

SIERRA BANCORP  
Form 10-Q  
May 09, 2011

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2011

Commission file number: 000-33063

SIERRA BANCORP  
(Exact name of Registrant as specified in its charter)

California  
(State of Incorporation)

33-0937517  
(IRS Employer Identification No)

86 North Main Street, Porterville, California 93257  
(Address of principal executive offices) (Zip Code)

(559) 782-4900  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

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

Yes  No

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

Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller Reporting Company

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

Yes  No

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

Common stock, no par value, 14,003,761 shares outstanding as of May 2, 2011

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## FORM 10-Q

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## PART I - FINANCIAL INFORMATION

## Item 1

SIERRA BANCORP  
CONSOLIDATED BALANCE SHEETS  
(dollars in thousands)

|   | March 31, 2011<br>(unaudited) | December 31, 2010<br>(audited) |
|---|-------------------------------|--------------------------------|
| <b>ASSETS</b>   |                               |                                |
| Cash and due from banks   | \$46,149                      | \$ 42,110                      |
| Interest-bearing deposits in other banks  | 11,373                        | 325                            |
| Federal funds sold  | -                             | 210                            |
| Total Cash & Cash Equivalents   | 57,522                        | 42,645                         |
| Investment securities available for sale  | 375,027                       | 331,730                        |
| Loans and leases:   |                               |                                |
| Gross loans and leases  | 776,392                       | 805,540                        |
| Allowance for loan and lease losses   | (21,464 )                     | (21,138 )                      |
| Deferred loan and lease fees, net   | 188                           | 113                            |
| Net Loans and Leases  | 755,116                       | 784,515                        |
| Premises and equipment, net   | 20,608                        | 20,190                         |
| Other assets  | 104,676                       | 107,491                        |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,312,949</b>           | <b>\$ 1,286,571</b>            |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                               |                                |
| <b>LIABILITIES</b>  |                               |                                |
| Deposits:   |                               |                                |
| Non-interest bearing  | \$ 266,209                    | \$ 251,908                     |
| Interest bearing  | 825,496                       | 800,366                        |
| Total Deposits  | 1,091,705                     | 1,052,274                      |
| Federal funds purchased and repurchase agreements   | 35                            | -                              |
| Short-term borrowings   | -                             | 14,650                         |
| Long-term borrowings  | 15,000                        | 15,000                         |
| Other liabilities   | 13,758                        | 14,122                         |
| Junior subordinated debentures  | 30,928                        | 30,928                         |
| <b>TOTAL LIABILITIES</b>  | <b>1,151,426</b>              | <b>1,126,974</b>               |
| <b>SHAREHOLDERS' EQUITY</b>   |                               |                                |
| Serial Preferred stock, no par value; 10,000,000 shares authorized; none issued   | -                             | -                              |
| Common stock, no par value; 24,000,000 shares authorized; 13,985,761 and 13,976,741 shares issued and outstanding at March 31, 2011 and December 31, 2010, respectively | 63,550                        | 63,477                         |
| Additional paid in capital  | 1,718                         | 1,652                          |
| Retained earnings   | 94,261                        | 93,570                         |
| Accumulated other comprehensive income  | 1,994                         | 898                            |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>   | <b>161,523</b>                | <b>159,597</b>                 |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>   | <b>\$ 1,312,949</b>           | <b>\$ 1,286,571</b>            |

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



SIERRA BANCORP  
CONSOLIDATED STATEMENTS OF INCOME  
(dollars in thousands, except per share data, unaudited)

|   | For the Quarter<br>Ended March 31, |                |
|---|------------------------------------|----------------|
|   | 2011                               | 2010           |
| <b>Interest income:</b>                                       |                                    |                |
| Interest and fees on loans                                    | \$11,782                           | \$13,578       |
| <b>Interest on investment securities:</b>                     |                                    |                |
| Taxable   | 1,916                              | 2,108          |
| Tax-exempt  | 716                                | 644            |
| Interest on federal funds sold and interest-bearing Deposits  | 8                                  | 17             |
| <b>Total interest income</b>                                  | <b>14,422</b>                      | <b>16,347</b>  |
| <b>Interest expense:</b>                                      |                                    |                |
| Interest on deposits  | 1,091                              | 1,658          |
| Interest on short-term borrowings                             | 34                                 | 38             |
| Interest on long-term borrowings                              | 140                                | 176            |
| Interest on manditorily redeemable trust preferred securities | 181                                | 175            |
| <b>Total interest expense</b>                                 | <b>1,446</b>                       | <b>2,047</b>   |
| <b>Net Interest Income</b>                                    | <b>12,976</b>                      | <b>14,300</b>  |
| <b>Provision for loan losses</b>                              | <b>3,600</b>                       | <b>3,400</b>   |
| <b>Net Interest Income after Provision for Loan Losses</b>    | <b>9,376</b>                       | <b>10,900</b>  |
| <b>Non-interest revenue:</b>                                  |                                    |                |
| Service charges on deposit accounts                           | 2,255                              | 2,703          |
| Other   | 1,321                              | 1,158          |
| <b>Total other operating income</b>                           | <b>3,576</b>                       | <b>3,861</b>   |
| <b>Other operating expense:</b>                               |                                    |                |
| Salaries and employee benefits                                | 5,710                              | 5,779          |
| Occupancy expense   | 1,575                              | 1,740          |
| Other   | 4,417                              | 4,654          |
| <b>Total other operating expenses</b>                         | <b>11,702</b>                      | <b>12,173</b>  |
| <b>Income before income taxes</b>                             | <b>1,250</b>                       | <b>2,588</b>   |
| <b>Provision for income taxes</b>                             | <b>(279 )</b>                      | <b>249</b>     |
| <b>Net Income</b>   | <b>\$1,529</b>                     | <b>\$2,339</b> |
| <b>PER SHARE DATA</b>   |                                    |                |
| Book value  | \$11.55                            | \$11.77        |
| Cash dividends  | \$0.06                             | \$0.06         |
| Earnings per share basic                                      | \$0.11                             | \$0.20         |

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|                                     |            |            |
|-------------------------------------|------------|------------|
| Earnings per share diluted          | \$0.11     | \$0.20     |
| Average shares outstanding, basic   | 13,981,780 | 11,630,773 |
| Average shares outstanding, diluted | 14,060,661 | 11,693,589 |

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



SIERRA BANCORP  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(dollars in thousands, unaudited)

|  | Three Months Ended March 31, |           |
|--|------------------------------|-----------|
|  | 2011                         | 2010      |
| <b>Cash Flows from Operating Activities</b>  |                              |           |
| Net income   | \$1,529                      | \$2,339   |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |                              |           |
| Gain on investment of securities   | \$-                          | \$-       |
| Gain on sales of loans   | (43 )                        | (24 )     |
| Loss on disposal of fixed assets   | 53                           | 108       |
| (Gain) Loss on sale on foreclosed assets   | (18 )                        | 10        |
| Writedown on foreclosed assets   | 458                          | 267       |
| Share-based compensation expense   | 64                           | 38        |
| Provision for loan losses  | 3,600                        | 3,400     |
| Depreciation and amortization  | 644                          | 743       |
| Net amortization on securities premiums and discounts                                    | 1,259                        | 581       |
| Increase in unearned net loan fees   | (76 )                        | (68 )     |
| Increase in cash surrender value of life insurance policies                              | (419 )                       | (420 )    |
| Proceeds from sales of loans portfolio   | 1,154                        | 1,968     |
| Net decrease (increase) in loans held-for-sale   | 870                          | (140 )    |
| Decrease in interest receivable and other assets   | 716                          | 644       |
| Decrease in other liabilities  | (363 )                       | (1,460 )  |
| Net decrease in FHLB Stock   | 316                          | -         |
| Deferred Income Tax (Benefit) Provision  | (3 )                         | 7         |
| Excess tax benefit from equity based compensation  | (1 )                         | -         |
| Net cash provided by operating activities  | 9,740                        | 7,993     |
| <b>Cash flows from investing activities:</b>   |                              |           |
| Maturities of securities available for sale  | -                            | 2,147     |
| Proceeds from sales/calls of securities available for sale                               | 1,275                        | 1,375     |
| Purchases of securities available for sale   | (62,148 )                    | (36,386 ) |
| Principal paydowns on securities available for sale                                      | 18,156                       | 16,442    |
| Decrease in loans receivable, net  | 22,327                       | 5,836     |
| Purchases of premises and equipment, net   | (988 )                       | (538 )    |
| Proceeds from sales of foreclosed assets   | 2,463                        | 808       |
| Net cash used in investing activities  | (18,915 )                    | (10,316 ) |
| <b>Cash flows from financing activities:</b>   |                              |           |
| Increase (decrease) in deposits  | 39,431                       | (17,432 ) |
| Decrease in borrowed funds   | (14,650 )                    | (3,850 )  |
| Increase in Fed funds purchased  | 35                           | -         |
| Cash dividends paid  | (839 )                       | (698 )    |
| Stock options exercised  | 74                           | 81        |
| Excess tax benefit from equity based compensation  | 1                            | -         |
| Net cash provided by (used in) financing activities                                      | 24,052                       | (21,899 ) |
| Increase (Decrease) in cash and due from banks   | 14,877                       | (24,222 ) |

| Cash and Cash Equivalents |          |          |
|---------------------------|----------|----------|
| Beginning of period       | 42,645   | 66,235   |
| End of period             | \$57,522 | \$42,013 |

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

SIERRA BANCORP  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
March 31, 2011

Note 1 – The Business of Sierra Bancorp

Sierra Bancorp (the “Company”), headquartered in Porterville, California, is a California corporation registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company was incorporated in November 2000 and acquired all of the outstanding shares of Bank of the Sierra (the “Bank”) in August 2001. The Company’s principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company’s only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities. Pursuant to the Financial Accounting Standards Board’s (FASB’s) standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the “Company” include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

The Bank is a California state-chartered bank headquartered in Porterville, California, that offers a full range of retail and commercial banking services to communities in the central and southern sections of the San Joaquin Valley. Our branch footprint stretches from Fresno on the north to Bakersfield on the south, and on the southern end extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. The Bank was incorporated in September 1977 and opened for business in January 1978, and in the ensuing years has grown to be the largest independent bank headquartered in the South San Joaquin Valley. Our growth has primarily been organic, but includes the acquisition of Sierra National Bank in 2000. We currently operate 25 full service branch offices throughout our geographic footprint, as well as an internet branch which provides the ability to open deposit accounts and submit certain loan applications online. The Bank’s newest “brick and mortar” branches opened for business in Selma in February 2011 and Farmersville in March 2010. In January 2011 we closed our first branch ever, in Bakersfield on California Avenue, due to lease issues. In addition to our full-service branches, the Bank has an agricultural credit division and an SBA lending unit with staff located at our corporate headquarters, and offsite ATM’s at eight different non-branch locations. The Bank’s deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts.

Note 2 – Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by U.S. generally accepted accounting principles (GAAP) for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for such period. Such adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. In preparing the accompanying consolidated financial statements, management has taken subsequent events into consideration and recognized them where appropriate. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2010 have been reclassified to be consistent with the reporting for 2011. The interim financial information should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2010, as filed with the Securities and Exchange Commission.

Note 3 – Current Accounting Developments

On April 5, 2011, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) No. 2011-02, Receivables (Topic 310): A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring, in an effort to improve financial reporting by creating greater consistency in the way GAAP is applied for various types of debt restructurings. ASU 2011-02 is intended to assist creditors in determining whether a modification of the terms of a loan meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: 1) the restructuring constitutes a concession; and 2) the debtor is experiencing financial difficulties. The amendments to Topic 310 clarify the guidance on a creditor’s evaluation of whether it has granted a concession, and likewise clarify the guidance on a creditor’s evaluation of whether a debtor is experiencing financial difficulties. In addition, the amendments to Topic 310 preclude creditors from using the effective interest rate test in the debtor’s guidance on restructuring of payables (paragraph 470-60-55-10) when evaluating whether a restructuring constitutes a troubled debt restructuring. For public companies, such as Sierra Bancorp, the new guidance is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. We have a number of loans that are not currently classified as troubled-debt restructurings, where interest rates on the loans have been adjusted to current market levels. While we have not yet examined all of those loans in detail to determine if this new guidance will result in reclassifications, the adoption of ASU 2011-02 for the third quarter of 2011 could result in a higher level of troubled debt restructurings than currently disclosed by the Company.

