segment Information* The Bank's two operating segments include the traditional community banking activities provided through its nine branches and its investment advisory and trust services. The activities of these two segments are monitored and reported by Bank management as separate operating segments. The accounting policies of the segments are the same as those described in this note. The Bank evaluates segment performance based on total segment revenue and does not allocate expenses between the segments. The investment advisory and trust services revenues were $525,815 in 2001, $669,571 in 2002, and $814,619 in 2003, which are included in non-interest income in the statement of operations. The revenues of the community banking segment are reflected in all other income lines in the statement of operations.

*New Accounting Principle* On January 1, 2001, the Bank adopted the provisions of SFAS No. 133-Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended by SFAS No. 138. The Statement establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. The Bank does not engage in hedging activities and owns no freestanding derivatives.

As permitted by the Statement, in connection with the adoption of SFAS 133, the Bank elected to reclassify certain of its investment securities from held-to-maturity to available for sale. On January 1, 2001, the Bank transferred $35,082,000 from held-to-maturity to available for sale. As a result of this transfer, an unrealized gain of $385,109, net of tax, was recognized in the first quarter of 2001 in other comprehensive income as a cumulative effect of change in accounting principle. There was no other impact to the Bank's financial statement of adopting this Statement.

*Reclassifications* Certain amounts in prior years' financial statements have been reclassified to conform with the current presentation. These reclassifications have no effect on previously reported net income.

*Use of Estimates* The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## Note 2: Investment Securities

An analysis of the investment security portfolio at December 31 follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Market Value |
|---|---|---|---|---|
| **2002 Held to maturity** | | | | |
| Oblig. of state & political subdivisions | $22,598,260 | $1,245,480 | $ -- | $23,843,740 |
| Corporate debt securities and other | 12,613,647 | 899,484 | --- | 13,513,131 |
| | 35,211,907 | 2,144,964 | --- | 37,356,871 |
| **2002 Available for sale** | | | | |
| U. S. Treasury Securities | 12,107,213 | 469,037 | --- | 12,576,250 |
| Securities of U.S. Government Agencies | 15,868,889 | 480,685 | --- | 16,349,574 |
| | 27,976,102 | 949,722 | --- | 28,925,824 |
| Total | $63,188,009 | $3,094,686 | $ --- | $66,282,695 |
| **2003 Held to maturity** | | | | |
| Oblig. of state & political subdivisions | $30,499,319 | $ 983,091 | $ (122,327) | $31,360,083 |
| Corporate debt securities and other | 11,690,557 | 689,726 | --- | 12,380,283 |
| | 42,189,876 | 1,672,817 | --- | 43,740,366 |
| **2003 Available for sale** | | | | |
| U. S. Treasury Securities | 13,316,120 | 134,948 | ( 21) | 13,451,047 |
| Securities of U.S. Government Agencies | 66,781,078 | 509,507 | (205,831) | 67,084,754 |
| | 80,097,198 | 644,455 | (205,852) | 80,535,801 |
| Total | $122,287,074 | $2,317,272 | $(328,179) | $124,276,167 |

The maturities of the investment security portfolio at December 31, 2003 follows:

| | Held to maturity Amortized Cost | Held to maturity Fair Market Value | Available for sale Amortized Cost | Available for sale Fair Market Value |
|---|---|---|---|---|
| Within one year | $ 10,496,306 | $10,525,916 | $ 42,459,125 | $ 42,871,377 |
| After one but within five years | 23,213,725 | 24,590,272 | 29,403,578 | 29,470,387 |
| After five years through ten years | 7,428,191 | 7,517,518 | 8,234,495 | 8,194,037 |
| After ten years | 1,051,654 | 1,106,660 | 0 | 0 |
| Total | $42,189,876 | $43,740,366 | $80,097,198 | $ 80,535,801 |

For the years ended December 31, 2001, 2002, and 2003 the Bank did not sell any of its available for sale securities, and accordingly, did not recognize any gains or losses. At December 31, 2003, investment securities carried at $12,550,000 were pledged with the Federal Reserve Bank: $4,174,000 to secure the Bank's Treasury, Tax and Loan account and trust deposits, $4,123,000 to provide collateral for potential future borrowings to meet unusual short term liquidity needs, and $4,253,000 to secure the Bank's public fund deposits.

