



Audited Financial Statements

December 31, 2013

# Richardson & Company

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## INDEPENDENT AUDITOR'S REPORT

The Shareholders and  
Board of Directors  
Redwood Capital Bancorp and Subsidiary  
Eureka, California

### **Report on the Financial Statements**

We have audited the accompanying consolidated financial statements of Redwood Capital Bancorp and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. 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 consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

The Shareholders and  
Board of Directors  
Redwood Capital Bancorp and Subsidiary

**Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Redwood Capital Bancorp and Subsidiary, as of December 31, 2013 and 2012, and the results of their operations, comprehensive income, and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Richardson & Company*

March 31, 2014

REDWOOD CAPITAL BANCORP  
AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2013 and 2012

	2013	2012
<b>ASSETS</b>		
Cash and due from banks	\$ 6,059,409	\$ 9,777,807
Federal funds sold	26,410,000	12,390,000
Interest-bearing deposits in other financial institutions	12,320,287	21,433,169
net of tax expense of (\$551,414) and \$46,034 as of	44,789,696	43,600,976
Investment securities available-for-sale, at fair value	25,031,139	30,845,712
Mortgages held for sale	2,211,319	3,026,410
Loans, net	170,209,289	153,126,498
Premises and equipment, net	4,037,986	4,216,158
Foreclosed real estate	73,320	366,335
Cash surrender value of life insurance	2,779,486	2,694,251
Accrued interest receivable and other assets	4,043,379	3,512,359
Mortgage servicing rights, at fair value	604,081	301,470
<b>TOTAL ASSETS</b>	<b>\$ 253,779,695</b>	<b>\$ 241,690,169</b>
 <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Deposits		
Non interest-bearing	\$ 48,025,740	\$ 40,889,168
Interest-bearing	179,421,407	174,108,164
Total deposits	227,447,147	214,997,332
Borrowings	2,421,875	2,576,546
Accrued interest payable and other liabilities	1,386,129	2,070,076
<b>TOTAL LIABILITIES</b>	231,255,151	219,643,954
 Commitments and contingencies (see accompanying notes)		
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock, Series A, B, and C, no par value; 10,000,000 shares authorized; 7,310 shares of Series C issued and outstanding in 2013 and 2012	7,283,990	7,283,990
Common stock, no par value; 30,000,000 shares authorized; 1,810,722 and 1,792,632 shares issued and outstanding in 2013 and 2012	12,400,686	12,195,212
Additional paid-in capital	173,659	509,998
Retained earnings	2,998,801	1,601,011
Accumulated other comprehensive (loss) income	(332,592)	456,004
<b>TOTAL SHAREHOLDERS' EQUITY</b>	22,524,544	22,046,215
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 253,779,695</b>	<b>\$ 241,690,169</b>

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

REDWOOD CAPITAL BANCORP  
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2013 and 2012

	2013	2012 (Restated)
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 8,464,016	\$ 8,343,403
Interest on taxable investment securities	672,593	704,525
net of tax expense of (\$551,414) and \$46,034 as of	52,572	14,617
Interest on federal funds sold	52,029	65,182
Interest on deposits in banks	58,302	73,704
Total interest income	9,299,512	9,201,431
<b>INTEREST EXPENSE</b>		
Interest on deposits	690,495	1,093,899
Interest on other borrowings	117,582	128,984
Total interest expense	808,077	1,222,883
<b>NET INTEREST INCOME</b>	8,491,435	7,978,548
Provision for loan losses	425,000	995,000
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	8,066,435	6,983,548
<b>OTHER INCOME</b>		
Service charges and fees	605,913	487,360
Mortgage banking revenue, net	896,100	720,747
Net gain on sale of foreclosed real estate	184,941	
Other income	138,126	182,271
Total other income	1,825,080	1,390,378
<b>OTHER EXPENSES</b>		
Salaries and employee benefits	3,529,338	3,294,084
Foreclosed real estate	284,686	204,143
Occupancy and equipment	582,866	593,540
Other	2,468,072	2,283,660
Total other expenses	6,864,962	6,375,427
<b>INCOME BEFORE PROVISION FOR INCOME TAXES</b>	3,026,553	1,998,499
Provision for income taxes	1,157,985	785,132
<b>NET INCOME</b>	\$ 1,868,568	\$ 1,213,367
<b>NET INCOME PER SHARE</b>	\$ 1.03	\$ 0.68
<b>NET INCOME PER SHARE – ASSUMING DILUTION</b>	\$ 1.02	\$ 0.67

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

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Years Ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
NET INCOME	\$ 1,868,568	\$ 1,213,367
Other comprehensive (loss) income, net of tax		
Available for sale securities		
Unrealized (losses) gains arising during the year, net of tax expense of (\$551,414) and \$46,034 as of 2013 and 2012, respectively	<u>(788,596)</u>	<u>65,835</u>
COMPREHENSIVE INCOME	<u>\$ 1,079,972</u>	<u>\$ 1,279,202</u>

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

REDWOOD CAPITAL BANCORP  
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Years Ended December 31, 2013 and 2012

	Preferred Stock	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
		Shares	Amount				
Balance at January 1, 2012	\$ 7,283,990	1,761,887	\$ 11,926,862	\$ 588,470	\$ 853,948	\$ 390,169	\$ 21,043,439
Cash dividends on common stock (\$0.15 per share)					(267,779)		(267,779)
Dividends on preferred stock					(198,525)		(198,525)
Redemption and retirement of stock		(2,799)	(18,460)				(18,460)
Stock options exercised and related tax benefits		14,812	120,580	(74,043)			46,537
Restricted stock expense				161,801			161,801
Restricted stock vested		18,732	166,230	(166,230)			
Net income					1,213,367		1,213,367
Other comprehensive income, net of taxes						65,835	65,835
Balance at December 31, 2012	7,283,990	1,792,632	12,195,212	509,998	1,601,011	456,004	22,046,215
Cash dividends on common stock (\$0.215 per share)					(388,278)		(388,278)
Dividends on preferred stock					(82,500)		(82,500)
Redemption and retirement of stock		(3,920)	(31,492)				(31,492)
Stock options exercised, net of shares repurchased and related tax benefits		2,340	78,242	(291,254)			(213,012)
Restricted stock expense				113,639			113,639
Restricted stock vested		19,670	158,724	(158,724)			
Net income					1,868,568		1,868,568
Other comprehensive loss, net of taxes						(788,596)	(788,596)
Balance at December 31, 2013	<u>\$ 7,283,990</u>	<u>1,810,722</u>	<u>\$ 12,400,686</u>	<u>\$ 173,659</u>	<u>\$ 2,998,801</u>	<u>\$ (332,592)</u>	<u>\$ 22,524,544</u>

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

REDWOOD CAPITAL BANCORP  
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2013 and 2012

	2013	2012
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 1,868,568	\$ 1,213,367
Adjustments to reconcile net income to net cash provided by operating activities:		
net of tax expense of (\$551,414) and \$46,034 as of	425,000	995,000
Deferred loan origination fees and costs, net	(15,109)	(118,176)
Gain on disposal of premises		(40,281)
Realized gain on sale of investment securities	(15,191)	
Realized gain on sale of foreclosed real estate	(184,941)	(15,080)
Provision for losses on foreclosed real estate	342,969	200,750
Depreciation and amortization	631,199	549,996
Change in mortgage servicing rights carried at fair value	(302,611)	(63,638)
Stock-based compensation expense	113,639	161,801
Net decrease (increase) in loans held for sale	815,091	(129,133)
Earnings on cash surrender value of life insurance	(85,235)	(96,264)
Net change in accrued interest receivable and other assets	251,284	424,983
Net change in accrued interest payable and other liabilities	(686,107)	983,294
NET CASH PROVIDED BY OPERATING ACTIVITIES	3,158,556	4,066,619
<b>INVESTING ACTIVITIES</b>		
Purchase of available-for-sale investment securities	(1,279,256)	(18,361,557)
Proceeds from maturity of available-for-sale investment securities	1,089,560	4,990,000
Proceeds from paydowns on mortgage-backed securities	4,337,862	3,547,038
Proceeds from sale of foreclosed real estate	1,509,781	665,984
Purchase of Federal Home Loan Bank stock	(114,100)	(5,600)
Net increase in loans	(18,867,476)	(13,207,047)
Proceeds from sale of premises and equipment		327,317
Purchases of premises and equipment	(111,439)	(688,193)
NET CASH USED BY INVESTING ACTIVITIES	(13,435,068)	(22,732,058)
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	12,449,815	(1,782,143)
Repurchase of restricted stock	(31,492)	(18,460)
Proceeds from exercise of stock options	15,608	98,796
Stock repurchases	(345,410)	
Proceeds from borrowings	2,500,000	
Repayments of borrowings	(2,654,671)	(266,047)
Dividends paid on common stock	(388,278)	(267,779)
Dividends paid on preferred stock	(80,340)	(201,264)
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	11,465,232	(2,436,897)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,188,720	(21,102,336)
Cash and cash equivalents at beginning of year	43,600,976	64,703,312
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 44,789,696	\$ 43,600,976

REDWOOD CAPITAL BANCORP  
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

For the Years Ended December 31, 2013 and 2012

	2013	2012
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid during the year for:		
Interest	\$ 831,489	\$ 1,237,493
Income taxes	\$ 923,000	\$ 548,000
 <b>SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES</b>		
Net change in unrealized gains/losses on available-for-sale investment securities	\$ (1,340,010)	\$ 111,869
Net change in deferred income taxes on unrealized gains and losses on securities available-for-sale	\$ 551,414	\$ (46,034)
Loans transferred to foreclosed real estate	\$ 1,374,794	\$ 695,403

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

REDWOOD CAPITAL BANCORP AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013 and 2012

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Business:** Redwood Capital Bancorp (the Company), formed in 2007, is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, Redwood Capital Bank (the Bank). The Bank was incorporated on November 3, 2003 and commenced operations on March 24, 2004. The Bank is subject to regulation, supervision, and regular examination by the California Department of Business Oversight (CDBO) and the Federal Deposit Insurance Corporation (FDIC). The regulations of these agencies govern most aspects of the Bank's business. The financial statements of the Company are prepared in conformity with generally accepted accounting principles and general practices within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing these financial statements.