In July 2010, the FASB updated disclosure requirements with respect to the credit quality of financing receivables and the allowance for credit losses. According to the guidance, there are two levels of detail at which credit information must be presented - the portfolio segment level and class level. The portfolio segment level is defined as the level where financing receivables are aggregated in developing a company’s systematic method for calculating its allowance for credit losses. The class level is the second level at which credit information will be presented, and represents the categorization of financing receivables at a slightly less aggregated level than the portfolio segment level. Companies will now be required to provide the following disclosures as a result of this update: A roll-forward of the allowance for credit losses at the portfolio segment level, with the ending balances further categorized according to impairment method along with the balance reported in the related financing receivables at period-end; additional disclosures of nonaccrual and impaired financing receivables by class as of period-end; credit quality and past due/aging information by class as of period-end; information surrounding the nature and extent of loan modifications and troubled-debt restructurings and their effect on the allowance for credit losses during the period; and details on any significant purchases or sales of financing receivables during the period. The increased period-end disclosure requirements become effective for periods ending on or after December 15, 2010, with the exception of the additional disclosures surrounding troubled-debt restructurings which were deferred in December 2010 and are required for annual and interim reporting periods ending on or after June 15, 2011. The increased disclosures for activity within a reporting period become effective for periods beginning on or after June 15, 2011, and should be applied retrospectively to January 1, 2011. The provisions of this FASB update expanded the Company’s current disclosures with respect to our allowance for loan and lease losses and the credit quality of our financing receivables.

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. This update added disclosure requirements for significant transfers into and out of Levels 1 and 2, clarified existing fair value disclosure requirements about the appropriate level of disaggregation, and clarified that a description of the valuation techniques was required for recurring and nonrecurring Level 2 and 3 fair value measurements. The Company adopted these provisions of the ASU in preparing the Consolidated Financial Statements for the period ended March 31, 2010. The adoption of these provisions only affected the disclosure requirements for fair value measurements and as a result had no impact on the Company’s

statements of income and condition. An additional requirement of this ASU is that activity within Level 3, including purchases, sales, issuances, and settlements, be presented on a gross basis rather than as a net number as currently permitted. This provision of the ASU is effective for the Company's reporting period ending March 31, 2011, i.e. for this report on 10-Q. As this provision only amends the disclosure requirements for fair value measurements, our adoption of it had no impact on the Company's statements of income and condition.

Note 4 – Supplemental Disclosure of Cash Flow Information

During the three months ended March 31, 2011 and 2010, cash paid for interest due on interest-bearing liabilities was \$1.3 million and \$2.5 million, respectively. There was no cash paid for income taxes during the three months ended March 31, 2011, and \$2.3 million in cash paid for income taxes during the three months ended March 31, 2010. Assets totaling \$1.9 million and \$2.9 million were acquired in the settlement of loans for the three months ended March 31, 2011 and March 31, 2010, respectively, while \$2.4 million in foreclosed assets were sold during the first three months of 2011 relative to \$690,000 sold during the first three months of 2010. The Company extended \$1.4 million in loans to finance the sale of other real estate during the three months ended March 31, 2011, but no such loans were made for the three months ended March 31, 2010.

Note 5 – Share Based Compensation

The 2007 Stock Incentive Plan (the “2007 Plan”) was adopted by the Company in 2007. Our 1998 Stock Option Plan (the “1998 Plan”) was concurrently terminated, although options to purchase 350,358 shares that were granted prior to the termination of the 1998 Plan were still outstanding as of March 31, 2011 and remain unaffected by the termination. The 2007 Plan provides for the issuance of both “incentive” and “nonqualified” stock options to officers and employees, and of “nonqualified” stock options to non-employee directors of the Company. The 2007 Plan also provides for the potential issuance of restricted stock awards to these same classes of eligible participants, on such terms and conditions as are established at the discretion of the Board of Directors or the Compensation Committee. The total number of shares of the Company’s authorized but unissued stock reserved and available for issuance pursuant to awards under the 2007 Plan was initially 1,500,000 shares, although options have been granted since the inception of the plan and the number remaining available for grant as of March 31, 2011 was 1,025,120. No restricted stock awards have been issued by the Company.

Pursuant to FASB’s standards on stock compensation, share-based compensation expense is reflected in our income statement for each option granted over the vesting period of such option. The Company is utilizing the Black-Scholes model to value stock options, and the “multiple option” approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach, an employee’s options for each vesting period are separately valued and amortized. This appears to be the preferred method for option grants with multiple vesting periods, which is the case for most options granted by the Company. A pre-tax charge of \$65,000 was reflected in the Company’s income statement during the first quarter of 2011 and \$38,000 was charged during the first quarter of 2010, as compensation expense related to outstanding and unvested stock options.

Note 6 – Earnings Per Share

Earnings per share, as presented in the Consolidated Statements of Income, is computed based on the weighted average number of shares outstanding during each period. There were 13,981,780 weighted average shares outstanding during the first quarter of 2011, and 11,630,773 during the first quarter of 2010. The increase is primarily due to the issuance of 2,325,000 shares pursuant to a registered direct offering in October 2010.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of outstanding “in-the-money” stock options. The dilutive effect of options outstanding was calculated using the treasury stock method, excluding anti-dilutive shares and adjusting for unamortized expense and windfall tax benefits. For the first quarter of 2011, the dilutive effect of options outstanding calculated under the treasury stock method totaled 78,881, which was added to basic weighted average shares outstanding for purposes of calculating diluted earnings per share. Likewise, for the first quarter of 2010, shares totaling 62,816 were added to basic weighted average shares outstanding in order to calculate diluted earnings per share.

Note 7 – Comprehensive Income

Comprehensive income includes net income and other comprehensive income. The Company’s only source of other comprehensive income is derived from unrealized gains and losses on available-for-sale investment securities. Reclassification adjustments, resulting from gains or losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are excluded from comprehensive income of the current period. The Company’s comprehensive income was as follows:



|   |   |          |
|---|---|----------|
| Comprehensive Income<br>(dollars in thousands, unaudited) | For the Three-Month Period<br>Ended March 31, |          |
|   | 2011  | 2010     |
| Net Income  | \$ 1,529                                      | \$ 2,339 |
| Other comprehensive income:                               |   |          |
| Unrealized holding gain                                   | 1,839   | 1,184    |
| Less: reclassification adjustment                         | -   | -        |
| Pre-tax other comprehensive income/(loss)                 | 1,839   | 1,184    |
| Less: tax impact of above                                 | 773   | 498      |
| Net other comprehensive income                            | 1,066   | 686      |
| Comprehensive income                                      | \$ 2,595                                      | \$ 3,025 |

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

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

|                              |                   |                      |
|------------------------------|-------------------|----------------------|
|                              | March 31,<br>2011 | December 31,<br>2010 |
| Commitments to extend credit | \$ 140,749        | \$ 142,309           |
| Standby letters of credit    | \$ 7,605          | \$ 7,761             |
| Commercial letters of credit | \$ 9,430          | \$ 9,435             |

Commitments to extend credit consist primarily of unfunded single-family residential construction loans and home equity lines of credit, and commercial real estate construction loans and commercial revolving lines of credit. Construction loans are established under standard underwriting guidelines and policies and are secured by deeds of trust, with disbursements made over the course of construction. Commercial revolving lines of credit have a high degree of industry diversification. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party, while commercial letters of credit represent the Company's commitment to pay a third party on behalf of a customer upon fulfillment of contractual requirements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

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

FASB's standards on fair value measurements and disclosures, and financial instruments, require all entities to disclose the estimated fair value of all financial instruments for which it is practicable to estimate fair value. In addition to those footnote disclosure requirements, FASB's standard on investments requires that our debt securities, which are



classified as available for sale, and our equity securities that have readily determinable fair values, be measured and reported at fair value in our statement of financial position. Certain impaired loans are also reported at fair value, as explained in greater detail below, and foreclosed assets are carried at the lower of cost or fair value. While the fair value option outlined under FASB's standard on financial instruments permits companies to report certain other financial assets and liabilities at fair value, we have not elected the fair value option for any additional financial assets or liabilities.

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

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a company's own assumptions about the factors that market participants would consider in pricing an asset or liability.

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any estimates. Because no market exists for a significant portion of the Company's financial instruments, fair value disclosures are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented. The following methods and assumptions were used by the Company to estimate the fair value of its financial instruments disclosed at March 31, 2011 and December 31, 2010:

- Cash and cash equivalents and short-term borrowings: For cash and cash equivalents and short-term borrowings, the carrying amount is estimated to be fair value.
- Investment securities: The fair values of investment securities are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on the securities' relationship to other benchmark quoted securities when quoted prices for the specific securities being valued are not readily available.
- Loans and leases: For variable-rate loans and leases that re-price frequently with no significant change in credit risk or interest rate spread, fair values are based on carrying values. Fair values for other loans and leases are estimated by discounting projected cash flows at interest rates being offered at each reporting date for loans and leases with similar terms to borrowers of comparable creditworthiness. Fair values of loans held for sale are estimated using quoted market prices for similar loans or the amount the purchasers have committed to purchase the loan. The carrying amount of accrued interest receivable approximates its fair value.
- Cash surrender value of life insurance policies: The fair values are based on current cash surrender values at each reporting date provided by the insurers.
- Investment in, and capital commitments to, limited partnerships: The fair values of our investments in WNC Institutional Tax Credit Fund Limited Partnerships and any other limited partnerships are estimated using quarterly indications of value provided by the general partner. The fair values of undisbursed capital commitments are assumed to be the same as their book values.
- Other investments: Included in other assets are certain long-term investments carried at cost, which approximates their estimated fair value.



- **Deposits:** The fair values for demand deposits and other non-maturity deposits are, by definition, equal to the amount payable on demand at the reporting date represented by their carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a cash flow analysis, discounted at interest rates being offered at each reporting date by the Bank for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.
- **Short-term borrowings:** The carrying amounts of federal funds purchased, overnight FHLB advances, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated by discounting projected cash flows at the Company's current incremental borrowing rates for similar types of borrowing arrangements.
- **Long-term borrowings:** The fair values of the Company's long-term borrowings are estimated using projected cash flow analyses discounted at the Company's current incremental borrowing rates for similar types of borrowing arrangements.
- **Subordinated debentures:** The fair value of subordinated debentures was determined based on the current market value for like kind instruments of a similar maturity and structure.
- **Commitments to extend credit and letters of credit:** Commitments to extend credit are primarily for adjustable rate loans. Commitments to fund fixed rate loans and letters of credit, where such exist, are also at rates which approximate market rates at each reporting date. Thus, if funded, the carrying amounts would approximate fair values for the newly created financial assets at the funding date. However, because of the high degree of uncertainty with regard to whether or not these commitments will ultimately be funded, fair values for loan commitments and letters of credit in their current undisbursed state cannot reasonably be estimated, and only notional values are disclosed in the table below.

Estimated fair values for the Company's financial instruments at March 31, 2011 and December 31, 2010 are as follows:

Fair Value of Financial Instruments  
(dollars in thousands, unaudited)

|  | March 31, 2011  |              | December 31, 2010 |              |
|--|-----------------|--------------|-------------------|--------------|
|  | Carrying Amount | Fair Value   | Carrying Amount   | Fair Value   |
| <b>Financial assets:</b>                   |                 |              |                   |              |
| Cash and due from banks                    | \$ 57,522       | \$ 57,522    | \$ 42,645         | \$ 42,645    |
| Investment securities available for sale   | \$ 375,027      | \$ 375,027   | \$ 331,730        | \$ 331,730   |
| Loans and leases, net                      | \$ 755,116      | \$ 782,173   | \$ 784,515        | \$ 816,185   |
| Cash surrender value of life ins. policies | \$ 32,010       | \$ 32,010    | \$ 31,591         | \$ 31,591    |
| Other investments                          | \$ 8,045        | \$ 8,045     | \$ 8,361          | \$ 8,361     |
| Investments in limited partnerships        | \$ 10,525       | \$ 10,525    | \$ 10,899         | \$ 10,899    |
| Accrued interest receivable                | \$ 5,425        | \$ 5,425     | \$ 5,677          | \$ 5,677     |
| <b>Financial liabilities:</b>              |                 |              |                   |              |
| Deposits                                   | \$ 1,091,705    | \$ 1,092,047 | \$ 1,052,274      | \$ 1,052,085 |
| Overnight borrowings                       | \$ 5,000        | \$ 5,000     | \$ 14,650         | \$ 14,650    |
| Term borrowings                            | \$ 10,000       | \$ 10,604    | \$ 15,000         | \$ 15,736    |
| Subordinated debentures                    | \$ 30,928       | \$ 11,685    | \$ 30,928         | \$ 11,610    |