Securities catagorized as temporarily impaired at December 31, 2003 follows:

| | Fair Value | Unrealized loss |
|---|---|---|
| Oblig. of state & political subdivisions | $ 3,857,219 | $(122,327) |
| U. S. Treasury Securities | 1,998,859 | (21) |
| Securities of U.S. Government Agencies | 20,052,630 | (205,831) |
| Total temporarily imparied securities | $ 25,908,708 | $(328,179) |

At December 31, 2003, the book value or amortized cost of the Bank’s investment portfolio totaled $122,287,074, and the fair market value was $124,276,167. The difference between these values represents a gross unrealized gain of $1,989,093 on the Bank’s portfolio. Included, are nine securities with a fair value of $25,908,708 that, as of December 31, 2003, had an unrealized loss of $328,179. This temporary impairment is attributable to general changes in short term interest rates as measured by the U.S. Treasury yield curve. The duration of this impairment was for a period of less than twelve months and is believed to be temporary.

## Note 3: Loans

Outstanding loans by type at December 31 follows:

| | 2002 | 2003 |
|---|---|---|
| Commercial loans | $85,191,566 | $105,846,577 |
| Real estate | | |
| Commercial | 187,384,100 | 196,702,770 |
| Construction | 41,736,463 | 44,471,036 |
| Residential | 29,823,644 | 28,051,819 |
| Installment | 66,019,058 | 75,808,424 |
| Total loans | 410,154,831 | 450,880,626 |
| Less - Allowance for loan losses | (5,034,653) | (5,457,635) |
| Net Loans | $405,120,178 | $445,422,991 |

At December 31, 2003 the Bank had no loans that were past due greater than 90 days.

The Bank has, and expects to have in the future, banking transactions in the ordinary course of its business with directors, officers, principal stockholders and their associates. These transactions, including loans and deposits, are granted on substantially the same terms, including interest rates and collateral on loans, as those prevailing at the same time for comparable transactions with others and do not involve more than the normal risk of collectibility or present other unfavorable features. Such loans, including loans guaranteed, amounted to $2,227,000 and $1,730,000 at December 31, 2002 and 2003, respectively. During 2003, new loans to such parties amounted to $546,000 and repayments were $1,043,000.

At December 31, 2002 the Bank had $2,379,974 of participated loans sold to third parties. The terms under the participation agreements have precluded the Bank from recording these loans as sales. As such, the gross amounts of the participated loans are recorded as both a loan and as a liability within interest payable and other liabilities as of December 31, 2002.

## Note 4: Allowance for Loan Losses

Activity in the allowance for loan losses for the three years in the period ended December 31 follows:

| | 2001 | 2002 | 2003 |
|---|---|---|---|
| Beginning balance | $ 4,003,275 | $ 4,579,744 | $ 5,034,653 |
| Provision for loan loss charged to expense | 619,178 | 577,157 | 685,485 |
| Loans charged off | (52,596) | (194,562) | (376,544) |
| Loan loss recoveries | 9,887 | 72,314 | 114,041 |
| Ending balance | $ 4,579,744 | $ 5,034,653 | $ 5,457,635 |
| Total loans outstanding at end of year, before deducting allowance for loan losses | $ 326,249,033 | $ 410,154,831 | $ 450,880,626 |
| Average total loans outstanding during the year | $ 291,716,706 | $ 366,407,696 | $ 434,908,002 |
| Ratio of allowance for loan losses to total loans at end of year | 1.40% | 1.23% | 1.21% |

Loans classified as nonaccrual amounted to $0 at December 31, 2002 and 2003.

At December 31, 2002 and 2003 the Bank had no impaired loans. The average recorded investment in impaired loans was $0 for the years ended December 31, 2002 and 2003.

## Note 5: Bank Premises and Equipment

A summary of Bank premises and equipment at December 31 follows:

| | 2002 | 2003 |
|---|---|---|
| Leasehold improvements | $ 4,709,089 | $ 5,213,825 |
| Furniture and equipment | 5,320,709 | 5,748,404 |
| | 10,029,798 | 10,962,229 |
| Accumulated depreciation and amortization | (5,479,160) | (6,454,007) |
| Bank premises and equipment, net | $ 4,550,638 | $ 4,508,222 |

The amount of depreciation and amortization was $710,007, $882,155 and $992,438 for the three years in the period ended December 31, 2003.