**Principles of Consolidation:** The consolidated financial statements include the accounts of the Company and the Bank. All material intercompany accounts and transactions have been eliminated.

**Nature of Operations:** The Bank provides commercial, industrial, agricultural, residential and personal credit and other banking services through its branches located in Eureka and Fortuna, California.

**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 assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral. The Company's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions. While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

**Investment Securities:** Securities are classified as held-to-maturity if the Company has both the intent and ability to hold those debt securities to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost, adjusted for amortization of premium and accretion of discount, computed by the interest method over their contractual lives.

Securities are classified as available-for-sale if the Company intends to hold those debt securities for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Securities held as available-for-sale are carried at fair value. Unrealized holding gains or losses are reported as increases or decreases in shareholders' equity, net of the related deferred tax effect. Realized gains or losses, determined on the basis of the cost of specific securities sold, are included in earnings.

**Mortgages Held for Sale:** Mortgages held for sale consist of one-to-four family residential loans originated for sale in the secondary market and are carried at the lower of cost or estimated fair value determined on an aggregate basis. The long-term, fixed rate loans are sold to investors on a best efforts basis such that the Company does not absorb the interest rate risk involved in the loans. The fair value of loans held for sale is determined by reference to quoted prices for loans with similar coupon rates and terms.

**Loans:** Loans are stated at the amount of unpaid principal reduced by net deferred loan fees. Loan origination fees, net of direct origination costs, are deferred and recognized as an adjustment of the yield on the related loan. Amortization of net deferred loan fees is discontinued when the loan is placed on nonaccrual status. Interest on loans is accrued and credited to income based on the principal amount outstanding.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses: The allowance is maintained at a level which, in the opinion of management, is adequate to absorb probable losses inherent in the loan portfolio. Credit losses related to off-balance-sheet instruments are included in other liabilities. Management determines the adequacy of the allowance based upon reviews of individual loans, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. The allowance is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed monthly and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance.

All loans, except those to individuals, are considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Allowances on impaired loans are established based on the present value of expected future cash flows discounted at the loan's historical effective interest rate or, for collateral-dependent loans, on the fair value of the collateral. Cash receipts on impaired loans are used to reduce principal.

Income Recognition on Impaired and Nonaccrual Loans: Loans, including those considered impaired, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or is partially charged off, the loan is classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

While a loan is classified as nonaccrual and the future collectability of the recorded balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectability of the recorded balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Premises and Equipment: Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation and amortization is computed principally by the straight-line method over estimated useful lives of the related assets.

Foreclosed Real Estate: Foreclosed real estate includes both formally foreclosed property and in-substance foreclosed property. In-substance foreclosed properties are those properties for which the Company has taken physical possession, regardless of whether formal foreclosure proceedings have taken place. At the time of foreclosure, foreclosed real estate is recorded at fair value less cost to sell, which becomes the property's new basis. Any write-downs based on the asset's fair value at date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of their new cost basis or fair value minus estimated costs to sell. Revenue and expenses from operations and subsequent adjustments to the carrying amount are included in other non-interest expenses.

Investment in Federal Home Loan Bank Stock: As a member of the Federal Home Loan Bank (FHLB) System, the Bank is required to maintain an investment in capital stock of the FHLB. The investment exceeds the minimum requirement at December 31, 2013 and 2012. The investment is stated at cost in the accompanying balance sheets and is reported as part of other assets.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Mortgage Servicing Rights: Servicing rights resulting from the sale or securitization of loans originated (asset transfers) are initially measured at fair value at the date of transfer and the changes in fair value, primarily due to changes in valuation inputs and assumptions and to the collection/realization of expected cash flows, are reported in noninterest income in the period in which the change occurs. The rights to service mortgage loans for others, or mortgage servicing rights, are recognized as assets whether purchased or resulting from an asset transfer.

Income Taxes: Provisions for income taxes are based on amounts reported in the statements of operations (after exclusion of non-taxable income such as interest on state and municipal securities) and include deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred taxes are computed using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are recognized for deductible temporary differences and tax credit carryforwards, and then a valuation allowance is established to reduce that deferred tax asset if it is “more likely than not” that the related tax benefits may not be realized.

Net Income Per Share of Common Stock: Net income per share of common stock is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year, after giving retroactive effect to stock dividends and splits. Net income per share assuming dilution is computed similar to net income per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. Included in the denominator is the dilutive effect of stock options computed under the treasury method.

Advertising: Advertising costs are charged to operations in the year incurred.

Off-Balance-Sheet Financial Instruments: In the ordinary course of business the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

Stock-Based Compensation Accounting: The Company has a stock-based employee and director compensation plan which is described more fully in Note N. The Company applies the fair value recognition provisions of FASB ASC 718, *Accounting for Stock-Based Compensation*. Accordingly, compensation cost for stock options is measured based on the grant-date fair value and is recognized in the income statement. Awards under the Company’s plan generally vest over five years.

Operating Segments: Reportable segments are based on products and services, geography, legal structure, management structure and any other manner in which management desegregates a company for making operating decisions and assessing performance. The Company has determined that its business is comprised of a single operating segment.

Cash and Cash Equivalents: For the purpose of presentation in the Statement of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption “Cash and due from banks” and “Federal funds sold” and “interest-bearing deposits in other financial institutions.”

Reclassifications: Certain reclassifications have been made to 2012 presentation to conform to the 2013 presentation. These reclassifications had no effect on previously reported changes in retained earnings or net income. The restatement of 2012 amounts on the Consolidated Statements of Operations was the result of the reclassification of the amortization of loan origination costs totaling \$279,908 from the salaries and benefits line item to interest and fees on loans.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Subsequent events: The Company evaluated all events or transactions that occurred after December 31, 2013 and up to March, 2014, the date the financial statements were issued. During this period, the Company did not have any recognizable or nonrecognizable subsequent events.

NOTE B – INVESTMENT SECURITIES

The amortized cost and approximate fair value of investment securities are summarized as follows:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2013				
Securities Available-for-Sale				
U.S. government agency securities	\$ 6,956,971	\$ 20,135	\$ (241,728)	\$ 6,735,378
Small Business Administration Securities	2,849,221		(75,911)	2,773,310
Mortgage-backed securities	2,633,923	17,144	(18,637)	2,632,430
Municipal securities	7,464,895	38,899	(341,949)	7,161,845
Collateralized mortgage obligations	5,691,280	129,936	(93,040)	5,728,176
Total	<u>\$ 25,596,290</u>	<u>\$ 206,114</u>	<u>\$ (771,265)</u>	<u>\$ 25,031,139</u>
December 31, 2012				
Securities Available-for-Sale				
U.S. government agency securities	\$ 6,987,964	\$ 219,622		\$ 7,207,586
Small Business Administration Securities	3,062,535	575	\$ (8,600)	3,054,510
Mortgage-backed securities	3,591,449	130,638		3,722,087
Municipal securities	7,307,506	154,068	(44,898)	7,416,676
Collateralized mortgage obligations	9,121,400	324,237	(784)	9,444,853
Total	<u>\$ 30,070,854</u>	<u>\$ 829,140</u>	<u>\$ (54,282)</u>	<u>\$ 30,845,712</u>

The maturities of investment securities at December 31, 2013 were as follows:

	Available-for-Sale	
	Amortized Cost	Fair Value
Due from one year to five years	\$ 2,262,131	\$ 2,287,317
Due from five years to ten years	9,579,558	9,375,644
Due after ten years	13,754,601	13,368,178
	<u>\$ 25,596,290</u>	<u>\$ 25,031,139</u>

The amortized cost and fair value of mortgage-backed securities and collateralized mortgage obligations are presented by contractual maturity in the preceding table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations without call or prepayment penalties.