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|  |            |                 |                 |        |
|--|------------|-----------------|-----------------|--------|
| Limited partnership capital commitment   | \$ 599     | \$ 764          | \$ 417          | \$ 417 |
| Accrued interest payable                 | \$ 523     | \$ 523          | \$ 678          | \$ 678 |
|  |            | Notional Amount | Notional Amount |        |
| Off-balance-sheet financial instruments: |            |                 |                 |        |
| Commitments to extend credit             | \$ 140,749 |                 | \$ 142,309      |        |
| Standby letters of credit                | \$ 7,605   |                 | \$ 7,761        |        |
| Commercial letters of credit             | \$ 9,430   |                 | \$ 9,435        |        |

For each category of financial assets that were actually reported at fair value at March 31, 2011, the Company used the following methods and significant assumptions:

- **Investment Securities:** The fair values of trading securities and securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities.
- **Loans held for sale:** Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are thus not relevant for reporting purposes. If available for sale loans stay on our books for an extended period of time, the fair value of those loans is determined using quoted secondary-market prices.
- **Impaired loans:** Impaired loans carried at fair value are those for which it is probable that the bank will be unable to collect all amounts due (including both interest and principal) according to the original contractual terms of the loan agreement, and for which the carrying value has been written down to the fair value of the loan. The carrying value of those loans is equivalent to the fair value of the collateral, net of expected disposition costs, for collateral-dependent loans, or the present value of anticipated future cash flows.
- **Foreclosed assets:** Repossessed real estate (OREO) and other assets are carried at the lower of cost or fair value. For those carried at fair value, fair value is appraised value less expected selling costs for OREO and some other assets such as mobile homes, and estimated sales proceeds as determined by using reasonably available sources for all other assets. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Other foreclosed assets are periodically re-evaluated by adjusting expected cash flows and timing of resolution, again using reasonably available sources. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

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

Fair Value Measurements -  
Recurring  
(dollars in thousands,  
unaudited)

|   | Fair Value Measurements at March 31, 2011, Using |                   |             |                   |
|---|--|-------------------|-------------|-------------------|
|   | Level 1  | Level 2           | Level 3     | Total             |
| <b>Investment Securities</b>                                    |  |                   |             |                   |
| U.S. Government agencies  | \$ -   | \$ 4,970          | \$ -        | \$ 4,970          |
| Obligations of states and political subdivisions                | -  | 72,917            | -           | 72,917            |
| U.S. Government agencies collateralized by mortgage obligations | -  | 295,582           | -           | 295,582           |
| Other Securities  | 1,558  | -                 | -           | 1,558             |
| Total available-for-sale securities                             | 1,558  | 373,469           | -           | 375,027           |
| Loans Held for Sale   | 44   | -                 | -           | 44                |
| <b>Total</b>  | <b>\$ 1,602</b>                                  | <b>\$ 373,469</b> | <b>\$ -</b> | <b>\$ 375,071</b> |

|   | Fair Value Measurements at December 31, 2010, Using |                   |             |                   |
|---|---|-------------------|-------------|-------------------|
|   | Level 1   | Level 2           | Level 3     | Total             |
| <b>Investment Securities</b>                                    |   |                   |             |                   |
| U.S. Government agencies  | \$ -  | \$ 5,062          | \$ -        | \$ 5,062          |
| Obligations of states and political subdivisions                | -   | 70,102            | -           | 70,102            |
| U.S. Government agencies collateralized by mortgage obligations | -   | 255,143           | -           | 255,143           |
| Other Securities  | 1,423   | -                 | -           | 1,423             |
| Total available-for-sale securities                             | 1,423   | 330,307           | -           | 331,730           |
| Loans Held for Sale   | 914   | -                 | -           | 914               |
| <b>Total</b>  | <b>\$ 2,337</b>                                     | <b>\$ 330,307</b> | <b>\$ -</b> | <b>\$ 332,644</b> |

Assets for which a nonrecurring change in fair value has been recorded are summarized below:

Fair Value Measurements -  
Nonrecurring  
(dollars in thousands,  
unaudited)

|                       | Fair Value Measurements at March 31, 2011, Using |                  |                  |                  |
|-----------------------|--|------------------|------------------|------------------|
|                       | Level 1  | Level 2          | Level 3          | Total            |
| <b>Impaired Loans</b> | <b>\$ -</b>                                      | <b>\$ 31,812</b> | <b>\$ 11,476</b> | <b>\$ 43,288</b> |
| Foreclosed Assets     | \$ -   | \$ 15,310        | \$ 3,904         | \$ 19,214        |

  

|  | Fair Value Measurements at December 31, 2010, Using |         |         |       |
|--|---|---------|---------|-------|
|  | Level 1   | Level 2 | Level 3 | Total |
|  |   |         |         |       |

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|                   |      |           |           |           |
|-------------------|------|-----------|-----------|-----------|
| Impaired Loans    | \$ - | \$ 29,482 | \$ 6,705  | \$ 36,187 |
| Foreclosed Assets | \$ - | \$ 3,123  | \$ 17,568 | \$ 20,691 |

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



PART I - FINANCIAL INFORMATION

ITEM 2

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

FORWARD-LOOKING STATEMENTS

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

A variety of factors could have a material adverse impact on the Company's financial condition or results of operations, and should be considered when evaluating the potential future financial performance of the Company. These include, but are not limited to, continued deterioration in economic conditions in the Company's service areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and net credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; the Company's ability to secure buyers for foreclosed properties; the loss in market value of available-for-sale securities that could result if interest rates change substantially or an issuer has real or perceived financial difficulties; the Company's ability to attract and retain skilled employees; the Company's ability to successfully deploy new technology; the success of branch expansion; and risks associated with the multitude of current and future laws and regulations to which the Company is and will be subject.

CRITICAL ACCOUNTING POLICIES

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

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the Company's allowance for loan and lease losses, as explained in detail in the “Provision for Loan and Lease Losses” and “Allowance for Loan and Lease Losses” sections of this discussion and analysis; the valuation of nonperforming real estate loans and foreclosed assets; income taxes, especially with regard to the ability of the Company to recover deferred tax assets, as discussed in the “Provision for Income Taxes” and “Other Assets” sections of this discussion and analysis; goodwill, which is evaluated annually for impairment based on the fair value of the Company and for which it has been determined that no impairment exists; and equity-based compensation, which is discussed in greater detail in Note 5 to the consolidated financial statements. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate the most recent expectations with regard to these areas.



OVERVIEW OF THE RESULTS OF OPERATIONS  
AND FINANCIAL CONDITION

RESULTS OF OPERATIONS SUMMARY

First Quarter 2011 compared to First Quarter 2010

Net income for the quarter ended March 31, 2011 was \$1.529 million, representing a decline of \$810,000, or 35%, relative to net income of \$2.339 million for the quarter ended March 31, 2010. The 52% drop in pretax income was proportionally greater than the decline in net income, because an income tax accrual reversal of \$279,000 helped boost net income in the first quarter of 2011. Basic and diluted earnings per share for the first quarter of 2011 were \$0.11, compared to \$0.20 basic and diluted earnings per share for the first quarter of 2010. The Company's annualized return on average equity was 3.86% and annualized return on average assets was 0.48% for the quarter ended March 31, 2011, compared to a return on equity of 6.97% and return on assets of 0.72% for the quarter ended March 31, 2010. The primary drivers behind the variance in net income are as follows:

- Net interest income was down \$1.324 million, or 9%, due to a decline in average interest-earning assets of \$38 million, or 3%, and a 29 basis point drop in our net interest margin. Negative factors impacting our net interest margin in 2011 include lower real estate loan yields resulting from increased competition for quality loans, a shift from average loan balances into lower-yielding investment balances, and a higher average balance of non-interest earning assets.
- The Company's loan loss provision increased by \$200,000, or 6%. Thus far in 2011, our loan loss provision has been utilized to provide specific reserves for impaired loans and to replenish reserves subsequent to loan charge-offs. Net loans charged off totaled \$3.3 million in the first quarter of 2011 relative to \$3.0 million in the first quarter of 2010.
- Total non-interest revenue declined by \$285,000, or 7%, due to a drop in overdraft income resulting from procedural changes implemented pursuant to regulatory guidance. The decline in overdraft income was partially offset by an increase in debit card interchange fees.
- Total operating expense fell by \$471,000, or 4%. Salaries and benefits fell slightly for the quarter despite the addition of staff for newer branches, due primarily to our efforts to improve operating efficiencies. The major variances in operating expense include the following: Occupancy expense declined by \$165,000, or 9%, due a drop in depreciation expense and lower maintenance/repair costs, as well as the January 2011 closure of a branch with a relatively costly lease; marketing costs declined \$100,000 due mainly to the timing of payments; and data processing expenses were down \$107,000, due to vendor credits for overcharges on processing software in previous years.
- As noted above, the Company experienced an income tax accrual reversal of \$279,000 in the first quarter of 2011 due to a high level of tax credits available relative to taxable income. The tax credits have a greater impact than might otherwise be expected due to the favorable effect of tax-exempt interest income and BOLI income when determining taxable income. In contrast to the negative tax provision in the first quarter of 2011, our effective tax accrual rate was 10% in the first quarter of 2010.

FINANCIAL CONDITION SUMMARY

March 31, 2011 relative to December 31, 2010

The most significant characteristics of, and changes in, the Company's balance sheet during the first three months of 2011 are outlined below:

- The Company's assets totaled \$1.313 billion at March 31, 2011, an increase of \$26 million, or 2%, relative to total assets of \$1.287 billion at December 31, 2010. Total assets increased due to growth in investment securities and an increase in cash and balances due from banks, partially offset by lower loan balances. Gross loan and lease balances declined \$29 million, or 4%, due to runoff in the normal course of business, prepayments, transfers to OREO, and charge-offs. Weak loan demand from quality borrowers and aggressive competition have hindered our ability to counteract this contraction.

- The \$73 million balance of nonperforming assets at March 31, 2011 reflects an increase of \$6 million, or 9%, since year-end 2010, but is still below its peak of \$78 million reached a year earlier. Much of the increase for the first quarter consists of a \$3.6 million participation purchased in a commercial real estate loan, which was placed on non-accrual status but for which no reserve is currently required based on the appraised value of the collateral. In addition to nonperforming assets we had \$12.6 million in performing restructured troubled debt (TDR's) at March 31, 2011, an increase of only \$86,000 relative to year-end 2010.
- Our allowance for loan and lease losses was \$21.5 million as of March 31, 2011, which represents a slight increase relative to the balance at December 31, 2010. Even though the allowance for loan and lease losses did not change significantly, our allowance as a percentage of total loans increased by 14 basis points, to 2.76% at March 31, 2011 from 2.62% at December 31, 2010, because loan balances fell during the first quarter.
- Total deposits increased by \$39 million, or 4%, with non-maturity deposits, in particular, experiencing significant growth. NOW deposits, however, dropped by \$10 million, or 5%, due to runoff in our online-only accounts subsequent to interest rate adjustments. We reduced non-deposit borrowings by \$15 million, but added \$15 million in longer-term wholesale-sourced brokered deposits for interest rate risk management purposes.
- Total capital increased by \$2 million, to \$162 million at March 31, 2011. Because capital increased and risk-adjusted assets declined, our consolidated total risk-based capital ratio increased to 21.20% at March 31, 2011 from 20.33% at year-end 2010. Further, our tier one risk-based capital ratio was 19.94% and our tier one leverage ratio was 14.11% at March 31, 2011.

## EARNINGS PERFORMANCE

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is non-interest income, which consists mainly of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expenses are operating costs that relate to providing a full range of banking services to our customers.

## NET INTEREST INCOME AND NET INTEREST MARGIN

For the first quarter of 2011 relative to the first quarter of 2010, net interest income declined by \$1.324 million, or 9%. The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volume of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest for loans placed on non-accrual, and by the recovery of interest on loans that have been on non-accrual and are either sold or returned to accrual status.

The following Average Balances and Rates table shows the average balance of each significant balance sheet category, and the amount of interest income or interest expense associated with that category, for the comparative quarters. The table also shows the calculated yields on each major component of the Company's investment and loan portfolio, the average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin.