**Note 6: Bank Owned Life Insurance**

The Bank has purchased life insurance policies on the lives of certain officers in the Bank and intends to use the policies ($10,202,986 cash surrender value as of December 31, 2003) to finance employee benefit programs. The investment in the Bank owned life insurance (BOLI) policies are reported in "interest receivable and other assets" at the cash surrender value of the policies. The carrying value includes both the Bank's original premiums invested in the life insurance policies and the accumulated accretion of policy income since inception of the policies. In 2003 income of $202,985 was recognized on the life insurance policies and is reported in "other non-interest income."

**Note 7: Time Deposits**

Time deposits in denominations of $100,000 or more were $79,083,000 and $71,520,000 at December 31, 2002 and 2003, respectively. At December 31, 2003 the scheduled maturities of time deposits were $54,280,000 in 2004, $8,733,000 in 2005, $2,876,000 in 2006, $2,537,000 in 2007, and $3,094,000 in 2008.

**Note 8: Benefit Plans**

In 2003 the Bank established an Officer Deferred Compensation Plan, which allows key executive officers designated by the Board of Directors of the Bank to defer up to 80% of their salary and 100% of their annual bonus. Amounts deferred earn interest at a rate set annually by the Board of Directors. The interest rate was set at 6% for the period from September 1, 2003 to December 31, 2003. The Bank's deferred compensation obligation of $113,440 at December 31, 2003 is included in "interest payable and other liabilities".

The Bank also established a Split Dollar Plan and a Survivor Income Plan in 2003 for officers designated by the Board of Directors. Death benefits are provided under the specific terms of these plans. The Bank has purchased life insurance policies on the designated officers in connection with these plans.

**Note 9: Income Taxes**

The current and deferred components of the income tax provision for the three years ended December 31, 2003 are as follows:

| | 2001 | 2002 | 2003 |
|---|---|---|---|
| Current tax provision | | | |
| Federal | $ 2,406,000 | $ 2,866,000 | $ 3,175,000 |
| State | 950,000 | 1,137,000 | 1,235,000 |
| Total current | 3,356,000 | 4,003,000 | 4,410,000 |
| Deferred tax( benefit)/liability | | | |
| Federal | (193,000) | (96,000) | 145,000 |
| State | (30,000) | (10,000) | 85,000 |
| Total deferred | (223,000) | (106,000) | 230,000 |
| Total income tax provision | $ 3,133,000 | $ 3,897,000 | $ 4,640,000 |

Income taxes recorded directly to comprehensive income are not included above. These income taxes relating to changes in the unrealized gains and losses on available for sale investment securities amounted to $347,000, ($188,000) and ($215,000), in 2001, 2002 and 2003, respectively.

The effective tax rate of the Bank for 2001, 2002 and 2003 differs from the current Federal statutory income tax rate as follows:

| | 2001 | 2002 | 2003 |
|---|---|---|---|
| Federal statutory income tax rate | 34.0% | 34.0% | 34.0% |
| Increase (decrease) due to: | | | |
| California franchise tax, net of federal tax benefit | 7.3 | 7.3 | 7.2 |
| Tax exempt interest on municipal securities | (3.8) | (3.3) | (2.8) |
| Other | 0.3 | 0.4 | (0.1) |
| | 37.8% | 38.4% | 38.3% |

The following table shows the tax effect of the Bank's cumulative temporary differences as of December 31:

| | 2002 | 2003 |
|---|---|---|
| Deferred tax asset: | | |
| Allowance for loan losses | $2,084,000 | $2,310,000 |
| Depreciation | 1,000 | 0 |
| State franchise tax | 316,000 | 481,000 |
| Deferred compensation | 124,000 | 148,000 |
| | 2,525,000 | 2,939,000 |
| Deferred tax liabilities: | | |
| Net unrealized gain on securities available for sale | (399,000) | (180,000) |
| Depreciation | 0 | (184,000) |
| | (399,000) | (364,000) |
| Net deferred tax asset | $2,126,000 | $2,575,000 |

**Note 10: Commitments and Contingencies**

At December 31, 2003 the approximate minimum future rentals payable under noncancelable operating leases for Bank premises totaled $7,358,000 as follows (in thousands): $1,342, $1,396, $845, $879, $914 for the years 2004 through 2008, and $1,982 thereafter. Rent expense was $964,000, $1,134,000 and $1,178,000 in 2001, 2002 and 2003, respectively.