Investment securities with an amortized cost of \$12,455,159 and a fair value of \$12,466,176 at December 31, 2013 were pledged to secure public deposits. Investment securities with an amortized cost of \$15,757,367 and a fair value of \$16,490,840 at December 31, 2012 were pledged to secure public deposits.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE B – INVESTMENT SECURITIES (Continued)

The following table shows the investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2013 and 2012.

Description of Securities	2013			
	Less than 12 months		More than 12 Months	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Government agency securities	\$ 2,758,272	\$ (241,728)		
Small Business Administration securities	1,295,833	(28,752)	\$ 1,477,477	\$ (47,159)
Mortgage-backed securities	2,353,155	(18,637)		
Municipal securities	2,190,535	(110,159)	2,642,730	(231,790)
Collateralized mortgage obligations	2,016,707	(93,040)		
	<u>\$ 10,614,502</u>	<u>\$ (492,316)</u>	<u>\$ 4,120,207</u>	<u>\$ (278,949)</u>
Description of Securities	2012			
	Less than 12 months		More than 12 Months	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Small Business Administration securities	\$ 1,974,681	\$ (8,600)		
Municipal securities	2,331,965	(44,898)		
Collateralized mortgage obligations	429,598	(784)		
	<u>\$ 4,736,244</u>	<u>\$ (54,282)</u>	<u>\$ -</u>	<u>\$ -</u>

There were two U.S. government agency securities, two Small Business Administration securities, three mortgage-backed securities, five municipal securities, and two collateralized mortgage obligations that were in a continuous loss position for less than 12 months as of December 31, 2013. There were two municipal securities and one Small Business Administration security that were in a continuous loss position for 12 months or more as of December 31, 2013. There were two Small Business Administration securities, two municipal securities, and one collateralized mortgage obligation that were in a loss position for less than 12 months as of December 31, 2012. The unrealized losses on these securities were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment. Because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2013 and 2012.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE C – LOANS, NET

Major classifications of loans at December 31 are summarized as follows:

	<u>2013</u>	<u>2012</u>
Commercial real estate	\$ 94,321,882	\$ 80,011,682
Commercial loans	19,492,570	20,390,135
Construction and land loans	8,285,365	7,672,156
Residential real estate	20,416,760	19,713,032
Loans to individuals	27,595,996	26,764,274
Agricultural	2,889,530	1,286,076
	<u>173,002,103</u>	<u>155,837,355</u>
Net deferred loan fees and costs	93,165	78,056
Allowance for loan losses	<u>(2,885,979)</u>	<u>(2,788,913)</u>
	<u>\$ 170,209,289</u>	<u>\$ 153,126,498</u>

The Company receives fees for servicing retained on loans sold. Loans being serviced by the Company for others totaled approximately \$76,348,218 and \$53,590,702 for the years ended December 31, 2013 and 2012, respectively.

The maturity and repricing of the loan portfolio is as follows at December 31:

	<u>2013</u>	<u>2012</u>
Fixed rate loan maturities		
Three months or less	\$ 214,043	\$ 1,006,689
Over three months to twelve months	2,385,869	730,230
Over one year to five years	7,712,582	10,086,638
Over five years to fifteen years	5,434,156	4,778,553
Over fifteen years	1,180,784	1,791,191
Floating rate loans repricing		
Quarterly or more frequently	63,561,647	57,703,599
Quarterly to annual frequency	3,191,773	8,235,476
One to five years frequency	75,204,673	57,170,723
Five to fifteen years frequency	12,649,293	11,440,766
Over fifteen years frequency		
Non-accrual loans	<u>1,467,283</u>	<u>2,893,490</u>
	<u>\$ 173,002,103</u>	<u>\$ 155,837,355</u>

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The Company's methodology for assessing the appropriateness of the allowance consists of three key elements, which include the general allowance, the specific allowance and an allowance for changing environmental factors. These various components are factored into a single allowance analysis.

General Allowance: The determination of general allowance is based on estimates made by management, including but not limited to, consideration of historical losses by portfolio segment, peer bank losses, analysis of the economy, market rate environment, underwriting standards and other criteria as identified by the credit administrator. The portfolio segments include commercial real estate, construction, single family residential, home equity lines of

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

credit, agricultural land, commercial, agricultural loans/lines and consumer. In addition, the Company segregates each of these segments into local and out-of-area loans. Local refers to properties located in Humboldt, Del Norte and Trinity counties, and out-of-area refers to properties located outside of the tri-county area. Peer bank loss information is used for loans that are out-of-area, unless the Company's loss history is higher. The general allowance consists of reserve factors that are based on charge-off history and management's assessment of each portfolio segment. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

**Commercial Real Estate**—These loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

**Commercial**—Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

**Construction and Land**—Construction and land loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

**Residential Real Estate**—The loans consist of single family residential loans and home equity lines of credit. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

**Installment and other loans to individuals**—The installment loan portfolio is comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for purchase of heavy equipment or industrial vehicles may also be included.

**Agriculture**—Loans secured by agricultural land and production are especially vulnerable to two risk factors that are largely outside the control of the Company and borrowers, commodity prices and weather conditions.

**Specific Allowance:** Regular credit reviews of the portfolio also identify loans that are considered potentially impaired. A loan is considered impaired when, based on current information and events, the Company determines that they will probably not be able to collect all amounts due according to the loan contract, including scheduled interest payments. When the Company identifies a loan as impaired, the Company measures the impairment using discounted cash flows, except when the sole remaining source of repayment for the loans is the liquidation of the collateral. In these cases, the Company uses the current fair value of the collateral, less selling costs. If the Company determines that the value of the impaired loan is less than the recorded investment in the loan, the Company either recognizes an impairment reserve as a specific allowance to be provided for in the allowance or charges-off the impaired balance on collateral dependent loans if it is determined that such amount represents a confirmed loss. Loans determined to be impaired with a specific allowance are excluded from the general allowance so as not to double-count the loss exposure.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

**Qualitative factors:** This component of the allowance is management’s best estimate of the probable impact that various qualitative factors may have on the loan portfolio. It is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by several factors, including changes in the nature and volume of the portfolio, changes in the terms of loans, changes in lending policies and procedures, underwriting collection practices, changes in international, national, regional, and local economic and business conditions, changes in the experience and ability of lending management and staff, changes in the volume and severity of past due loans, changes in the volume of non-accrual loans, changes in the volume and severity of adversely classified or graded loans, changes in the quality of the Company’s loan review system, changes in the value of underlying collateral, the existence and effect of any concentrations of credit, changes in the level of concentrations of credit and the effect of other external factors such as competition and legal and regulatory requirements.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. The Board of Directors review the adequacy of the allowance quarterly, including consideration of current economic conditions, 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, or past loan experience and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company’s primary regulators, the FDIC and the CDBO, review the adequacy of the allowance as an integral part of their examination process. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

The following table summarizes activity related to the allowance for loan losses by loan portfolio segment and the allocation of the allowance for loan losses by loan portfolio segment and by impairment methodology for the years ended December 31, 2013 and 2012:

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Unallocated and Qualitative Factors	Total
<u>2013</u>								
<u>Allowance for credit losses:</u>								
Beginning balance	\$ 1,155,655	\$ 317,195	\$ 174,924	\$ 291,022	\$ 615,324	\$ 16,090	\$ 218,703	\$ 2,788,913
Charge-offs	(38,533)	(32,845)		(5,340)	(302,613)			(379,331)
Recoveries	5,167	30,443		3,047	12,740			51,397
Provision	166,532	(18,762)	58,372	38,555	256,605	22,379	(98,681)	425,000
Ending balance	<u>\$ 1,288,821</u>	<u>\$ 296,031</u>	<u>\$ 233,296</u>	<u>\$ 327,284</u>	<u>\$ 582,056</u>	<u>\$ 38,469</u>	<u>\$ 120,022</u>	<u>\$ 2,885,979</u>
Ending balance:								
Individually evaluated for impairment		<u>\$ 14,151</u>		<u>\$ 35,000</u>	<u>\$ 150,500</u>			<u>\$ 199,651</u>
Ending balance:								
Collectively evaluated for impairment	<u>\$ 1,288,821</u>	<u>\$ 281,880</u>	<u>\$ 233,296</u>	<u>\$ 292,284</u>	<u>\$ 431,556</u>	<u>\$ 38,469</u>	<u>\$ 120,022</u>	<u>\$ 2,686,328</u>
<u>Loans:</u>								
Ending balance	<u>\$ 94,321,882</u>	<u>\$ 19,492,570</u>	<u>\$ 8,285,365</u>	<u>\$ 20,416,760</u>	<u>\$ 27,595,996</u>	<u>\$ 2,889,530</u>		<u>\$ 173,002,103</u>
Ending balance:								
Individually evaluated for impairment		<u>\$ 145,431</u>	<u>\$ 629,900</u>	<u>\$ 772,696</u>	<u>\$ 212,522</u>			<u>\$ 1,760,549</u>
Ending balance:								
Collectively evaluated for impairment	<u>\$ 94,321,882</u>	<u>\$ 19,347,139</u>	<u>\$ 7,655,465</u>	<u>\$ 19,644,064</u>	<u>\$ 27,383,474</u>	<u>\$ 2,889,530</u>		<u>\$ 171,241,554</u>