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| Average Balances and Rates<br>(dollars in thousands, except per share data) | For the Quarter<br>Ended March 31, 2011 |                    |                       | For the Quarter<br>Ended March 31, 2010 |                    |                       |
|---|---|--------------------|-----------------------|---|--------------------|-----------------------|
|   | (1)                                     | (2)                | (3)                   | (1)                                     | (2)                | (3)                   |
|   | Average<br>Balance                      | Income/<br>Expense | Average<br>Rate/Yield | Average<br>Balance                      | Income/<br>Expense | Average<br>Rate/Yield |
| <b>Assets</b>   |   |                    |                       |   |                    |                       |
| <b>Investments:</b>   |   |                    |                       |   |                    |                       |
| Federal funds sold/Due from time  | \$ 10,326                               | \$ 8               | 0.31 %                | \$ 22,107                               | \$ 17              | 0.31 %                |
| Taxable   | 276,740                                 | 1,916              | 2.81 %                | 221,884                                 | 2,108              | 3.85 %                |
| Non-taxable   | 71,814                                  | 716                | 6.22 %                | 64,280                                  | 644                | 6.25 %                |
| Equity  | 1,549                                   | -                  | 0.00 %                | 1,519                                   | -                  | 0.00 %                |
| Total Investments   | 360,429                                 | 2,640              | 3.40 %                | 309,790                                 | 2,769              | 4.08 %                |
| <b>Loans and Leases: (4) (5)</b>  |   |                    |                       |   |                    |                       |
| Agricultural  | 12,088                                  | 152                | 5.10 %                | 9,672                                   | 120                | 5.03 %                |
| Commercial  | 102,185                                 | 1,522              | 6.04 %                | 119,125                                 | 1,754              | 5.97 %                |
| Real Estate   | 569,672                                 | 9,049              | 6.44 %                | 626,876                                 | 10,408             | 6.73 %                |
| Consumer  | 44,082                                  | 944                | 8.68 %                | 54,713                                  | 1,123              | 8.32 %                |
| Direct Financing Leases   | 7,948                                   | 115                | 5.87 %                | 12,183                                  | 173                | 5.76 %                |
| Other   | 49,730                                  | -                  | 0.00 %                | 51,661                                  | -                  | 0.00 %                |
| Total Loans and Leases  | 785,705                                 | 11,782             | 6.08 %                | 874,230                                 | 13,578             | 6.30 %                |
| Total Interest Earning Assets (5)   | 1,146,134                               | 14,422             | 5.24 %                | 1,184,020                               | 16,347             | 5.72 %                |
| Other Earning Assets  | 8,347                                   |                    |                       | 9,361                                   |                    |                       |
| Non-Earning Assets  | 138,694                                 |                    |                       | 127,584                                 |                    |                       |
| Total Assets  | \$ 1,293,175                            |                    |                       | \$ 1,320,965                            |                    |                       |
| <b>Liabilities and Shareholders' Equity</b>                                 |   |                    |                       |   |                    |                       |
| <b>Interest Bearing Deposits:</b>   |   |                    |                       |   |                    |                       |
| NOW   | \$ 177,104                              | \$ 215             | 0.49 %                | \$ 160,549                              | \$ 384             | 0.97 %                |
| Savings Accounts  | 78,182                                  | 46                 | 0.24 %                | 65,090                                  | 36                 | 0.22 %                |
| Money Market  | 156,491                                 | 190                | 0.49 %                | 175,332                                 | 252                | 0.58 %                |
| CDAR's  | 32,762                                  | 54                 | 0.67 %                | 114,247                                 | 263                | 0.93 %                |
| Certificates of Deposit < \$100,000   | 161,388                                 | 274                | 0.69 %                | 144,595                                 | 320                | 0.90 %                |
| Certificates of Deposit ≥ \$100,000   | 191,285                                 | 287                | 0.61 %                | 194,305                                 | 306                | 0.64 %                |
| Brokered Deposits   | 6,833                                   | 25                 | 1.48 %                | 21,200                                  | 97                 | 1.86 %                |
| Total Interest Bearing Deposits   | 804,045                                 | 1,091              | 0.55 %                | 875,318                                 | 1,658              | 0.77 %                |
| <b>Borrowed Funds:</b>  |   |                    |                       |   |                    |                       |
| Federal Funds Purchased   | 3                                       | -                  | 0.00 %                | 3                                       | -                  | 0.00 %                |
| Repurchase Agreements   | -                                       | -                  | 0.00 %                | -                                       | -                  | 0.00 %                |
| Short Term Borrowings   | 5,103                                   | 34                 | 2.70 %                | 9,396                                   | 38                 | 1.64 %                |
| Long Term Borrowings  | 15,000                                  | 140                | 3.79 %                | 19,222                                  | 176                | 3.71 %                |
| TRUPS   | 30,928                                  | 181                | 2.37 %                | 30,928                                  | 175                | 2.29 %                |
| Total Borrowed Funds  | 51,034                                  | 355                | 2.82 %                | 59,549                                  | 389                | 2.65 %                |
| Total Interest Bearing Liabilities  | 855,079                                 | 1,446              | 0.69 %                | 934,867                                 | 2,047              | 0.89 %                |
| Demand Deposits   | 261,801                                 |                    |                       | 237,609                                 |                    |                       |
| Other Liabilities   | 15,489                                  |                    |                       | 12,454                                  |                    |                       |
| Shareholders' Equity  | 160,806                                 |                    |                       | 136,035                                 |                    |                       |
| Total Liabilities and Shareholders' Equity                                  | \$ 1,293,175                            |                    |                       | \$ 1,320,965                            |                    |                       |

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|  |           |        |           |        |
|--|-----------|--------|-----------|--------|
| Interest Income/Interest Earning Assets  |           | 5.24 % |           | 5.72 % |
| Interest Expense/Interest Earning Assets |           | 0.51 % |           | 0.70 % |
| Net Interest Income and Margin (6)       | \$ 12,976 | 4.73 % | \$ 14,300 | 5.02 % |

- 
- (1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.
- (2) Yields and net interest margin have been computed on a tax equivalent basis using an effective tax rate of 35%.
- (3) Annualized
- (4) Net loan costs have been included in the calculation of interest income. Net loan costs were approximately \$193 thousand and \$39 thousand for the quarters ended March 31, 2011 and 2010. Loans are gross of the allowance for possible loan losses.
- (5) Non-accrual loans have been included in total loans for purposes of total earning assets.
- (6) Represents net interest income as a percentage of average interest-earning assets.



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

| Volume & Rate Variances<br>(dollars in thousands) | Quarter Ended March 31,<br>2011 over 2010 |                  |                    |
|---|---|------------------|--------------------|
|   | Increase (decrease) due to                |                  |                    |
|   | Volume                                    | Rate             | Net                |
| <b>Assets:</b>                                    |   |                  |                    |
| <b>Investments:</b>                               |   |                  |                    |
| Federal funds sold / Due from time                | \$ (9 )                                   | \$ -             | \$ (9 )            |
| Taxable   | 521                                       | (713 )           | (192 )             |
| Non-taxable (1)                                   | 75  | (3 )             | 72                 |
| Equity  | 0   | 0                | 0                  |
| <b>Total Investments</b>                          | <b>587</b>                                | <b>(716 )</b>    | <b>(129 )</b>      |
| <b>Loans and Leases:</b>                          |   |                  |                    |
| Agricultural                                      | 30  | 2                | 32                 |
| Commercial  | (249 )                                    | 17               | (232 )             |
| Real Estate                                       | (950 )                                    | (409 )           | (1,359 )           |
| Consumer  | (218 )                                    | 39               | (179 )             |
| Direct Financing Leases                           | (60 )                                     | 2                | (58 )              |
| Other   | 0   | 0                | 0                  |
| <b>Total Loans and Leases</b>                     | <b>(1,447 )</b>                           | <b>(349 )</b>    | <b>(1,796 )</b>    |
| <b>Total Interest Earning Assets</b>              | <b>(860 )</b>                             | <b>(1,065 )</b>  | <b>(1,925 )</b>    |
| <b>Liabilities</b>                                |   |                  |                    |
| <b>Interest Bearing Deposits:</b>                 |   |                  |                    |
| NOW   | 40  | (209 )           | (169 )             |
| Savings Accounts                                  | 7   | 3                | 10                 |
| Money Market                                      | (27 )                                     | (35 )            | (62 )              |
| CDAR's  | (188 )                                    | (21 )            | (209 )             |
| Certificates of Deposit < \$100,000               | 37  | (83 )            | (46 )              |
| Certificates of Deposit ≥ \$100,000               | (5 )                                      | (14 )            | (19 )              |
| Brokered Deposits                                 | (66 )                                     | (6 )             | (72 )              |
| <b>Total Interest Bearing Deposits</b>            | <b>(202 )</b>                             | <b>(365 )</b>    | <b>(567 )</b>      |
| <b>Borrowed Funds:</b>                            |   |                  |                    |
| Federal Funds Purchased                           | 0   | 0                | 0                  |
| Repurchase Agreements                             | 0   | 0                | 0                  |
| Short Term Borrowings                             | (17 )                                     | 13               | (4 )               |
| Long Term Borrowings                              | (39 )                                     | 3                | (36 )              |
| TRUPS   | 0   | 6                | 6                  |
| <b>Total Borrowed Funds</b>                       | <b>(56 )</b>                              | <b>22</b>        | <b>(34 )</b>       |
| <b>Total Interest Bearing Liabilities</b>         | <b>(258 )</b>                             | <b>(343 )</b>    | <b>(601 )</b>      |
| <b>Net Interest Margin/Income</b>                 | <b>\$ (602 )</b>                          | <b>\$ (722 )</b> | <b>\$ (1,324 )</b> |

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

As shown above, the volume variance for the first quarter of 2011 relative to the first quarter of 2010 was negative \$602,000, due primarily to the fact that average interest-earning assets were \$38 million lower in the first quarter of 2011. The negative volume variance was exacerbated by balance movement within assets, where we experienced an \$89 million drop in average loans due to declining balances of relatively high-yielding real estate, commercial and consumer loans, and a \$51 million increase in the average balance of investments, which have significantly lower yields. Furthermore, the average balance of non-earning assets was \$11 million higher, due mainly to an increase in the average balance of cash and due from banks and a higher deferred tax asset balance. The unfavorable shift in average asset balances was partially offset by favorable changes on the liability side, where we experienced movement out of CDARS, brokered deposits, and wholesale borrowings into lower-cost core deposits. An increase in average equity, resulting from our registered direct offering in October 2010 and the addition of net income, also helped reduced our reliance on interest-bearing liabilities and thus helped limit the magnitude of the negative volume variance.

The rate variance was also negative for the quarter, contributing \$722,000 to the drop in net interest income. There hasn't been a significant change in market interest rates during the past year, but our weighted average yield on interest-earning assets was 48 basis points lower due to the addition of investment securities in a relatively low-rate environment, and lower real estate loan yields, which declined 29 basis points due to increased competition for quality loans. The negative rate variance is exacerbated by our sizeable net interest position, which is the difference between interest-earning assets and interest-bearing liabilities. Our average net interest position for the first quarter of 2010, which is the base period for the rate variance calculation, was \$249 million, meaning that the yield decrease for interest-earning assets was applied to a much higher balance than the rate decrease for interest-bearing liabilities and had a greater impact on net interest income. Factors partially offsetting the negative pressures on our rate variance include a drop in our weighted average cost of interest-bearing liabilities, which was 20 basis points lower due primarily to an improving deposit mix and the easing of competitive pressures on time deposit rates. Net interest reversals totaled only \$27,000 in the first quarter of 2011 relative to \$285,000 in the first quarter of 2010, which also helped partially offset the negative factors.

The Company's net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, is affected by the same factors discussed above relative to rate and volume variances. Our net interest margin was 4.73% in the first quarter of 2011, a decline of 29 basis points relative to the first quarter of 2010. Negative factors impacting our net interest margin in 2011 include lower real estate loan yields, a shift from average loan balances into lower-yielding investment balances, and higher average balances for non-interest earning assets. Having a favorable impact on our net interest margin were a lower level of net interest reversals, a shift in average balances from higher-cost liabilities into lower-cost core deposits, and a reduced reliance on interest-bearing liabilities. We expect that our net interest margin could continue to experience slight contraction due to heightened competitive pressures on loan yields, and that effect will be intensified if we are unable to reverse the unfavorable trend in loan balances.

#### PROVISION FOR LOAN AND LEASE LOSSES

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses through periodic charges to earnings, which are reflected in the income statement as the provision for loan losses. Those charges are in amounts sufficient to achieve an allowance for loan and lease losses that, in management's judgment, is adequate to absorb probable loan losses related to specifically-identified impaired loans, as well as probable incurred loan losses in the remaining loan portfolio.

The Company's provision for loan losses increased by \$200,000, or 6%, in the first quarter of 2011 relative to the first quarter of 2010. The loan loss provision typically includes reserve replenishment subsequent to loan charge-offs, as well as the enhancement of general reserves for performing loans and specific reserves for impaired loans as needed pursuant to a detailed analysis of the adequacy our allowance for loan and lease losses. Thus far in 2011, our loan loss provision has been utilized primarily to provide specific reserves for impaired loans and to replenish reserves subsequent to loan charge-offs. Much of the increase in specific reserves was centered in a few large loans, where updated appraisals indicated deterioration in underlying collateral values. Balances transferred to non-accrual status totaled \$15 million for the first quarter of 2011, and net loans charged off during the same period totaled \$3.3 million relative to \$3.0 million in the first quarter of 2010. The Company's policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed below in "Allowance for Loan and Lease Losses."