The Bank is party to legal actions which arise from time to time as part of the normal course of its business. The Bank believes, after consultation with legal counsel, that it has meritorious defenses in these actions, and that the liability, if any, will not have a material adverse effect on the financial position, results of operations, or cash flows of the Bank.

**Note 11: Fair Value of Financial Instruments**

The carrying amounts and fair values of the Bank's financial instruments at December 31, 2002 and 2003 follows:

| | 2002 | | 2003 | |
|---|---|---|---|---|
| | Carrying Amounts | Fair Value | Carrying Amounts | Fair Value |
| Financial assets | | | | |
| Cash and cash equivalents | $ 58,668,026 | $ 58,668,026 | $ 52,925,596 | $ 52,925,596 |
| Investment securities | 63,188,009 | 66,282,695 | 122,287,074 | 124,276,167 |
| Loans, net | 405,120,178 | 414,972,937 | 445,422,991 | 452,489,741 |
| Accrued interest receivable | 2,975,835 | 2,975,835 | 2,960,182 | 2,960,182 |
| Financial liabilities | | | | |
| Deposits | 486,029,151 | 487,322,816 | 584,115,680 | 584,969,946 |
| Accrued interest payable | 403,843 | 403,843 | 322,342 | 322,342 |

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and Cash Equivalents - Cash and cash equivalents are valued at their carrying amounts because of the short-term nature of these instruments.

Investment Securities - Investment securities are valued at the quoted market prices. See Note 2 for further analysis.

Loans - Loans with variable interest rates are valued at the current carrying value, because these loans are regularly adjusted to market rates. The fair value of fixed rate loans with remaining maturities in excess of one year is estimated by discounting the future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings for the same remaining maturities.

Accrued Interest Receivable - The accrued interest receivable balance approximates its fair value.

Deposits - The fair value of non-interest bearing deposits, interest bearing transaction accounts and savings accounts is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting the future cash flows using current rates offered for deposits of similar remaining maturities.

Commitments - The fair value of commitments is not material.

## Note 12: Stockholders' Equity

On April 12, 2001, April 11, 2002, and April 10, 2003, the Board of Directors declared 5% stock dividends. Cash was paid in lieu of issuing fractional shares. Earnings per share amounts and information with respect to stock options have been restated for all years presented to reflect the stock dividends.

The Bank has stock option plans for full-time, salaried officers and employees who have substantial responsibility for the successful operation of the Bank. Terms of the plans provide for the issuance of up to 674,606 shares of common stock for these officers and employees. Options are issued at the fair market value of the stock at the date of grant. Options expire ten years from the grant date, and vest over a four year period. Terms of the plans also provide for the issuance of up to 115,473 shares for non-employee directors. These options expire seven years from the grant date, and vest over a four year period. A summary of the status of the Bank's stock option plans at December 31, 2001, 2002 and 2003 and changes for the year then ended is presented in the following table.

| | 2001 | | 2002 | | 2003 | |
|---|---|---|---|---|---|---|
| | Shares | Weighted Avg. Exercise Price | Shares | Weighted Avg. Exercise Price | Shares | Weighted Avg. Exercise Price |
| Outstanding at beg. of year | 445,001 | $16.02 | 518,075 | $17.08 | 566,596 | $18.55 |
| Granted | 114,907 | 19.95 | 83,057 | 24.80 | 52,259 | 30.09 |
| Exercised | (29,204) | 11.81 | (29,236) | 9.72 | (49,892) | 15.17 |
| Forfeited | (12,629) | 18.35 | (5,300) | 21.21 | (11,742) | 21.85 |
| Expired | --- | | --- | | --- | |
| Outstanding at end of year | 518,075 | 17.08 | 566,596 | 18.55 | 557,221 | 19.86 |
| Exercisable at end of year | 276,727 | 15.54 | 347,432 | 17.26 | 395,654 | 18.42 |

A summary of the options outstanding and exercisable by price range as of December 31, 2003 is presented in the following table.