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Unallocated and Qualitative Factors	Total
<u>2012</u>								
<u>Allowance for credit losses:</u>								
Beginning balance	\$ 1,146,513	\$ 361,614	\$ 216,998	\$ 277,673	\$ 585,687	\$ 4,415	\$ 429,501	\$ 3,022,401
Charge-offs	(245,557)	(22,706)	(589,424)	(128,292)	(280,773)			(1,266,752)
Recoveries	32,224	1,000			5,040			38,264
Provision	222,475	(22,713)	547,350	141,641	305,370	11,675	(210,798)	995,000
Ending balance	<u>\$ 1,155,655</u>	<u>\$ 317,195</u>	<u>\$ 174,924</u>	<u>\$ 291,022</u>	<u>\$ 615,324</u>	<u>\$ 16,090</u>	<u>\$ 218,703</u>	<u>\$ 2,788,913</u>
Ending balance: Individually evaluated for impairment	<u>\$ 32,845</u>	<u>\$ 23,387</u>	<u>\$ 25,603</u>	<u>\$ 1,518</u>	<u>\$ 210,046</u>			<u>\$ 293,399</u>
Ending balance: Collectively evaluated for impairment	<u>\$ 1,122,810</u>	<u>\$ 293,808</u>	<u>\$ 149,321</u>	<u>\$ 289,504</u>	<u>\$ 405,278</u>	<u>\$ 16,090</u>	<u>\$ 218,703</u>	<u>\$ 2,495,514</u>
<u>Loans:</u>								
Ending balance	<u>\$ 80,011,682</u>	<u>\$ 20,390,135</u>	<u>\$ 7,672,156</u>	<u>\$ 19,713,032</u>	<u>\$ 26,764,274</u>	<u>\$ 1,286,076</u>		<u>\$ 155,837,355</u>
Ending balance: Individually evaluated for impairment	<u>\$ 856,452</u>	<u>\$ 130,614</u>	<u>\$ 1,710,645</u>	<u>\$ 511,549</u>	<u>\$ 210,046</u>			<u>\$ 3,419,306</u>
Ending balance: Collectively evaluated for impairment	<u>\$ 79,155,230</u>	<u>\$ 20,259,521</u>	<u>\$ 5,961,511</u>	<u>\$ 19,201,483</u>	<u>\$ 26,554,228</u>	<u>\$ 1,286,076</u>		<u>\$ 152,418,049</u>

Credit Quality of Loans

The Company assigns a risk rating to loans over a certain threshold and periodically performs detailed reviews of all such loans to identify credit risks and to assess the overall collectability of the portfolio. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. These risk ratings can be grouped into the following major categories, defined as follows:

Pass: A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Watch List: A watch list loan has significant weaknesses resulting from performance trends or management concerns.

Special Mention: A special mention loan is currently protected, but is weak due to negative trends in the financial statements of the borrower and current cash flow problems, among other criteria. Special mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard: A substandard loan has well-defined weaknesses where a payment default and/or a loss is possible, but not yet probable. Cash flow is insufficient to service the debt, with prospects that the condition is permanent. Loans classified as substandard are inadequately protected by the current net worth and repayment capacity of the borrower and there is a likelihood that collateral will have to be liquidated and/or guarantor called upon to repay the debt.

Doubtful: Loans classified as doubtful have characteristics of those classified as substandard but available information suggests it is unlikely that the loan will be repaid in its entirety. Cash flow is insufficient to service the debt. If the current material adverse trends continue, it is unlikely the borrower will have the ability to meet the terms of the loan agreement. It may be difficult to project the exact amount of loss, but the probability of some loss is greater than 50%.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

Loss: Loans classified as loss have characteristics those classified as of doubtful but the loan will not be repaid in full. Debt service coverage clearly reflects the borrower's inability to service the debt. The borrower cannot generate sufficient cash flow to cover fixed charges. All near-term and long-term trends concerning cash flow and earnings are negative. Collateral and guarantees provide no support.

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2013 and 2012:

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Total
<u>2013</u>							
Grade:							
Pass	\$ 87,054,899	\$ 16,331,276	\$ 7,655,465	\$ 18,262,780	\$ 26,931,893	\$ 2,889,530	\$ 159,125,843
Watch	5,414,690	2,003,561		1,381,284	451,581		9,251,116
Special Mention	122,953						122,953
Substandard	1,729,340	1,157,733	629,900	772,696	212,522		4,502,191
Doubtful							-
Total	<u>\$ 94,321,882</u>	<u>\$ 19,492,570</u>	<u>\$ 8,285,365</u>	<u>\$ 20,416,760</u>	<u>\$ 27,595,996</u>	<u>\$ 2,889,530</u>	<u>\$ 173,002,103</u>
<u>2012</u>							
Grade:							
Pass	\$ 72,100,273	\$ 15,789,367	\$ 6,821,738	\$ 17,451,032	\$ 25,671,277	\$ 305,331	\$ 138,139,018
Watch	4,255,927	2,305,042	120,518	1,750,451	863,189		9,295,127
Special Mention	375,880	658,258					1,034,138
Substandard	3,279,602	1,637,468	729,900	511,549	229,808	980,745	7,369,072
Doubtful							-
Total	<u>\$ 80,011,682</u>	<u>\$ 20,390,135</u>	<u>\$ 7,672,156</u>	<u>\$ 19,713,032</u>	<u>\$ 26,764,274</u>	<u>\$ 1,286,076</u>	<u>\$ 155,837,355</u>

The following table summarizes the Company's past due loans and non-accrual loans by loan portfolio segment as of December 31, 2013 and 2012:

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
<u>2013</u>							
Commercial real estate						\$ 94,321,882	\$ 94,321,882
Commercial					\$ 145,432	19,347,138	19,492,570
Construction and land		\$ 75,523		\$ 75,523	629,900	7,579,942	8,285,365
Residential	\$ 410,776			410,776	479,429	19,526,555	20,416,760
Individual					212,522	27,383,474	27,595,996
Agriculture						2,889,530	2,889,530
Total	<u>\$ 410,776</u>	<u>\$ 75,523</u>	<u>\$ -</u>	<u>\$ 486,299</u>	<u>\$ 1,467,283</u>	<u>\$ 171,048,521</u>	<u>\$ 173,002,103</u>

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
<u>2012</u>							
Commercial real estate					\$ 68,306	\$ 79,943,376	\$ 80,011,682
Commercial					471,708	19,918,427	20,390,135
Construction and land					729,900	6,942,256	7,672,156
Residential	\$ 789,126	\$ 130,112		\$ 919,238	511,549	18,282,245	19,713,032
Individual	198,891			198,891	131,282	26,434,101	26,764,274
Agriculture					980,745	305,331	1,286,076
Total	<u>\$ 988,017</u>	<u>\$ 130,112</u>	<u>\$ -</u>	<u>\$ 1,118,129</u>	<u>\$ 2,893,490</u>	<u>\$ 151,825,736</u>	<u>\$ 155,837,355</u>

There were no accruing loans past due 90 days or more at December 31, 2013 and 2012.

The following table shows information related to impaired loans by loan portfolio segment as of December 31, 2013 and 2012:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<u>2013</u>					
With no related allowance recorded:					
Commercial real estate				\$ 424,856	\$ 16,295
Commercial	\$ 60,946	\$ 59,776		31,678	45
Construction and land	636,023	629,900		1,354,492	
Residential	479,001	479,429		496,413	
Individual	12,975	12,561		87,199	520
With an allowance recorded:					
Commercial real estate					
Commercial	86,607	85,655	\$ 14,151	96,650	
Construction and land					
Residential	292,298	293,267	35,000		
Individual	202,313	199,961	150,500	33,719	
Total:					
Commercial real estate				424,856	16,295
Commercial	147,553	145,431	14,151	128,328	45
Construction and land	636,023	629,900		1,354,492	
Residential	771,299	772,696	35,000	496,413	
Individual	215,288	212,522	150,500	120,918	520
Total	<u>\$ 1,770,163</u>	<u>\$ 1,760,549</u>	<u>\$ 199,651</u>	<u>\$ 2,525,007</u>	<u>\$ 16,860</u>

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<u>2012</u>					
With no related allowance recorded:					
Commercial real estate	\$ 527,506	\$ 525,216		\$ 791,872	\$ 43,306
Commercial	22,013	21,597		536,268	16,828
Construction and land	1,002,703	980,745		1,000,811	-
Residential	385,663	383,806		361,311	5,239
Individual				87,756	1,966
With an allowance recorded:					
Commercial real estate	333,897	331,236	\$ 32,845	55,992	4,800
Commercial	108,044	109,017	23,387	148,256	6,919
Construction and land	736,024	729,900	25,603	980,825	4,208
Residential	128,162	127,743	1,518	136,359	7,493
Individual	209,650	210,046	210,046	132,603	4,479
Total:					
Commercial real estate	861,403	856,452	32,845	847,864	48,106
Commercial	130,057	130,614	23,387	684,524	23,747
Construction and land	1,738,727	1,710,645	25,603	1,981,636	4,208
Residential	513,825	511,549	1,518	497,670	12,732
Individual	209,650	210,046	210,046	220,359	6,445
	<u>\$ 3,453,662</u>	<u>\$ 3,419,306</u>	<u>\$ 293,399</u>	<u>\$ 4,232,053</u>	<u>\$ 95,238</u>