#### NON-INTEREST REVENUE AND OPERATING EXPENSE

The following table provides details on the Company's non-interest income and operating expense for the first quarter of 2011 relative to the first quarter of 2010:



## Non Interest

## Income/Expense

(dollars in thousands,  
unaudited)

|   | For the Quarter<br>Ended March 31, |               |          |                  |               |          |
|---|------------------------------------|---------------|----------|------------------|---------------|----------|
|   | 2011                               | % of<br>Total |          | 2010             | % of<br>Total |          |
| <b>OTHER OPERATING INCOME:</b>                |                                    |               |          |                  |               |          |
| Service charges on deposit accounts           | \$ 2,255                           | 63.06         | %        | \$ 2,703         | 70.01         | %        |
| Other service charges, commissions & fees     | 906                                | 25.33         | %        | 830              | 21.50         | %        |
| Gains on sales of loans                       | 43                                 | 1.20          | %        | 24               | 0.62          | %        |
| Gains on securities                           | -                                  | 0.00          | %        | -                | 0.00          | %        |
| Loan servicing income                         | 6                                  | 0.17          | %        | 9                | 0.23          | %        |
| Bank owned life insurance                     | 374                                | 10.46         | %        | 370              | 9.58          | %        |
| Other   | (8 )                               | -0.22         | %        | (75 )            | -1.94         | %        |
| <b>Total non-interest income</b>              | <b>3,576</b>                       | <b>100.00</b> | <b>%</b> | <b>3,861</b>     | <b>100.00</b> | <b>%</b> |
| As a % of average interest-earning assets (1) |                                    | 1.27          | %        |                  | 1.32          | %        |
| <b>OTHER OPERATING EXPENSES:</b>              |                                    |               |          |                  |               |          |
| Salaries and Employee Benefits                | 5,710                              | 48.80         | %        | 5,779            | 47.47         | %        |
| Occupancy costs                               |                                    |               |          |                  |               |          |
| Furniture & equipment                         | 521                                | 4.45          | %        | 668              | 5.49          | %        |
| Premises                                      | 1,054                              | 9.01          | %        | 1,072            | 8.80          | %        |
| Advertising and marketing costs               | 422                                | 3.61          | %        | 522              | 4.29          | %        |
| Data processing costs                         | 273                                | 2.33          | %        | 380              | 3.12          | %        |
| Deposit services costs                        | 637                                | 5.44          | %        | 684              | 5.62          | %        |
| Loan services costs                           |                                    |               |          |                  |               |          |
| Loan processing                               | 226                                | 1.93          | %        | 140              | 1.15          | %        |
| Foreclosed assets                             | 624                                | 5.33          | %        | 639              | 5.25          | %        |
| Credit card                                   | -                                  | 0.00          | %        | -                | 0.00          | %        |
| Other operating costs                         |                                    |               |          |                  |               |          |
| Telephone & data communications               | 295                                | 2.52          | %        | 282              | 2.32          | %        |
| Postage & mail                                | 141                                | 1.21          | %        | 142              | 1.17          | %        |
| Other   | 230                                | 1.97          | %        | 241              | 1.98          | %        |
| Professional services costs                   |                                    |               |          |                  |               |          |
| Legal & accounting                            | 382                                | 3.26          | %        | 336              | 2.76          | %        |
| Other professional service                    | 933                                | 7.97          | %        | 969              | 7.96          | %        |
| Stationery & supply costs                     | 172                                | 1.47          | %        | 212              | 1.74          | %        |
| Sundry & tellers                              | 82                                 | 0.70          | %        | 107              | 0.88          | %        |
| <b>Total non-interest Expense</b>             | <b>\$ 11,702</b>                   | <b>100.00</b> | <b>%</b> | <b>\$ 12,173</b> | <b>100.00</b> | <b>%</b> |
|   |                                    | 4.14          | %        |                  | 4.17          | %        |

As a % of average  
interest-earning assets (1)

|                      |       |   |       |   |
|----------------------|-------|---|-------|---|
| Efficiency Ratio (2) | 68.13 | % | 64.66 | % |
|----------------------|-------|---|-------|---|

(1) Annualized

(2) Tax Equivalent

The Company's results reflect total non-interest income of \$3.576 million in the first quarter of 2011, a decline of \$285,000, or 7%, relative to the first quarter of 2010. The decline is centered in service charges on deposits, but the drop in service charges was partially offset by higher debit card interchange fees and a lower level of losses realized on the termination of operating leases. Total other operating income was an annualized 1.27% of average interest-earning assets in the first quarter of 2011, relative to 1.32% in the first quarter of 2010.

Service charge income on deposits declined by \$448,000, or 17%, in the first quarter of 2011 relative to the first quarter of 2010, and fell to 0.51% of average transaction account balances in the first quarter of 2011 from 0.68% in the first quarter of 2010. This decline is due to a \$495,000 drop in overdraft and returned item charges, which is primarily the result of procedural changes implemented pursuant to new consumer legislation and updated regulatory guidelines on overdrafts. Other service charges, commissions, and fees increased by \$76,000, or 9%, for the quarter, due mainly to an increase of \$114,000 in debit card point-of-sale interchange fees that was partially offset by declining income on operating leases. Debit card interchange fees are higher due to an increase in the number of active cards outstanding and increased per-card usage. Loan sale and servicing income remained at minimal levels in 2011 and 2010.

Bank-owned life insurance income increased very slightly, by \$4,000, or 1%, in the first quarter of 2011 relative to the first quarter of 2010. The Company owns and derives income from two basic types of BOLI: “general account,” and “separate account.” At March 31, 2011, the Company had \$29.2 million invested in single-premium general account BOLI. Income from our general account BOLI is used to fund expenses associated with executive salary continuation plans and director retirement plans, and is typically fairly consistent with interest credit rates that do not change frequently. In addition to general account BOLI, the Company had \$2.9 million invested in separate account BOLI at March 31, 2011, the earnings on which help offset deferred compensation accruals for certain directors and senior officers. These deferred compensation BOLI accounts have returns pegged to participant-directed investment allocations which can include equity, bond, or real estate indices, and are thus subject to gains or losses. While this often results in significant fluctuations in income from quarter to quarter, net gains on separate account BOLI totaled \$124,000 in the first quarter of 2011 relative to net gains of \$112,000 in the first quarter of 2010, an immaterial difference. Gains and losses on separate account BOLI are related to participant gains and losses on deferred compensation balances. Participant gains are accounted for as expense accruals which, combined with their associated tax effect, effectively offset income on separate account BOLI, while participant losses result in expense accrual reversals that also effectively offset losses on separate account BOLI.

The “Other” category under non-interest income includes gains and losses on the disposition of real properties and other assets, and rental income generated by the Company’s alliance with Investment Centers of America (ICA). Other non-interest income was up by \$67,000 in the first quarter of 2011 in comparison to the first quarter of 2010, due in large part to a \$52,000 decline in losses incurred upon the disposition of equipment that was acquired subsequent to the termination of operating leases. Also helping out for the first quarter of 2011 was the realization of \$18,000 in net gains from the sale of OREO, relative to net losses of \$10,000 in the first quarter of 2010.

Total operating expense (non-interest expense) was \$11.702 million for the quarter ended March 31, 2011, a decline of \$471,000, or 4%, relative to total operating expense for the same period in 2010. The decline is primarily due to lower occupancy costs, advertising and marketing costs, and data processing costs. Non-interest expense fell slightly to an annualized 4.14% of average interest-earning assets for the first quarter of 2011 from 4.17% in the first quarter of 2010.

The largest component of non-interest expense, salaries and employee benefits, dropped by \$69,000, or 1%, for the comparative quarters. This decline came in spite of additional staffing costs for our newer branches opened in February 2011 and March 2010, as we have been striving to improve operating efficiencies. Partially offsetting the reduction was a \$66,000 decline in salaries relating to successful loan originations in the first quarter of 2011 compared to the first quarter of 2010, due to lower loan origination activity. Since this portion of salaries is deferred and amortized against interest income it has the effect of reducing current-period expense, hence a lower deferral equates to higher salaries expense. Despite their dollar decline, salaries and benefits increased to 48.80% of total non-interest expense for the first quarter of 2011 from 47.47% in the first quarter of 2010, due simply to the fact that certain other expense categories declined by even greater amounts.

Occupancy expense dropped by \$165,000, or 9%, for the quarter, due mainly to a drop in depreciation expense and lower maintenance/repair costs, although the January 2011 closure of a branch with a relatively costly lease also contributed to the decline. Marketing costs also declined by \$100,000, or 19%, although the drop was due to the timing of payments and does not represent a permanent decline. Data processing costs were down as well, decreasing by \$107,000, or 28%, for the quarter, due to vendor credits for overcharges on processing software in previous years. Deposit services costs declined by \$47,000, or 7%, due primarily to lower costs associated with our online checking product. Loan processing costs rose by \$86,000, or 61%, for the quarter, due primarily to increases in costs related to appraisals and collections. Foreclosed asset costs declined by only \$15,000, or 2%, but there were significant changes in the two largest components within this category: OREO write-downs totaled \$458,000 in the first quarter of 2011 relative to \$267,000 in the first quarter of 2010, and foreclosed asset operating expenses totaled

\$166,000 in the first quarter of 2011 as compared to \$371,000 in the first quarter of 2010. Changes in other operating expenses were primarily caused by fluctuations in the timing of payments.

Because income fell by a relatively greater amount than non-interest expense, the Company's tax-equivalent overhead efficiency ratio increased to 68.13% in the first quarter of 2011 from 64.66% in the first quarter of 2010. The overhead efficiency ratio represents total operating expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses, investment gains/losses, and other extraordinary gains/losses excluded from the equation.



## PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. The amount of the tax provision is determined by applying the Company's statutory income tax rates to pre-tax book income, adjusted for permanent differences between pre-tax book income and actual taxable income. Such permanent differences include but are not limited to tax-exempt interest income, increases in the cash surrender value of BOLI, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits. The Company's tax credits consist primarily of those generated by our \$9.9 million investment in low-income housing tax credit funds, and California state employment tax credits. The Company had a negative income tax provision of \$279,000 in the first quarter of 2011, which helped boost income, relative to a tax accrual of \$249,000 in the first quarter of 2010. The tax accrual reversal for the first quarter of 2011 is the result of a relatively high level of tax credits, which had a greater impact than might be expected due to the favorable effect of tax-exempt interest income and BOLI income on pre-tax income. Our tax credits stem from investments in low-income housing tax credit funds, as well as hiring tax credits. Our tax accrual rate is currently very sensitive to changes in pretax income, because of our level of permanent differences relative to pretax income.

## BALANCE SHEET ANALYSIS

### EARNING ASSETS

#### INVESTMENTS

The major components of the Company's earning asset base are its investments and loans, and the detailed composition and growth characteristics of both are significant determinants of the financial condition of the Company. The Company's investments are analyzed in this section, while the loan and lease portfolio is discussed in a later section of this Form 10-Q.

The Company's investments consist of debt and marketable equity securities (together, the "investment portfolio"), investments in the time deposits of other banks, and overnight fed funds sold. Fed funds sold represent the investment of temporary excess liquidity with one or more correspondent banks. The Company's investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are an alternative interest-earning use of funds when loan demand is light; and 5) they can provide partially tax exempt income. Aggregate investments were 29% of total assets at March 31, 2011, and 26% at December 31, 2010.