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Outstanding | Weighted Avg. Remaining Contractual Life | Weighted Avg. Exercise Price | Exercisable | Weighted Avg. Exercise Price |
| $5.00 - $10.00 | 27,614 | 1.5 | $6.96 | 27,614 | $6.96 |
| $10.01 - $15.00 | 20,876 | 2.5 | $10.43 | 20,876 | $10.43 |
| $15.01 - $20.00 | 307,815 | 5.0 | $18.57 | 256,381 | $18.65 |
| $20.01 - $25.00 | 127,893 | 7.1 | $21.93 | 71,587 | $21.61 |
| $25.01 - $30.00 | 53,946 | 8.1 | $27.93 | 15,381 | $27.68 |
| $30.01 - $35.00 | 19,077 | 8.5 | $33.04 | 3,815 | $33.04 |
| | 557,221 | 5.6 | $19.86 | 395,654 | $18.42 |

For the years ended December 2001, 2002 and 2003 the Bank recorded benefits expense related to the Bank of Marin Employee Stock Ownership and Savings Plan and Trust of $565,700, $652,000 and $653,000 respectively. In December 2003 the Plan's trustees arranged for a $1,000,000 26-month revolving line of credit at prime plus 1/4% from an unaffiliated community bank. At December 31, 2003 there had been no borrowings on the line.

Under California state banking laws, payment of dividends is restricted to the lesser of retained earnings or the amount of undistributed net profits from the three most recent fiscal years. Under this restriction, the balance of retained earnings equalling approximately $17,955,000 was available for payment of dividends as of December 31, 2003.

## Note 13: Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal and California banking agencies. The Federal Deposit Insurance Corporation (FDIC) has adopted risk-based capital regulations, which assign risk weightings to bank assets and "off-balance sheet" items (such as loan commitments). Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by the FDIC that, if undertaken, could have a material effect on the Bank's financial statements. The regulations require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2002 and 2003, that the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2003, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios as of December 31, 2002 and 2003 are presented in the table.

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2002 | | | | | | |
| Total Capital (to risk-weighted assets) | $51,600,426 | 10.61% | ≥$38,910,053 | ≥8.0% | ≥$48,637,566 | ≥10.0% |
| Tier 1 Capital (to risk-weighted assets) | $46,565,773 | 9.57% | ≥$19,455,026 | ≥4.0% | ≥$29,182,540 | ≥ 6.0% |
| Tier 1 Capital (to average assets) | $46,565,773 | 8.69% | ≥$19,783,245 | ≥4.0% | ≥$24,729,056 | ≥ 5.0% |
| As of December 31, 2003 | | | | | | |
| Total Capital (to risk-weighted assets) | $61,164,024 | 10.92% | ≥$44,795,015 | ≥8.0% | ≥$55,993,769 | ≥10.0% |
| Tier 1 Capital (to risk-weighted assets) | $55,322,151 | 9.88% | ≥$22,397,507 | ≥4.0% | ≥$33,596,261 | ≥ 6.0% |
| Tier 1 Capital (to average assets) | $55,322,151 | 8.80% | ≥$23,263,018 | ≥4.0% | ≥$29,078,773 | ≥ 5.0% |

**Note 14: Financial Instruments with Off-Balance Sheet Risk**

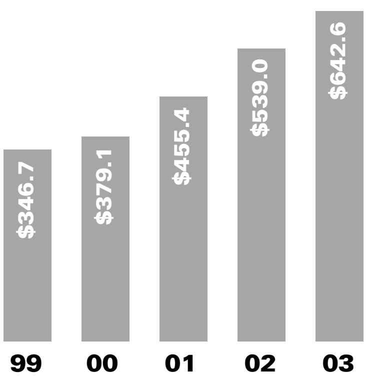
The Bank makes commitments to extend credit in the normal course of business to meet the financing needs of its customers. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The Bank is exposed to credit loss, in the event of nonperformance by the borrower, in the contract amount of the commitment. The Bank uses the same credit policies in making commitments as it does for on-balance-sheet instruments and evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Bank is based on management's credit evaluation of the borrower. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and real property. The contract amount of loan commitments not reflected on the statement of condition was $153,695,000 at December 31, 2003, for which the Bank has set aside an allowance in the amount of $384,000, which is recorded in interest payable and other liabilities.