NOTE E – PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31:

	<u>2013</u>	<u>2012</u>
Land	\$ 830,448	\$ 902,528
Building and improvements	4,266,155	4,178,233
Furniture, fixtures and equipment	1,482,878	1,387,281
	<u>6,579,481</u>	<u>6,468,042</u>
Less: Accumulated depreciation	<u>(2,541,495)</u>	<u>(2,251,884)</u>
	<u>\$ 4,037,986</u>	<u>\$ 4,216,158</u>

Depreciation and amortization included in occupancy expense totaled \$323,065 and \$308,913 in 2013 and 2012, respectively.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE F – MORTGAGE SERVICING RIGHTS

The following table presents the changes in the Bank’s mortgage servicing rights for the year ended December 31, 2013:

	<u>2013</u>	<u>2012</u>
Fair value, beginning of year	\$ 301,470	\$ 237,832
Additions for new mortgage servicing rights capitalized	191,836	156,517
Change in fair value due to changes in model inputs and assumptions	<u>110,775</u>	<u>(92,879)</u>
Fair value, end of year	<u>\$ 604,081</u>	<u>\$ 301,470</u>
Balance of mortgage loans serviced for others	\$ 73,685,146	\$ 50,814,335
Mortgage servicing rights as a percentage of serviced loans	0.82%	0.59%

The amounts of contractually specified servicing fees, late fees and ancillary fees earned, recorded in mortgage banking revenue on the consolidated statements of operations, were \$154,165 and \$97,240 for the years ended December 31, 2013 and 2012, respectively. Changes in fair value are also included in mortgage banking revenue on the consolidated statements of operations.

The fair value of mortgage servicing rights is determined using a discounted cash flow model. In order to determine the fair value of the mortgage servicing rights, the present value of expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds, delinquency and foreclosure rates, and ancillary fee income. Key assumptions used in measuring the fair value of mortgage servicing rights as of December 31, 2013 and 2012 include a discount rate of 11%. A proprietary market implied prepayment model is used by the independent valuation group.

The expected life of the loans can vary from management’s estimates due to prepayments by borrowers, especially when rates fall. Prepayments in excess of management’s estimates would negatively impact the recorded value of the mortgage servicing rights. The value of the mortgage servicing rights is also dependent upon the discount rate used in the model, which is based on current market rates. A significant increase in the discount rate would reduce the value of mortgage servicing rights.

NOTE G – INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following at December 31:

	<u>2013</u>	<u>2012</u> (Restated)
Negotiable order of withdrawal (NOW)	\$ 52,109,671	\$ 41,000,067
Savings and money markets	78,958,409	79,947,926
Time, \$100,000 and over	39,080,800	43,050,929
Other time	<u>9,272,527</u>	<u>10,109,242</u>
	<u>\$ 179,421,407</u>	<u>\$ 174,108,164</u>

The 2012 amounts have been adjusted to reclassify certain time deposits with balances of \$100,000 and over to the proper category. The related interest was also reclassified.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE G – INTEREST-BEARING DEPOSITS (Continued)

Interest expense on these deposits for the years ended December 31 is as follows:

	2013	2012 (Restated)
Negotiable order of withdrawal (NOW)	\$ 91,601	\$ 164,303
Savings and money markets	272,878	408,835
Time, \$100,000 and over	266,454	424,685
Other time	59,562	96,076
	<u>\$ 690,495</u>	<u>\$ 1,093,899</u>

The maturities of time deposits at December 31 are as follows:

	2013	2012
Three months or less	\$ 19,490,943	\$ 15,181,516
Over three months through twelve months	21,573,027	29,310,767
Over one year through three years	7,050,368	8,319,047
Over three years	238,989	348,841
	<u>\$ 48,353,327</u>	<u>\$ 53,160,171</u>

NOTE H – LENDING AGREEMENTS

The Company has federal funds line of credit agreements with other banks. The maximum borrowings available under these lines amount to \$16,000,000 at December 31, 2013 and 2012. There were no borrowings outstanding under these agreements at December 31, 2013 and 2012.

The Company has an agreement to borrow from the Federal Home Loan Bank to the extent of pledged assets, up to 15% of total assets. Assets pledged under the agreement at December 31, 2013 totaled \$253,671,764, resulting in a limit on borrowings of \$38,050,765. Assets pledged under the agreement at December 31, 2012 totaled \$241,542,951, resulting in a limit on borrowings of \$36,231,443. The Company also maintains a letter of credit with the Federal Home Loan Bank of \$3,000,000 and \$10,500,000, as of December 31, 2013 and 2012, respectively, which serves as collateral for public and other deposits and is collateralized by a portion of the loans discussed above. No amounts were outstanding under this agreement as of December 31, 2013 and 2012.

The Company has an agreement to borrow from the Federal Reserve Bank by obtaining advances or discounting eligible paper to the extent of pledged collateral. Promissory notes and deeds of trust on the Bank's loans totaling \$5,918,122 and \$6,189,821 for 2013 and 2012, respectively, were held by the Federal Reserve Bank as collateral. There were no borrowings outstanding under this agreement at December 31, 2013 and 2012.

The Company has an agreement to borrow from another financial institution in the original amount of \$2,500,000. Interest on the outstanding balance is calculated at a variable rate equal to the prime rate, plus 0.75%. The interest rate at December 31, 2013 was 4.00%. Quarterly principal and interest payments of \$78,125 are due for 31 consecutive quarters concluding with one final quarterly payment of \$78,924. The outstanding principal balance at December 31, 2013 was \$2,421,875.

The Company had an agreement to borrow from another financial institution for \$3,100,000. In 2013, the Company paid off the loan with proceeds from another agreement to borrow with a different financial institution for \$2,500,000. Interest on the outstanding balance was calculated at a variable rate equal to the prime rate. The interest rate at December 31, 2012 was 3.25%. The outstanding principal balance at December 31, 2012 was \$2,576,546.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE I – OTHER EXPENSES

Other expenses consisted of the following for the years ended December 31:

	2013	2012
Data processing	\$ 501,133	\$ 453,718
Professional fees	381,134	384,579
Marketing and promotion	300,515	280,069
Director and shareholder	274,068	270,511
Loan and collection expense	177,881	204,419
Operating expense	195,209	188,221
Insurance expense	283,249	175,971
Postage and delivery	69,988	67,535
Stationary and forms	71,286	61,331
Miscellaneous employee expense	93,337	54,301
Operational losses	12,383	47,030
Telephone expense	47,935	45,171
Dues and memberships	44,556	29,939
Subscriptions	7,919	11,065
Security expense	6,450	5,861
Other non-interest expense	1,029	3,939
	<u>\$ 2,468,072</u>	<u>\$ 2,283,660</u>

NOTE J – PREFERRED STOCK

On July 21, 2011, the Company completed the issuance of \$7,310,000 of Series C preferred stock under the U.S. Department of Treasury's Small Business Lending Fund and issued 7,310 shares of Series C preferred stock. The Series C preferred stock has a cumulative dividend for the first two and a half years of 1 to 5% per annum, which is dependent on the amount of loans to small businesses. After two and a half years, the dividend rate can increase to 7% if lending to small businesses has not increased. The rate increases to 9% for all banks after 4.5 years. The liquidation amount is \$1,000 per share. The Preferred Stock has no maturity date and ranks senior to the Company's common stock with respect to the payment of dividends and distributions and amounts payable upon liquidation, dissolution and winding up of the Company. The Preferred Stock is generally non-voting, other than class voting on certain matters that could adversely affect the Preferred Stock. Preferred stock dividends totaled \$82,500 and \$198,525 in 2013 and 2012, respectively.

NOTE K – RETIREMENT PLANS

The Company has a defined contribution retirement plan covering substantially all of the Company's employees. Employees may elect to have a portion of their compensation contributed to the plan in conformity with the requirements of Section 401(k) of the Internal Revenue Code. The Company will make contributions equal to 100% of the effective deferral made by the employees, up to a maximum of 4% of the employees' eligible earnings. Salaries and employee benefits expense includes the Company's contributions to the plan of \$52,000 and \$90,500 during 2013 and 2012, respectively.