We had no fed funds outstanding at March 31, 2011, relative to \$210,000 at December 31, 2010. As noted above, however, our balance of interest-bearing balances at other banks was over \$11 million at March 31, 2011, up from only \$325,000 at the end of 2010, because excess balance sheet liquidity was placed in our Federal Reserve Bank account at higher yields than could be realized by selling fed funds. Surplus liquidity, which was generated during the quarter from growth in deposits and loan runoff, was also deployed into longer-term, higher-yielding agency-issued mortgage-backed securities and municipal bonds, hence the book balance of the Company's investment portfolio increased by \$43 million, or 13%, during the first three months of 2011. The book balance of our investment securities was \$375 million at March 31, 2011. Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management. Pursuant to FASB's guidance on accounting for debt and equity securities, available for sale securities are carried on the Company's

financial statements at their estimated fair market value, with monthly tax-effected “mark-to-market” adjustments made vis-à-vis accumulated other comprehensive income in shareholders’ equity. The following table sets forth the Company’s investment portfolio by investment type as of the dates noted:

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Investment Portfolio  
(dollars in thousands,  
unaudited)

|  | March 31,<br>2011 |                      | December 31,<br>2010 |                      |
|--|-------------------|----------------------|----------------------|----------------------|
|  | Amortized<br>Cost | Fair Market<br>Value | Amortized<br>Cost    | Fair Market<br>Value |
| <b>Available for Sale</b>              |                   |                      |                      |                      |
| US Treasury securities                 | \$ -              | \$ -                 | \$ -                 | \$ -                 |
| US Gov't agencies                      | 4,914             | 4,970                | 4,954                | 5,062                |
| Mortgage-backed<br>securities          | 292,008           | 295,582              | 252,320              | 255,143              |
| State & political<br>subdivisions      | 72,012            | 72,917               | 70,201               | 70,102               |
| Other equity securities                | 2,705             | 1,558                | 2,705                | 1,423                |
| <b>Total Investment<br/>Securities</b> | <b>\$ 371,639</b> | <b>\$ 375,027</b>    | <b>\$ 330,180</b>    | <b>\$ 331,730</b>    |

Mortgage-backed securities increased by \$40 million, or 16%, net of prepayments, during the first three months of 2011. The balance of municipal bonds increased by \$3 million, or 4%, as the Company has also taken advantage of relative value in that sector. It should be noted that all newly purchased municipal bonds have strong underlying ratings. No equity securities were bought or sold during the first three months of 2011, although the market value of those securities increased slightly. Investment portfolio securities that were pledged as collateral for FHLB borrowings, repurchase agreements, public deposits and for other purposes as required or permitted by law totaled \$135 million at March 31, 2011 and \$146 million at December 31, 2010, leaving \$240 million in unpledged debt securities at March 31, 2011 and \$186 million at December 31, 2010. Securities pledged in excess of actual pledging needs, and thus available for liquidity purposes if necessary, totaled \$84 million at March 31, 2011 and \$103 million at December 31, 2010.

At March 31, 2011 and December 31, 2010, the Company had 121 securities and 141 securities, respectively, with unrealized losses. Management has evaluated these securities as of the respective dates, and does not believe that any of the associated unrealized losses are other than temporary. Information pertaining to these investment securities, aggregated by investment category and length of time that individual securities have been in a continuous loss position, is disclosed in the table below.

Investment Portfolio - Unrealized Losses  
(dollars in thousands, unaudited)

|   | March 31, 2011                    |                               |                                 |                               |
|---|-----------------------------------|-------------------------------|---------------------------------|-------------------------------|
|   | Less than 12 Months<br>Fair Value | Gross<br>Unrealized<br>Losses | Over 12 Months<br>Fair<br>Value | Gross<br>Unrealized<br>Losses |
| US Treasuries                                       | \$ -                              | \$ -                          | \$ -                            | \$ -                          |
| US Government Agencies                              | -                                 | -                             | -                               | -                             |
| Obligations of States and Political<br>Subdivisions | 17,729                            | (430 )                        | 2,521                           | (250 )                        |
| Agency-Issued Mortgage-Backed<br>Securities (MBS)   | 113,022                           | (819 )                        | -                               | -                             |
| Private-Label MBS                                   | -                                 | -                             | 328                             | (1 )                          |
| Other Securities                                    | -                                 | -                             | 1,558                           | (1,148 )                      |
| <b>TOTAL</b>  | <b>\$ 130,751</b>                 | <b>\$ (1,249 )</b>            | <b>\$ 4,407</b>                 | <b>\$ (1,399 )</b>            |

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|   | December 31, 2010   |                               |                 |                               |
|---|---------------------|-------------------------------|-----------------|-------------------------------|
|   | Less than 12 Months |                               | Over 12 Months  |                               |
|   | Fair Value          | Gross<br>Unrealized<br>Losses | Fair<br>Value   | Gross<br>Unrealized<br>Losses |
| US Treasuries                                       | \$ -                | \$ -                          | \$ -            | \$ -                          |
| US Government Agencies                              | -                   | -                             | -               | -                             |
| Obligations of States and Political<br>Subdivisions | 24,728              | (884 )                        | 2,478           | (283 )                        |
| Agency-Issued Mortgage-Backed<br>Securities (MBS)   | 108,203             | (1,009 )                      | -               | -                             |
| Private-Label MBS                                   | -                   | -                             | 558             | (21 )                         |
| Other Securities                                    | -                   | -                             | 1,408           | (1,292 )                      |
| <b>TOTAL</b>  | <b>\$ 132,931</b>   | <b>\$ (1,893 )</b>            | <b>\$ 4,444</b> | <b>\$ (1,596 )</b>            |

## LOAN PORTFOLIO

The Company's loans and leases, gross of the associated allowance for losses and deferred fees and origination costs, totaled \$776 million at the end of March 2011, a drop of \$29 million, or 4%, since December 31, 2010. Loan balances have been declining because of runoff in the normal course of business (including prepayments), transfers to OREO, and charge-offs. Furthermore, loan origination activity in our branches has been light due to weak demand from creditworthy borrowers, tightened credit criteria for real estate loans, heightened competition, and increased attention devoted to monitoring and managing current loan relationships. Management has made selective personnel changes and realigned branch objectives in order to place additional emphasis on high-quality loan growth, with a particular focus on commercial loans and agricultural loans, and we have seen a recent increase in the volume of potential loan deals reviewed. However, no assurance can be provided that loan balances will not continue to decline, especially in the near term. A comparative schedule of the distribution of the Company's loans at March 31, 2011 and December 31, 2010, by outstanding balance as well as by percentage of total loans, is presented in the following Loan and Lease Distribution table. The balances shown for each loan type are before deferred or unamortized loan origination, extension, or commitment fees, and deferred origination costs for loans in that category.

## Loan and Lease Distribution

(dollars in thousands, unaudited)

|                                     | March 31<br>2011 | December 31<br>2010 |
|-------------------------------------|------------------|---------------------|
| <b>Real Estate:</b>                 |                  |                     |
| 1-4 family residential construction | 13,803           | 13,866              |
| Other Construction/Land             | 45,872           | 52,047              |
| 1-4 family - closed-end             | 103,098          | 105,459             |
| Equity Lines                        | 68,820           | 70,783              |
| Multi-family residential            | 10,768           | 10,962              |
| Commercial RE- owner occupied       | 192,007          | 187,970             |
| Commercial RE- non-owner occupied   | 119,070          | 120,500             |
| Farmland                            | 47,959           | 61,293              |
| Total Real Estate                   | 601,397          | 622,880             |
| Agricultural products               | 14,518           | 13,457              |
| Commercial and Industrial           | 89,074           | 94,768              |
| Small Business Administration Loans | 20,061           | 18,616              |
| Direct finance leases               | 8,790            | 10,234              |
| Consumer loans                      | 42,552           | 45,585              |
| Total Loans and Leases              | \$ 776,392       | \$ 805,540          |

## Percentage of Total Loans and Leases

Real Estate:

|                                     |       |   |       |   |
|-------------------------------------|-------|---|-------|---|
| 1-4 family residential construction | 1.78  | % | 1.72  | % |
| Other Construction/land             | 5.91  | % | 6.46  | % |
| 1-4 family - closed-end             | 13.28 | % | 13.09 | % |
| Equity Lines                        | 8.87  | % | 8.79  | % |
| Multi-family residential            | 1.39  | % | 1.36  | % |
| Commercial RE- owner occupied       | 24.73 | % | 23.33 | % |
| Commercial RE- non-owner occupied   | 15.34 | % | 14.96 | % |
| Farmland                            | 6.18  | % | 7.61  | % |
| Total Real Estate                   | 77.47 | % | 77.32 | % |
| Agricultural products               | 1.87  | % | 1.67  | % |
| Commercial and Industrial           | 11.47 | % | 11.77 | % |

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|                                     |        |   |        |   |
|-------------------------------------|--------|---|--------|---|
| Small Business Administration Loans | 2.58   | % | 2.31   | % |
| Direct finance leases               | 1.13   | % | 1.27   | % |
| Consumer loans                      | 5.48   | % | 5.66   | % |
| Total Loans and Leases              | 100.00 | % | 100.00 | % |

Agricultural production loans show a slight increase relative to their year-end 2010 balance, due to seasonal disbursements. SBA loan balances also increased slightly, but balances declined in the total real estate, commercial, direct finance lease, and consumer loan categories. The largest decline in the real estate category came in loans secured by farmland, which declined by \$13 million due primarily to the payoff of \$9 million in loans from a single borrower when the underlying collateral was sold. Charge-offs represent about \$2 million of the total \$21 million decline in real estate loan balances, and we had close to \$3 million in balances transferred to OREO. Charge-offs were close to \$1 million each for commercial loans and consumer loans, which declined by \$6 million and \$3 million, respectively.

Although not reflected in the loan totals above, the Company occasionally originates and sells, or participates out portions of, certain commercial real estate loans, agricultural or residential mortgage loans, and other loans to non-affiliated investors, and we currently provide servicing for some of those loans including a small number of SBA loans. The balance of loans serviced for others declined to \$470,000 at March 31, 2011 from \$5.0 million at December 31, 2010.

#### CREDIT QUALITY AND NONPERFORMING ASSETS

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

- Pass – Loans listed as pass include larger non-homogeneous loans not meeting the risk rating definitions below and smaller, homogeneous loans that are not assessed on an individual basis.
- Special Mention – Loans classified as special mention have potential issues that deserve the close attention of management. If left uncorrected, these potential weaknesses could eventually diminish the prospects for full repayment of principal and interest according to the contractual terms of the loan agreement, or could result in deterioration of the Company’s credit position at some future date.
- Substandard – Loans classified as substandard are loans with at least one clear and well-defined weakness such as a highly leveraged position, unfavorable financial operating results and/or trends, uncertain repayment sources or poor financial condition, which could jeopardize ultimate recoverability of the debt.
- Impaired – A loan is considered impaired, when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include all nonperforming loans, loans classified as restructured troubled debt, and certain other loans that are still being maintained on accrual status. If the Bank grants a concession to a borrower in financial difficulty, the loan falls into the category of a troubled debt restructuring (TDR). TDR’s may be classified as either nonperforming or performing loans depending on their accrual status.

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

Credit Quality Classifications

(dollars in thousands, unaudited)

|                                       | March 31, 2011 |                    |             |          |           |
|---------------------------------------|----------------|--------------------|-------------|----------|-----------|
|                                       | Pass           | Special<br>Mention | Substandard | Impaired | Total     |
| <b>Real Estate:</b>                   |                |                    |             |          |           |
| 1-4 - family residential construction | \$4,404        | \$5,470            | \$ -        | \$3,929  | \$13,803  |
| Other construction/Land               | 19,746         | 16,980             | 1,297       | 7,849    | 45,872    |
| 1-4 Family - closed end               | 81,994         | 7,180              | 2,169       | 11,755   | 103,098   |
| Equity Lines                          | 64,332         | 1,453              | 1,303       | 1,732    | 68,820    |
| Multi-family residential              | 4,736          | 3,076              | -           | 2,956    | 10,768    |
| Commercial RE - owner-occupied        | 152,771        | 17,528             | 12,956      | 8,752    | 192,007   |
| Commercial RE - non-owner occupied    | 73,400         | 10,384             | 3,680       | 31,606   | 119,070   |
| Farmland                              | 32,607         | 9,782              | 5,051       | 519      | 47,959    |
| Total Real Estate                     | 433,990        | 71,853             | 26,456      | 69,098   | 601,397   |
| Agricultural                          | 12,623         | 1,626              | 269         | -        | 14,518    |
| Commercial and Industrial             | 72,647         | 7,288              | 6,347       | 2,792    | 89,074    |
| Small Business Administration         | 14,853         | 1,210              | 585         | 3,413    | 20,061    |
| Direct finance leases                 | 8,023          | 270                | 12          | 485      | 8,790     |
| Consumer loans                        | 39,477         | 647                | 694         | 1,734    | 42,552    |
| Total Gross Loans and Leases          | \$581,613      | \$82,894           | \$34,363    | \$77,522 | \$776,392 |

|                                       | December 31, 2010 |                    |             |          |           |
|---------------------------------------|-------------------|--------------------|-------------|----------|-----------|
|                                       | Pass              | Special<br>Mention | Substandard | Impaired | Total     |
| <b>Real Estate:</b>                   |                   |                    |             |          |           |
| 1-4 - family residential construction | \$4,309           | \$5,500            | \$ -        | \$4,057  | \$13,866  |
| Other construction/Land               | 24,988            | 17,979             | 1,411       | 7,669    | 52,047    |
| 1-4 Family - closed end               | 83,543            | 6,345              | 2,326       | 12,331   | 104,545   |
| Equity Lines                          | 66,560            | 1,426              | 1,558       | 1,239    | 70,783    |
| Multi-family residential              | 4,930             | 3,076              | -           | 2,956    | 10,962    |
| Commercial RE - owner-occupied        | 149,451           | 18,892             | 11,936      | 7,691    | 187,970   |
| Commercial RE - non-owner occupied    | 79,842            | 7,498              | 6,051       | 27,109   | 120,500   |
| Farmland                              | 35,949            | 21,091             | 3,848       | 405      | 61,293    |
| Total Real Estate                     | 449,572           | 81,807             | 27,130      | 63,457   | 621,966   |
| Agricultural                          | 11,547            | 1,673              | 237         | -        | 13,457    |
| Commercial and Industrial             | 79,083            | 8,156              | 5,425       | 2,104    | 94,768    |
| Small Business Administration         | 13,219            | 1,335              | 621         | 3,441    | 18,616    |
| Direct finance leases                 | 9,604             | 129                | -           | 501      | 10,234    |
| Consumer loans                        | 42,436            | 830                | 775         | 1,544    | 45,585    |
| Total Gross Loans and Leases          | \$605,461         | \$93,930           | \$34,188    | \$71,047 | \$804,626 |