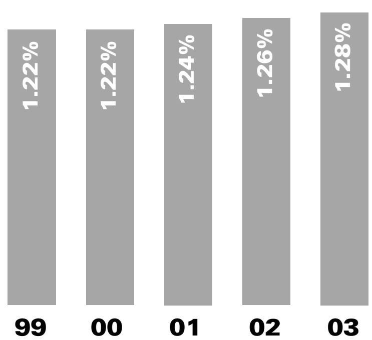
## SELECTED FINANCIAL DATA (in thousands except per share)

| At December 31 | 1999 | 2000 | 2001 | 2002 | 2003 | 02/03 % change |
|---|---|---|---|---|---|---|
| Total assets | $ 346,681 | $ 379,096 | $ 455,417 | $ 539,025 | $ 642,607 | 19.2% |
| Total loans | 217,964 | 264,948 | 326,249 | 410,155 | 450,881 | 9.9% |
| Total deposits | 315,866 | 341,711 | 411,818 | 486,029 | 584,116 | 20.2% |
| Total stockholders' equity | 28,691 | 34,352 | 40,601 | 47,117 | 55,577 | 18.0% |
| Equity to assets ratio | 8.3% | 9.1% | 8.9% | 8.7% | 8.6% | |

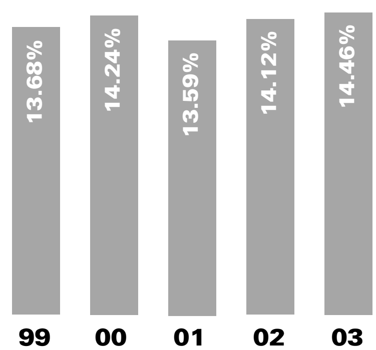
| For year ended December 31 | 1999 | 2000 | 2001 | 2002 | 2003 | 02/03 % change |
|---|---|---|---|---|---|---|
| Net interest income | $ 15,906 | $ 19,271 | $ 21,456 | $ 25,522 | $ 27,656 | 8.4% |
| Provision for possible loan losses | 800 | 986 | 619 | 577 | 685 | 18.7% |
| Non-interest income | 1,239 | 1,638 | 1,873 | 2,318 | 2,960 | 27.7% |
| Non-interest expense | 10,474 | 12,675 | 14,428 | 17,125 | 17,817 | 4.0% |
| Net income | 3,650 | 4,523 | 5,148 | 6,242 | 7,473 | 19.7% |
| Net income per share | 1.31 | 1.58 | 1.76 | 2.06 | 2.38 | 15.5% |
| Dividend payout ratio | 0% | 0% | 0% | 0% | 0% | |



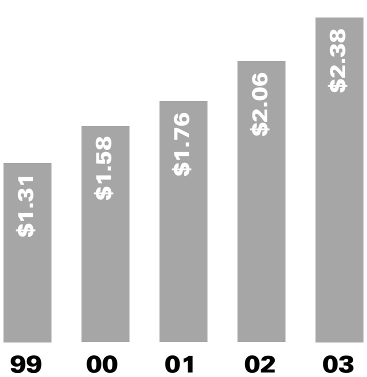
**Total Assets** (in millions)



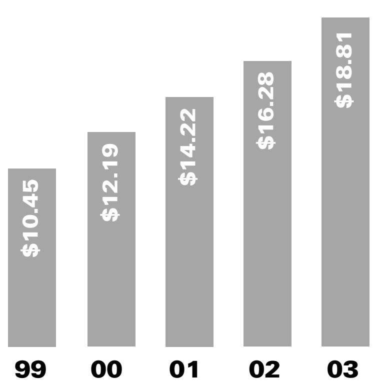
**Return on Assets**



**Return on Equity**



**Earnings Per Share**



**Book Value Per Share**

### DIVIDEND INFORMATION, STOCK PRICE AND MARKETPLACE DESIGNATION

On April 10, 2003 the Board of Directors declared a 5% stock dividend payable May 5, 2003 to stockholders of record on April 21, 2003. The Bank paid cash for fractional shares.

During 2003 there were 863 trades at prices ranging from a high of $41.89 to a low of $28.00. In 2002 there were 685 trades at prices ranging from a high of $31.00 to a low of $23.00.

Bank of Marin common stock trades on the Nasdaq SmallCap Market under the symbol BMRC. There were 805 holders of record of the Bank's common stock as of March 1, 2004.