The Company has single premium life insurance policies in connection with the retirement plans for two key officers. The policies provide protection against the adverse financial effects from the death of key officers and to provide income to offset expenses associated with the plan. The officers are insured under the policies, but the Company is the owner and beneficiary. At December 31, 2013 and 2012, the cash surrender value of these policies totaled \$2,779,486 and \$2,694,251, respectively.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE K – RETIREMENT PLANS (Continued)

The Company has a retirement plan that is unfunded, which provides for the Company to pay the officers specified amounts for specified periods after retirement and allow them to defer a portion of current compensation in exchange for the Company's commitment to pay a deferred benefit at retirement. Directors are also eligible to participate in the deferred compensation plan. If death occurs prior to or during retirement, the Company will pay the officer's beneficiary or estate the benefits set forth in the plan. Deferred compensation is vested as to the amounts deferred. Liabilities are recorded for the estimated present value of future salary continuation benefits. At December 31, 2013 and 2012, the liability recorded for the executive officer supplemental retirement plan totaled \$232,101 and \$191,451, respectively. The amount of expense related to this plan for 2013 and 2012 was \$40,650 and \$34,192, respectively. At December 31, 2013 and 2012, the liability recorded for the deferred compensation plan totaled \$181,235 and \$134,320, respectively.

NOTE L – INCOME TAXES

The provision for income taxes for 2013 and 2012 is comprised of the following:

	<u>2013</u>	<u>2012</u>
Current		
Federal	\$ 624,867	\$ 507,533
State	146,003	79,908
	<u>770,870</u>	<u>587,441</u>
Deferred		
Federal	216,893	85,696
State	170,222	111,995
	<u>387,115</u>	<u>197,691</u>
Provision for income taxes	<u>\$ 1,157,985</u>	<u>\$ 785,132</u>

The following is a reconciliation of income taxes computed at the Federal statutory rate of 34% to the effective rate used for the provision for income taxes for the years ended December 31:

	<u>2013</u>	<u>2012</u>
Income benefit at the Federal statutory rate	\$ 1,029,030	\$ 679,490
State franchise tax benefit, less Federal income tax effect	216,532	142,981
Interest on enterprise zone loans exempt from State tax	(70,811)	(73,506)
Tax exempt municipal securities	(59,428)	(31,131)
Earnings on cash surrender value of life insurance	(35,078)	(39,617)
Nondeductible expenses and other	77,740	106,915
Net provision for income taxes	<u>\$ 1,157,985</u>	<u>\$ 785,132</u>

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE L – INCOME TAXES (Continued)

The tax effects of temporary differences that give rise to the components of the net deferred tax assets as of December 31 were as follows:

	<u>2013</u>	<u>2012</u>
Deferred tax assets:		
Allowance for loan losses	\$ 772,738	\$ 753,095
Available for sale securities	232,560	
Salary continuation accrual	95,520	78,791
Depreciation	86,330	51,701
Deferred compensation	74,586	
Accrued vacation	64,977	64,977
Non accrual interest	49,844	64,518
Nonstatutory stock option expense	47,073	72,849
Non-qualified restricted stock	46,767	66,588
Allowance for loan commitments	24,693	24,693
Enterprise zone credits	13,200	
Net operating loss and contribution carryforwards	10,901	128,353
Other	13,288	8,328
Total deferred tax assets	<u>1,532,477</u>	<u>1,313,893</u>
Deferred tax liabilities:		
Mortgage servicing rights	(248,606)	(124,068)
Federal Home Loan Bank dividends	(24,940)	(24,940)
Other	(94,627)	
Available for sale securities		(318,854)
Discount accretion		(205)
Total deferred tax liabilities	<u>(368,173)</u>	<u>(468,067)</u>
Net deferred tax assets	<u>\$ 1,164,304</u>	<u>\$ 845,826</u>

Amounts presented for the tax effects of temporary differences are based upon estimates and assumptions and could vary from amounts ultimately reflected on the Company's tax returns. Accordingly, the variances from amounts reported in prior years are primarily adjustments to conform to the tax returns as filed. As of December 31, 2013 and 2012, the Company had income tax receivable of \$268,648 and \$176,723, respectively.

The Company and its subsidiary file an income tax return in the U.S. federal jurisdiction and a franchise tax return in the State of California jurisdiction. The Company is no longer subject to U.S. federal income tax examinations and State franchise tax examinations by taxing authorities for years prior to 2010 and 2009, respectively.

FASB ASC 740-10 clarifies the accounting for income taxes, by prescribing a minimum recognition threshold a tax position taken or expected to be taken in a tax return is required to meet before being recognized in the financial statements. The Company adopted provisions of FASB ASC 740-10, on January 1, 2007. There have been no adjustments identified for unrecognized tax benefits requiring an adjustment to the income statement since this pronouncement was implemented. The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. The Company has recognized no interest or penalties since this pronouncement was implemented.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE L – INCOME TAXES (Continued)

The California Franchise Tax Board (FTB) is currently auditing the Company’s 2010 and 2009 franchise tax returns and has asserted that enterprise zone loan net interest deductions totaling approximately \$791,000 were improperly taken during these tax years. The Company and several other financial institutions have disputed the position taken by the FTB. The Company, if it does not prevail, could be required to pay the assessed franchise taxes of approximately \$72,000 plus interest on the amount assessed. The Company accrued approximately \$82,000 as a potential settlement at December 31, 2013. However, the ultimate resolution of this matter could differ from management’s estimate and could result in additional franchise tax being expensed or credited, which would affect the Company’s effective tax rate. The Company expects the exam to be completed during the next twelve months.

The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2013 and 2012, the Company recognized no interest and penalties.

As of December 31, 2013 and 2012, the Company had State of California net operating loss carryforwards available to reduce future taxable income as follows:

<u>2013</u>				<u>2012</u>		
Net Operating Loss Carryforward	Expiration Date			Net Operating Loss Carryforward	Expiration Date	
\$ 13,528	2020		State	\$ 817,961	2018	
<u>138,844</u>	2031			520,003	2019	
				120,860	2020	
<u>\$ 152,372</u>				<u>138,844</u>	2031	
				<u>\$ 1,597,668</u>		

As of December 31, 2012, the Company also had state contribution carryforwards of \$38,152, which were used in 2013.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE M– EARNINGS PER SHARE

The following is a computation of basic and diluted earnings per share for the years ended December 31, 2013 and 2012.

	<u>2013</u>	<u>2012</u>
Basic:		
Net income	<u>\$ 1,868,568</u>	<u>\$ 1,213,367</u>
Weighted-average common shares outstanding	<u>1,805,567</u>	<u>1,780,677</u>
Earnings per share	<u>\$ 1.03</u>	<u>\$ 0.68</u>
Diluted:		
Net income	<u>\$ 1,868,568</u>	<u>\$ 1,213,367</u>
Weighted-average common shares outstanding	1,805,567	1,780,677
Net effect of dilutive stock options - based on the Treasury stock method using average market price	<u>28,367</u>	<u>19,782</u>
Weighted-average common shares outstanding and common stock equivalents	<u>1,833,934</u>	<u>1,800,459</u>
Earnings per share - assuming dilution	<u>\$ 1.02</u>	<u>\$ 0.67</u>

Options to purchase 24,000 shares of common stock at \$13.33 to \$14.67 per share and 27,056 shares of restricted stock were outstanding during 2013 but were not included in the computation of diluted earnings per share because the options' exercise price and stock issuance price was greater than the average market price of the common shares. Options to purchase 24,000 shares of common stock at \$13.33 to \$14.67 per share and 46,726 shares of restricted stock were outstanding during 2012 but were not included in the computation of diluted earnings per share because the options' exercise price and stock issuance price was greater than the average market price of the common shares.

NOTE N – STOCK OPTION PLAN

The Company has a stock option plan established in 2004 under which incentive and nonstatutory stock options and restricted stock may be granted. The Company's Stock Option Plan provides for the granting of a maximum of 495,000 shares of the Company's common stock to directors, key employees and consultants at an exercise price not less than the fair market value of the shares on the date of grant and for a term of no more than 10 years. Options granted vest at a rate of 20% per year over five years from the date the option is granted. Generally, if an optionee's continuous status as a director, employee or consultant is terminated for various reasons, the nonvested options expire.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE N – STOCK OPTION PLAN (Continued)

A summary of stock option activity follows for the years ended December 31:

	Stock Options			
	2013		2012	
	Weighted- Average Exercise Price	Shares	Weighted- Average Exercise Price	Shares
Shares under option at beginning of year	\$ 7.42	234,268	\$ 7.37	249,080
Options exercised	6.67	(2,340)	6.67	(14,812)
Options settled in cash	6.67	(147,297)		
Options forfeited	6.67	(26,250)		
Shares under option at end of year	9.68	<u>58,381</u>	7.42	<u>234,268</u>
Options exercisable at end of year		<u>58,381</u>		<u>234,268</u>

Following is the intrinsic value and weighted-average contractual term of stock options outstanding for the years ended December 31:

	Stock Options	
	2013	2012
Intrinsic value:		
Outstanding shares	\$ 73,689	\$ 91,109
Exercisable shares	73,689	91,109
Weighted-average remaining contractual term:		
Outstanding shares	0.85 years	1.29 years
Exercisable shares	0.85 years	1.30 years

Upon the exercise of stock options, new shares are issued. The total amount of cash received from the exercise of stock options during 2013 and 2012 was \$15,608 and \$98,796, respectively. The tax benefits realized for the tax deductions from stock options exercised during 2013 and 2012 was \$1,688 and \$21,784.