The table below shows our average investment in impaired loans and interest recognized on those loans for the periods noted:



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(dollars in thousands, unaudited)

|  | 3 months ended<br>March 31,<br>2011 | 12 months ended<br>December 31,<br>2010 |
|--|-------------------------------------|---|
| Average investment in impaired loans                         | \$ 87,626                           | \$ 86,336                               |
| Interest income recognized on impaired loans                 | \$ 292                              | \$ 1,575                                |
| Interest income recognized on a cash basis on impaired loans | \$ -                                | \$ -                                    |

Nonperforming assets are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets, including mobile homes and other real estate owned (“OREO”). OREO consists of properties acquired by foreclosure or similar means, which the Company is offering or will offer for sale. Nonperforming loans and leases result when reasonable doubt exists with regard to the ability of the Company to collect all principal and interest on a loan or lease. At that point, we stop accruing interest on the loan or lease in question, and reverse any previously-recognized interest to the extent that it is uncollected or associated with interest-reserve loans. Any asset for which principal or interest has been in default for a period of 90 days or more is also placed on non-accrual status, even if interest is still being received, unless the asset is both well secured and in the process of collection. The loan balances classified by the Company as past due and nonaccrual were as follows, as of the indicated dates:

(dollars in thousands, unaudited)

|                                  | March 31, 2011         |                          |            |
|----------------------------------|------------------------|--------------------------|------------|
|                                  | Still Accruing         |                          | Nonaccrual |
|                                  | 30-89 Days<br>Past Due | Over 90 Days<br>Past Due |            |
| <b>Real Estate:</b>              |                        |                          |            |
| Commercial and land development  | \$ 401                 | \$ -                     | \$ 9,902   |
| 1-4 Family residential           | 1,706                  | -                        | 5,951      |
| Multifamily residential          | -                      | -                        | -          |
| Commercial real estate and other | 8,037                  | -                        | 29,971     |
| Commercial and Industrial        | 3,437                  | -                        | 6,418      |
| Consumer and Other               | 1,208                  | -                        | 1,390      |
|                                  | \$ 14,789              | \$ -                     | \$ 53,632  |

|                                  | December 31, 2010      |                          |            |
|----------------------------------|------------------------|--------------------------|------------|
|                                  | Still Accruing         |                          | Nonaccrual |
|                                  | 30-89 Days<br>Past Due | Over 90 Days<br>Past Due |            |
| <b>Real Estate:</b>              |                        |                          |            |
| Commercial and land development  | \$ 14,747              | \$ -                     | \$ 10,241  |
| 1-4 Family residential           | 6,491                  | -                        | 6,134      |
| Multifamily residential          | 2,634                  | -                        | -          |
| Commercial real estate and other | 5,078                  | -                        | 22,521     |
| Commercial and Industrial        | 3,400                  | -                        | 5,946      |
| Consumer and Other               | 1,183                  | -                        | 1,112      |
|                                  | \$ 33,533              | \$ -                     | \$ 45,954  |

The following table presents comparative data for the Company's nonperforming assets and performing TDR's, as of the dates noted:

| Nonperforming Assets<br>(dollars in thousands, unaudited)                                | March 31,<br>2011 | December 31,<br>2010 |             |          |
|--|-------------------|----------------------|-------------|----------|
| <b>Non-accrual loans:</b>  |                   |                      |             |          |
| <b>Real Estate:</b>  |                   |                      |             |          |
| 1-4 family residential construction  | \$ 3,929          | \$ 4,057             |             |          |
| Other Construction/Land  | 5,973             | 6,185                |             |          |
| 1-4 family - closed-end  | 4,219             | 4,894                |             |          |
| Equity Lines   | 1,732             | 1,239                |             |          |
| Multi-family residential   | -                 | -                    |             |          |
| Commercial RE- owner occupied  | 8,497             | 7,412                |             |          |
| Commercial RE- non-owner occupied  | 20,955            | 14,704               |             |          |
| Farmland   | 519               | 405                  |             |          |
| <b>Total Real Estate</b>   | <b>45,824</b>     | <b>38,896</b>        |             |          |
| Agricultural products  | -                 | -                    |             |          |
| Commercial and Industrial  | 2,520             | 2,005                |             |          |
| Small Business Administration Loans  | 3,413             | 3,440                |             |          |
| Direct finance leases  | 485               | 501                  |             |          |
| Consumer loans   | 1,390             | 1,112                |             |          |
| <b>Total nonperforming loans</b>   | <b>\$ 53,632</b>  | <b>\$ 45,954</b>     |             |          |
| <b>Foreclosed assets</b>   | <b>19,214</b>     | <b>20,691</b>        |             |          |
| <b>Total nonperforming assets</b>  | <b>\$ 72,846</b>  | <b>\$ 66,645</b>     |             |          |
| <b>Performing loans classified as troubled debt restructurings (TDR's) (1)</b>           | <b>\$ 12,551</b>  | <b>\$ 12,465</b>     |             |          |
| <b>Nonperforming loans as a % of total gross loans and leases</b>                        | <b>6.91</b>       | <b>%</b>             | <b>5.70</b> | <b>%</b> |
| <b>Nonperforming assets as a % of total gross loans and leases and foreclosed assets</b> | <b>9.16</b>       | <b>%</b>             | <b>8.07</b> | <b>%</b> |

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

Total nonperforming assets increased \$6.2 million, or 9%, during the first three months of 2011. Total nonperforming loans increased by \$7.7 million, but foreclosed assets declined by \$1.5 million. The balance of nonperforming loans at March 31, 2011 includes \$22.8 million in TDR's which were paying as agreed under modified terms or forbearance agreements but were still classified as nonperforming. As shown in the table, we also had \$12.6 million in loans classified as performing TDR's for which we were still accruing interest at March 31, 2011, relative to a balance of \$12.5 million at December 31, 2010.

Non-accruing loan balances secured by real estate comprised \$45.8 million of total nonperforming loans at March 31, 2011, and reflect a net increase of \$6.9 million, or 18%, during the first three months of 2011. Gross additions to nonperforming real estate loans totaled \$11.5 million for the quarter, most of which was comprised of balances secured by commercial real estate. Offsetting some of the increase created by additional real estate loans placed on non-accrual status during the first three months of 2011 were \$2.6 million in transfers to OREO from nonperforming real estate loans, and net pay-downs on nonperforming real estate loans of \$1.5 million.

Nonperforming commercial and SBA loans increased by a combined \$488,000, or 9%, during the first three months of 2011, ending the period at \$5.9 million. Gross additions to nonperforming commercial and SBA loans totaled \$2.1 million for the quarter, but this was offset by net pay-downs of \$482,000, the return to accrual status of \$346,000 in loans, the charge-off of \$816,000 in loan balances, and the transfer of a small amount to foreclosed assets.

Non-accrual direct finance leases did not change materially during first three months of 2011, and nonperforming consumer loans, which are largely unsecured, increased by \$278,000, or 25%, to a total of \$1.4 million.

As noted above, foreclosed assets declined by \$1.5 million, or 7%, during the first three months of 2011. The balance of foreclosed assets at March 31, 2011 had an aggregate carrying value of \$19.2 million, and was comprised of 79 separate parcels classified as OREO and 13 mobile homes. Much of our OREO consists of vacant lots or land, but there are also 19 residential properties totaling \$2.9 million, and three commercial buildings with a combined book balance of \$1.6 million. At the end of 2010 foreclosed assets totaled \$20.7 million, comprised of 79 properties in OREO and 17 mobile homes. All foreclosed assets are periodically evaluated and written down to their fair value less expected disposition costs, if lower than the then-current carrying value.

Total nonperforming assets were 9.16% of gross loans and leases plus foreclosed assets at March 31, 2011, up from 8.07% at December 31, 2010. While our balance of nonperforming assets has increased since year-end 2010, an action plan is in place for each of our nonperforming and foreclosed assets and they are all being actively managed. Collection efforts are continuously pursued for all nonperforming loans, but we cannot provide assurance that all will be resolved in a timely manner or that nonperforming balances will not increase further.

#### ALLOWANCE FOR LOAN AND LEASE LOSSES

The allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses based on management's evaluation of probable loan losses related to certain specifically identified loans, as well as probable incurred loan losses in the remaining loan portfolio. It is maintained at a level which is adequate to absorb remaining probable loan losses after factoring in charge-offs taken against the allowance, and recoveries credited back to the allowance. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when cash payments are received subsequent to the charge off. At March 31, 2011, the allowance for loan and lease losses was \$21.5 million, or 2.76% of gross loans, a 2% increase relative to the \$21.1 million allowance at December 31, 2010 which was 2.62% of gross loans. The allowance declined by \$2.6 million, or 11%, in comparison to March 31, 2010, due to the charge-off of certain impaired, collateral-dependent loan balances against previously-established specific reserves during the intervening 12 months, but the allowance is the same percentage of gross loans since loan balances also declined. The Company's total allowance was 40.02% of nonperforming loans at March 31, 2011, relative to 46.00% at December 31, 2010 and 46.66% at March 31, 2010. An allowance for potential losses inherent in unused commitments, totaling \$160,000 at March 31, 2011, is included in other liabilities.

We employ a systematic methodology, consistent with FASB guidelines on loss contingencies and impaired loans, for determining the appropriate level of the allowance for loan and lease losses and adjusting it on at least a quarterly basis. Pursuant to that methodology, impaired loans and leases are individually analyzed and a criticized asset action plan is completed specifying the financial status of the borrower and, if applicable, the characteristics and condition of collateral and any associated liquidation plan. A specific loss allowance is created for each impaired loan, if necessary. The following tables disclose the unpaid principal balance, recorded investment, average recorded investment, and interest income recognized for impaired loans on our books as of the dates indicated. Balances are shown by loan type, and are further broken out by those that required an allowance and those that did not, with the associated allowance disclosed for those that required such.

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(dollars in thousands, unaudited)

|                                   | March 31, 2011                 |                        |                      |                                   |                                  |
|-----------------------------------|--------------------------------|------------------------|----------------------|-----------------------------------|----------------------------------|
|                                   | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <b>With an Allowance Recorded</b> |                                |                        |                      |                                   |                                  |
| Real Estate:                      |                                |                        |                      |                                   |                                  |
| Construction and land development | \$8,930                        | \$6,977                | \$1,735              | \$9,455                           | \$14                             |
| 1-4 Family residential            | 7,791                          | 7,948                  | 1,045                | 8,016                             | 58                               |
| Multifamily residential           | 2,956                          | 2,963                  | 27                   | 2,963                             | 48                               |
| Commercial RE and Other           | 25,394                         | 26,287                 | 5,212                | 27,226                            | 36                               |
| Commercial and Industrial         | 6,711                          | 6,782                  | 2,382                | 6,865                             | 3                                |
| Consumer and Other                | 1,381                          | 1,407                  | 866                  | 1,418                             | 3                                |
|                                   | \$53,163                       | \$52,364               | \$11,267             | \$55,943                          | \$162                            |

| <b>With no Related Allowance Recorded</b> |                 |                 |                 |                 |              |
|---|-----------------|-----------------|-----------------|-----------------|--------------|
| Real Estate:                              |                 |                 |                 |                 |              |
| Construction and land development         | \$7,922         | \$5,977         | \$-             | \$8,689         | \$22         |
| 1-4 Family residential                    | 5,960           | 5,776           | -               | 6,161           | 104          |
| Multifamily residential                   | -               | -               | -               | -               | -            |
| Commercial RE and Other                   | 15,483          | 15,888          | -               | 16,418          | 3            |
| Commercial and Industrial                 | 6               | 6               | -               | 6               | -            |
| Consumer and Other                        | 353             | 358             | -               | 409             | 1            |
|   | 29,724          | 28,005          | -               | 31,683          | 130          |
| <b>Total</b>                              | <b>\$82,887</b> | <b>\$80,369</b> | <b>\$11,267</b> | <b>\$87,626</b> | <b>\$292</b> |