In 2013, the Company approved cash payments for the repurchase of stock for stock options exercised. The total amount of cash paid for the repurchase of stock during 2013 was \$345,410. The tax benefits realized for the tax deductions from stock options exercised and shares repurchased during 2013 was \$142,151.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE N – STOCK OPTION PLAN (Continued)

A summary of restricted stock activity follows for the years ended December 31:

	Restricted Stock					
	2013			2012		
	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested at beginning of year	46,726	\$ 8.10		64,254	\$ 8.29	
Granted				1,304	6.50	
Shares vested and issued	(19,670)	8.31		(18,732)	8.87	
Forfeited				(100)	12.00	
Nonvested at end of year	<u>27,056</u>	7.94	<u>\$ 238,363</u>	<u>46,726</u>	8.10	<u>\$ 323,279</u>

As of December 31, 2013 and 2012, there was \$114,068 and \$231,408 of total unrecognized compensation cost related to nonvested restricted stock. That cost is expected to be recognized over a weighted-average period of 1.98 and 2.46 years, respectively.

Total compensation cost for all share-based payments recognized in net income for 2013 and 2012 totaled \$113,639 and \$161,801, respectively. A tax benefit of \$46,762 and \$66,581 was recognized during 2013 and 2012, respectively, related to this compensation cost.

NOTE O – RELATED PARTY TRANSACTIONS

During the normal course of business, the Company has entered into transactions with its directors, executive officers, significant shareholders and their affiliates (related parties). The aggregate amount of loans to such related parties totaled \$8,510,130 and \$5,855,915 at December 31, 2013 and 2012, respectively. At December 31, 2013 and 2012, commitments to related parties of \$2,742,291 and \$3,135,096, respectively, were undisbursed. The Company has received deposits from directors and officers and their related interests totaling \$4,761,320 and \$4,991,032 at December 31, 2013 and 2012, respectively.

The Company entered into a lease agreement with a director's business as the landlord for two office spaces. The total rent paid for 2012 was \$19,803. In 2012, the Bank sold the office space to the director's business for \$327,317. The director's business paid the Bank \$2,149 for common area maintenance in 2012 after the sale.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE P – CONTINGENT LIABILITIES AND COMMITMENTS

Financial Instruments with Off-Balance-Sheet Risk: The Company’s financial statements do not reflect various commitments and contingent liabilities which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities are commitments to extend credit and standby letters of credit. A summary of the Company’s commitments and contingent liabilities at December 31, 2013 and 2012 are as follows:

	Contractual Amounts	
	2013	2012
Commitments to extend credit	\$ 37,980,090	\$ 39,817,121
Standby letters of credit	272,599	272,599

Commitments to extend credit and standby letters of credit include exposure to some credit loss in the event of nonperformance of the customer. The Company’s credit policies and procedures for credit commitments and financial guarantees are the same as those for extension of credit that are recorded on the balance sheet. Because most of these instruments have fixed maturity dates, and because many of them expire without being drawn upon, they do not generally present any significant liquidity risk to the Company. 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. The Company evaluates each customer’s credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management’s credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, deeds of trust on residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending facilities to customers.

The Company did not incur any losses on its commitments in 2013 and 2012.

NOTE Q – CONCENTRATIONS OF CREDIT RISK

Most of the Company’s business activity is with customers located within the State of California, primarily in and around the counties of Humboldt, Del Norte, and Trinity. Most of the Company’s loans have been granted to customers in the Company’s market area. General economic conditions or natural disasters affecting the primary market area could affect the ability of customers to repay loans and the value of real property used as collateral. The loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. The Company requires that all loans have adequate collateral to secure the loan or that the borrower has evidence of sufficient cash flows to repay loans when the loans are made. All collateral must have an appraisal, if applicable, and collateral is generally secured by liens. The Company’s access to this collateral is through judicial procedures.

The concentrations of credit by type of loan are set forth in Note C. Approximately 92% of the Company’s loans are collateralized by real estate in the Company’s service area. The National Banking Laws, Title 12 of the United States Code, generally restricts loans to a single borrower or group of related borrowers and investments by the Company to 25% of the sum of the Company’s equity capital plus the allowance for loan losses, subject to certain adjustments. The Company evaluates each customer’s credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, upon extension of credit, is based on management’s credit evaluation of the customer. Collateral held varies but may include residential and commercial real property, marketable securities, accounts receivable, inventory, equipment and savings accounts.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE Q – CONCENTRATIONS OF CREDIT RISK (Continued)

The concentrations by type of investment security are set forth in Note B. The Company places its investments primarily in financial instruments backed by the U.S. Government and its agencies. At December 31, 2013, the Bank has \$26,410,000 in federal funds sold to two correspondent banks, which represents 108% of the Bank's net worth. Deposits with three correspondent banks were in excess of federally insured limits by \$2,179,001 at December 31, 2013. While management recognizes the inherent risks involved in such concentrations, this concentration provides the Bank with an effective and cost efficient means of managing its liquidity position and item processing needs. Management closely monitors the financial condition of their correspondent banks on a continuous basis. The Bank also maintains additional deposit accounts with other correspondent banks should management determine that a change in its correspondent banking relationship would be appropriate.

NOTE R – SUBSEQUENT EVENTS

On February 1, 2014, the Company entered into an agreement with Humboldt State University (University) for the transfer of a Company-owned building to the University in exchange for a reduced lease rate on a building owned by the University that the Company is leasing from the University. The initial term of the lease will be five years with an option to extend the lease for seven periods of five years. The lease will be extended automatically the first five periods unless the Bank elects to decline the lease option. The monthly rental rate will be \$5,480 per month, but the rent will be reduced by \$3,327 per month for the first twenty years of the lease as consideration for the transfer of the Bank building and the Bank paying for \$95,000 of renovation costs at the Bank-owned building. The net rent will be increased every five years by the change in the consumer price index.

NOTE S – REGULATORY MATTERS

The Bank is subject to the dividend restrictions set forth by the FDIC. Under such restrictions, the Bank may not, without the prior approval of the FDIC, declare dividends in excess of the sum of the current year's net income plus the retained earnings from the prior two years. As of December 31, 2013, \$3,557,200 was available for cash dividend distribution without prior approval.

The Company is subject to various regulatory capital requirements administered by its primary federal regulator, the FDIC. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2013, that the Company meets all capital adequacy requirements to which it is subject.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE S – REGULATORY MATTERS (Continued)

As of December 31, 2013, the most recent notification from the FDIC categorized the Company as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Company must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Company's category. The Company's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(in thousands)						
As of December 31, 2013						
Total Capital						
(to Risk Weighted Assets)	\$ 26,398	14.93%	≥ \$ 14,141	≥ 8.00%	≥ \$ 17,676	≥ 10.00%
Tier I Capital						
(to Risk Weighted Assets)	\$ 24,180	13.68%	≥ \$ 7,071	≥ 4.00%	≥ \$ 10,606	≥ 6.00%
Tier I Capital						
(to Average Assets)	\$ 24,180	9.45%	≥ \$ 10,230	≥ 4.00%	≥ \$ 12,787	≥ 5.00%
As of December 31, 2012						
Total Capital						
(to Risk Weighted Assets)	\$ 25,612	15.95%	≥ \$ 14,847	≥ 8.00%	≥ \$ 16,058	≥ 10.00%
Tier I Capital						
(to Risk Weighted Assets)	\$ 23,607	14.70%	≥ \$ 6,423	≥ 4.00%	≥ \$ 9,635	≥ 6.00%
Tier I Capital						
(to Average Assets)	\$ 23,607	9.66%	≥ \$ 9,776	≥ 4.00%	≥ \$ 12,220	≥ 5.00%

NOTE T – FAIR VALUE MEASUREMENT

The following tables present information about financial instruments, whether or not recognized or recorded at fair value in the balance sheet. In general, fair values are determined by:

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.

Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any market activity for the asset or liability.

In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE T – FAIR VALUE MEASUREMENT (Continued)

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Company's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3.

The carrying amount and estimated fair values of the Company's financial instruments are as follows:

	Carrying Amount	Fair Value			Total
		Level 1	Level 2	Level 3	
<u>December 31, 2013</u>					
Financial assets:					
Cash and due from banks	\$ 6,059,409	\$ 6,059,409			\$ 6,059,409
Federal funds sold	26,410,000	26,410,000			26,410,000
Interest-bearing deposits in other banks	12,320,287	12,320,287			12,320,287
Investment securities available-for-sale	25,031,139		\$ 25,031,139		25,031,139
Mortgages held for sale	2,211,319		2,245,865		2,245,865
Loans, net	170,209,289			\$ 174,124,207	174,124,207
Foreclosed real estate	73,320			73,320	73,320
Cash surrender value of life insurance	2,779,486	2,779,486			2,779,486
Federal Home Loan Bank and Pacific					
Coast Bankers Bank Stock	1,320,400	1,320,400			1,320,400
Accrued interest receivable	711,982	711,982			711,982
Mortgage servicing rights	604,081			604,081	604,081
Financial liabilities:					
Deposits					
Non-interest bearing	48,025,740	48,025,740			48,025,740
Interest bearing	179,421,407	131,068,080	48,196,213		179,264,293
Borrowings	2,421,875	2,421,875			2,421,875
Accrued interest payable	20,812	20,812			20,812

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE T – FAIR VALUE MEASUREMENT (Continued)

	Carrying Amount	Fair Value			Total
		Level 1	Level 2	Level 3	
<u>December 31, 2012</u>					
Financial assets:					
Cash and due from banks	\$ 9,777,807	\$ 9,777,807			\$ 9,777,807
Federal funds sold	12,390,000	12,390,000			12,390,000
Interest-bearing deposits in other banks	21,433,169	21,433,169			21,433,169
Investment securities available-for-sale	30,845,712		\$ 30,845,712		30,845,712
Mortgages held for sale	3,026,410		3,110,740		3,110,740
Loans, net	153,126,498			\$ 157,594,217	157,594,217
Foreclosed real estate	366,335			366,335	366,335
Cash surrender value of life insurance Federal Home Loan Bank and Pacific	2,694,251	2,694,251			2,694,251
Coast Bankers Bank Stock	1,206,300	1,206,300			1,206,300
Accrued interest receivable	658,475	658,475			658,475
Mortgage servicing rights	301,470			301,470	301,470
Financial liabilities:					
Deposits					
Non-interest bearing	40,889,168	40,889,168			40,889,168
Interest bearing	174,108,164	120,947,993	52,876,569		173,824,562
Borrowings	2,576,546	2,576,546			2,576,546
Accrued interest payable	44,224	44,224			44,224

The carrying amounts in the preceding table are included in the balance sheet under the applicable captions. The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and due from banks, federal funds sold and interest-bearing deposits in other financial institutions: The carrying amount approximates fair value and is classified as level 1.

Investment securities: Fair values for investment securities are based on quoted market prices, where available, and are classified as level 1. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments and indications of value provided by brokers and are classified as level 2. The carrying amount of accrued interest receivable approximates its fair value and is classified as level 1.

Mortgages held for sale: The fair value for mortgages held for sale is based on the actual selling price, if available or quoted market prices of comparable loans, which are classified as level 2.

Loans, net: For variable-rate loans that reprice frequently and fixed rate loans that mature in the near future, with no significant change in credit risk, fair values are based on carrying amounts, resulting in a level 3 classification. The fair values for other fixed rate loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality, resulting in a level 3 classification. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics and are adjusted for the allowance for loan losses. The carrying amount of accrued interest receivable approximates its fair value and is classified as level 1.

Cash surrender value of life insurance: The carrying amount approximates fair value and is classified as level 1.

FHLB and PCBB Stock: For FHLB and PCBB stock, the carrying amount is equal to the par value at which the stock may be sold back to FHLB or PCBB, which approximates fair value and is classified as level 1.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE T – FAIR VALUE MEASUREMENT (Continued)

Deposits: The fair values disclosed for demand deposits (for example, interest-bearing checking, money market and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts), resulting in a level 1 classification. The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on the certificates to a schedule of aggregated contractual maturities on such time deposits, resulting in a level 2 classification. The carrying amount of accrued interest payable approximates fair value and is classified as level 1.

Borrowings: The carrying amount approximates fair value and is classified as level 1.

The following table presents information about the Company’s assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2013 and 2012, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value.

	Fair Value	Level 1	Level 2	Level 3	Total Losses
December 31, 2013:					
Measured at fair value on a recurring basis					
Investment securities	\$ 25,031,139		\$ 25,031,139		
Mortgage servicing rights	604,081			\$ 604,081	
Total recurring	<u>\$ 25,635,220</u>	<u>\$ -</u>	<u>\$ 25,031,139</u>	<u>\$ 604,081</u>	<u>\$ -</u>
Measured at fair value on a nonrecurring basis					
Impaired loans	\$ 1,560,898			\$ 1,560,898	\$ (199,651)
Foreclosed real estate	73,320			73,320	(7,590)
Total nonrecurring	<u>\$ 1,634,218</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,634,218</u>	<u>\$ (207,241)</u>
December 31, 2012:					
Measured at fair value on a recurring basis					
Investment securities	\$ 30,845,712		\$ 30,845,712		
Mortgage servicing rights	301,470			\$ 301,470	
Total recurring	<u>\$ 31,147,182</u>	<u>\$ -</u>	<u>\$ 30,845,712</u>	<u>\$ 301,470</u>	<u>\$ -</u>
Measured at fair value on a nonrecurring basis					
Impaired loans	\$ 3,125,907			\$ 3,125,907	\$ (293,399)
Foreclosed real estate	366,335			366,335	(200,750)
Total nonrecurring	<u>\$ 3,492,242</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,492,242</u>	<u>\$ (494,149)</u>

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE T – FAIR VALUE MEASUREMENT (Continued)

The following methods were used to estimate the fair value of each class of financial instrument above:

Securities Available-for-Sale: To value securities available-for-sale, the Company obtains fair value measurements from an independent pricing service. The fair value measurement considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions among other things.

Mortgage Servicing Rights: Mortgage servicing rights do not trade in an active market with readily observable prices. Accordingly, the Company determines the fair value of mortgage servicing rights using a valuation model that calculates the present value of estimated future net servicing income. Fair value measurements of the mortgage servicing rights use significant unobservable inputs and, accordingly, are classified as Level 3. Total gains recognized in earnings during 2013 and 2012 were \$110,775 and \$63,638, respectively, which are reflected in mortgage banking revenue, on the consolidated statements of operations.

Impaired Loans: The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraisal value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3. Management typically reduces the appraisal value by 10% to determine the fair value of the collateral.

Foreclosed Real Estate: Foreclosed real estate is held for sale and is initially recorded at fair value less estimated costs of disposition at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or estimated fair value less costs of disposition. The fair value of foreclosed real estate is determined using various valuation techniques which are not readily observable in the market place, including consideration of appraised values and other pertinent real estate market data. Management typically reduces the appraisal value by 10% to determine the fair value of the property.

No amounts were transferred among level 1, level 2 or level 3 during 2013 or 2012.

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE U – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY

Condensed balance sheets as of December 31, 2013 and 2012 and the related condensed statement of operations and cash flows for the years then ended for Redwood Capital Bancorp (parent company only) are presented as follows:

Condensed Balance Sheets  
December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Assets		
Cash	\$ 290,248	\$ 127,322
Other assets	107,931	147,218
Intercompany receivable	191,363	45,356
Investment in subsidiary	<u>24,450,568</u>	<u>24,364,620</u>
	<u>\$ 25,040,110</u>	<u>\$ 24,684,516</u>
Liabilities and shareholders' equity		
Accrued interest payable and other liabilities	\$ 93,691	\$ 61,755
Borrowings	2,421,875	2,576,546
Preferred stock	7,283,990	7,283,990
Common stock	12,400,686	12,195,212
Additional paid-in capital	173,659	509,998
Retained earnings	<u>2,666,209</u>	<u>2,057,015</u>
	<u>\$ 25,040,110</u>	<u>\$ 24,684,516</u>

Condensed Statements of Operations  
For the years ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Dividends from subsidiary	\$ 1,270,000	\$ 650,000
Interest expense	(104,807)	(116,579)
Other expenses	<u>(362,816)</u>	<u>(440,743)</u>
Loss before equity in undistributed income of subsidiary and income taxes	802,377	92,678
Equity in undistributed income of subsidiary	874,544	908,933
Income tax benefit	<u>191,647</u>	<u>211,756</u>
	<u>\$ 1,868,568</u>	<u>\$ 1,213,367</u>

REDWOOD CAPITAL BANCORP AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

December 31, 2013 and 2012

NOTE U – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY (Continued)

Condensed Statements of Cash Flows  
For the years ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Cash flows from operating activities:		
Net income	\$ 1,868,568	\$ 1,213,367
Adjustments to reconcile net income to net cash used by operating activities:		
Equity in income of subsidiary	(2,144,544)	(1,558,933)
Dividends from subsidiary	1,270,000	650,000
Stock-based compensation expense	113,639	161,801
Change in other assets	156,077	(644)
Change in intercompany receivable	(146,007)	199,243
Change in interest payable and other liabilities	34,096	5,241
Net cash provided by operating activities	<u>1,151,829</u>	<u>670,075</u>
Cash flows from financing activities:		
Repurchase of restricted stock	(31,492)	(18,460)
Proceeds from exercise of stock options	15,608	98,796
Proceeds from borrowings	2,500,000	
Repayments of borrowings	(2,654,671)	(266,047)
Stock repurchases	(345,410)	
Dividends paid on common stock	(388,278)	(267,779)
Dividends paid on preferred stock	(84,660)	(201,264)
Net cash used by financing activities	<u>(988,903)</u>	<u>(654,754)</u>
Net increase in cash	162,926	15,321
Cash at beginning of year	<u>127,322</u>	<u>112,001</u>
CASH AT END OF YEAR	<u>\$ 290,248</u>	<u>\$ 127,322</u>