|                                   | December 31, 2010              |                        |                      |                                   |                                  |
|-----------------------------------|--------------------------------|------------------------|----------------------|-----------------------------------|----------------------------------|
|                                   | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <b>With an Allowance Recorded</b> |                                |                        |                      |                                   |                                  |
| Real Estate:                      |                                |                        |                      |                                   |                                  |
| Construction and land development | \$6,493                        | \$5,306                | \$1,544              | \$10,938                          | \$43                             |
| 1-4 Family residential            | 8,047                          | 8,208                  | 1,068                | 8,279                             | 181                              |
| Multifamily residential           | 2,956                          | 2,963                  | 37                   | 2,966                             | 212                              |
| Commercial RE and Other           | 15,749                         | 16,216                 | 2,580                | 18,203                            | 155                              |
| Commercial and Industrial         | 6,065                          | 6,114                  | 2,235                | 6,670                             | 1                                |
| Consumer and Other                | 1,170                          | 1,205                  | 565                  | 1,227                             | 18                               |
|                                   | \$40,480                       | \$40,012               | \$8,029              | \$48,283                          | \$610                            |

| <b>With no Related Allowance Recorded</b> |          |         |     |          |       |
|---|----------|---------|-----|----------|-------|
| Real Estate:                              |          |         |     |          |       |
| Construction and land development         | \$10,264 | \$7,670 | \$- | \$11,545 | \$129 |
| 1-4 Family residential                    | 5,782    | 5,607   | -   | 5,964    | 99    |
| Multifamily residential                   | -        | -       | -   | -        | -     |
| Commercial RE and Other                   | 19,456   | 19,920  | -   | 20,140   | 736   |
| Commercial and Industrial                 | 6        | 6       | -   | 9        | -     |
| Consumer and Other                        | 374      | 377     | -   | 395      | 1     |
|   | 35,882   | 33,580  | -   | 38,053   | 965   |

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|       |          |          |         |          |         |
|-------|----------|----------|---------|----------|---------|
| Total | \$76,362 | \$73,592 | \$8,029 | \$86,336 | \$1,575 |
|-------|----------|----------|---------|----------|---------|

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Similar but condensed information for the comparative periods noted is provided in the following table:

(dollars in thousands, unaudited)

|   | March 31<br>2011 | December 31<br>2010 |
|---|------------------|---------------------|
| Impaired loans without a valuation allowance                | \$ 26,789        | \$ 32,035           |
| Impaired loans with a valuation allowance                   | 50,733           | 39,012              |
| <b>Total impaired loans</b>                                 | <b>\$ 77,522</b> | <b>\$ 71,047</b>    |
| Valuation allowance related to impaired loans               | \$ 11,267        | \$ 8,029            |
| <b>Total non-accrual loans</b>                              | <b>\$ 53,632</b> | <b>\$ 49,954</b>    |
| Total loans past-due ninety days or more and still accruing | \$ -             | \$ -                |

The loss allowance represents the difference between the face value of the loan and either its current appraised value less estimated disposition costs, or its net present value as determined by a discounted cash flow analysis. The discounted cash flow approach is used to measure impairment on loans for which it is anticipated that repayment will be provided from cash flows other than those generated solely by the disposition of underlying collateral. If a distressed borrower displays the desire and ability to continue paying on the loan, but is unable to do so except on a modified basis, an amended repayment plan may be negotiated. For these TDR's, the act of modification in and of itself suggests that the Company believes the source of repayment will likely be from borrower-generated cash flows, thus they are also typically evaluated for impairment by discounting projected cash flows.

For loans where repayment is expected to be provided solely by the underlying collateral, impairment is measured using the fair value of the collateral. If the collateral value, net of the expected costs of disposition, is less than the loan balance, then a specific loss reserve is established for the amount of the collateral coverage shortfall. If the discounted collateral value is greater than or equal to the loan balance, no specific loss reserve is established. At the time a collateral-dependent loan is designated as nonperforming, a new appraisal is ordered and typically received within 30 to 60 days if a recent appraisal was not already available. We generally use external appraisals to determine the fair value of the underlying collateral for nonperforming real estate loans, although the Company's licensed staff appraisers may update older appraisals based on current market conditions and property value trends. Until an updated appraisal is received, the Company uses the existing appraisal to determine the amount of the specific loss allowance that may be required, and adjusts the specific loss allowance, as necessary, once a new appraisal is received. Updated appraisals are generally ordered at least annually for collateral-dependent loans that remain impaired. Current appraisals were available for 79% of the Company's impaired loans at March 31, 2011. Furthermore, the Company analyzes collateral-dependent loans on at least a quarterly basis, to determine if any portion of the recorded investment in such loans can be identified as uncollectible and would therefore constitute a confirmed loss. All amounts deemed to be uncollectible are promptly charged off against the Company's allowance for loan and lease losses, with the loan then carried at the fair value of the collateral, as appraised, less estimated costs of disposition if such costs were not reflected in appraised values. Once a charge-off or write-down is recorded, it will not be restored to the loan balance on the Company's accounting books.

Our methodology also provides that a "general" allowance be established for probable incurred losses inherent in loans and leases that are not impaired. These unimpaired loan balances are segregated by credit quality, and are then evaluated in pools with common characteristics. At the present time, pools are based on the same segmentation of loan types presented in our regulatory filings. While this methodology utilizes historical loss data and other measurable information, the classification of loans and the establishment of the allowance for loan and lease losses are both to some extent based on management's judgment and experience. Our methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan and lease losses that management believes is appropriate at each reporting date. Quantitative information includes our historical loss



experience, delinquency and charge-off trends, current collateral values, and the anticipated timing of collection of principal for nonperforming loans. Qualitative factors include the general economic environment in our markets and, in particular, the state of the agricultural industry and other key industries in the Central San Joaquin Valley. Lending policies and procedures (including underwriting standards), the experience and abilities of lending staff, the quality of loan review, credit concentrations (by geography, loan type, industry and collateral type), the rate of loan portfolio growth, and changes in legal or regulatory requirements are additional factors that are considered. The total general reserve established for probable incurred losses on unimpaired loans was \$10.2 million at March 31, 2011.

During the three months ended March 31, 2011, there were no material changes made to the methodology used to determine our allowance for loan and lease losses. As we add new products and expand our geographic coverage, and as the economic environment changes, we expect to continue to enhance our methodology to keep pace with the size and complexity of the loan and lease portfolio and respond to pressures created by external forces. We engage outside firms on a regular basis to assess our methodology and perform independent credit reviews of our loan and lease portfolio. In addition, the Company's external auditors, the FDIC, and the California DFI review the allowance for loan and lease losses as an integral part of their audit and examination processes. Management believes that the current methodology is appropriate given our size and level of complexity.

The table that follows summarizes the activity in the allowance for loan and lease losses for the quarter ended March 31, 2011:

Allowance for Credit Losses and Recorded Investment in Financing Receivables  
(dollars in thousands, unaudited)

|   | For the Quarter Ended March 31, 2011 |             |                     |           |                |           |            |
|---|--------------------------------------|-------------|---------------------|-----------|----------------|-----------|------------|
|   | Real Estate                          | Ag Products | Comm'l & Industrial | SBA Loans | Finance Leases | Consumer  | Total      |
| <b>Allowance for credit losses:</b>             |                                      |             |                     |           |                |           |            |
| Beginning Balance                               | \$ 10,142                            | \$ 62       | \$ 5,797            | \$ 1,274  | \$ 284         | \$ 3,579  | \$ 21,138  |
| Charge-offs                                     | 1,626                                | -           | 884                 | 77        | 9              | 784       | 3,380      |
| Recoveries                                      | 6                                    | -           | 30                  | 7         | 7              | 56        | 106        |
| Provision                                       | 3,013                                | 7           | 165                 | 285       | 157            | (27 )     | 3,600      |
| Ending Balance                                  | \$ 11,535                            | \$ 69       | \$ 5,108            | \$ 1,489  | \$ 439         | \$ 2,824  | \$ 21,464  |
| <b>Ending balance:</b>                          |                                      |             |                     |           |                |           |            |
| individually evaluated for impairment           | \$ 8,019                             | \$ -        | \$ 923              | \$ 1,316  | \$ 143         | \$ 866    | \$ 11,267  |
| <b>Ending balance:</b>                          |                                      |             |                     |           |                |           |            |
| collectively evaluated for impairment           | \$ 3,516                             | \$ 69       | \$ 4,185            | \$ 173    | \$ 296         | \$ 1,958  | \$ 10,197  |
| <b>Ending balance:</b>                          |                                      |             |                     |           |                |           |            |
| loans acquired with deteriorated credit quality | \$ -                                 | \$ -        | \$ -                | \$ -      | \$ -           | \$ -      | \$ -       |
| <b>Loan balance:</b>                            |                                      |             |                     |           |                |           |            |
| Ending Balance                                  | \$ 601,397                           | \$ 14,518   | \$ 89,074           | \$ 20,061 | \$ 8,790       | \$ 42,552 | \$ 776,392 |
| <b>Ending balance:</b>                          |                                      |             |                     |           |                |           |            |
| individually evaluated for impairment           | \$ 69,098                            | \$ -        | \$ 2,792            | \$ 3,413  | \$ 485         | \$ 1,734  | \$ 77,522  |

|  |            |           |           |           |          |           |            |
|--|------------|-----------|-----------|-----------|----------|-----------|------------|
| Ending balance:<br>collectively<br>evaluated for<br>impairment | \$ 532,299 | \$ 14,518 | \$ 86,282 | \$ 16,648 | \$ 8,305 | \$ 40,818 | \$ 698,870 |
|--|------------|-----------|-----------|-----------|----------|-----------|------------|

|  |      |      |      |      |      |      |      |
|--|------|------|------|------|------|------|------|
| Ending balance:<br>loans acquired with<br>deteriorated credit<br>quality | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
|--|------|------|------|------|------|------|------|

Similar information for the comparative periods noted is disclosed in the table below:

Allowance for Loan and Lease Losses  
(dollars in thousands, unaudited)

|  | For the Quarter<br>Ended March 31,<br>2011 | For the Year<br>Ended December 31,<br>2010 | For the Quarter<br>Ended March 31,<br>2010 |
|--|--|--|--|
| <b>Balances:</b>   |  |  |  |
| Average gross loans and leases outstanding during period (1) | \$ 785,705                                 | \$ 851,292                                 | \$ 874,230                                 |
| Gross loans and leases outstanding at end of period          | \$ 776,392                                 | \$ 805,540                                 | \$ 872,211                                 |
| <b>Allowance for Loan and Lease Losses:</b>                  |  |  |  |
| Balance at beginning of period                               | \$ 21,138                                  | \$ 23,715                                  | \$ 23,715                                  |
| Provision charged to expense                                 | 3,600                                      | 16,680                                     | 3,400                                      |
| <b>Charge-offs</b>   |  |  |  |
| <b>Real Estate:</b>  |  |  |  |
| 1-4 family residential construction                          | -  | 1,706                                      | -  |
| Other Construction/Land                                      | 717  | 4,579                                      | 129  |
| 1-4 family - closed-end                                      | 155  | 1,400                                      | 233  |
| Equity Lines   | 258  | 596  | -  |
| Multi-family residential                                     | -  | 97   | 97   |
| Commercial RE- owner occupied                                | 496  | 946  | 19   |
| Commercial RE- non-owner occupied                            | -  | 1,358                                      | 113  |
| Farmland   | -  | 27   | -  |
| Total Real Estate  | 1,626                                      | 10,709                                     | 591  |
| Agricultural products  | -  | -  | -  |
| Commercial and Industrial                                    | 884  | 4,998                                      | 1,083                                      |
| Small Business Administration Loans                          | 77   | 293  | 46   |
| Direct finance leases  | 9  | 646  | 505  |
| Consumer loans   | 784  | 3,691                                      | 986  |
| Consumer Credit Cards  | -  | -  | -  |
| Total charge-offs  | 3,380                                      | 20,337                                     | 3,211                                      |
| <b>Recoveries</b>  |  |  |  |
| <b>Real Estate:</b>  |  |  |  |
| 1-4 family residential construction                          | -  | 25   | 25   |
| Other Construction/Land                                      | -  | 13   | -  |
| 1-4 family - closed-end                                      | 5  | 41   | 3  |
| Equity Lines   | 1  | 41   | 1  |
| Multi-family residential                                     | -  | -  | -  |
| Commercial RE- owner occupied                                | -  | -  | -  |
| Commercial RE- non-owner occupied                            | -  | -  | -  |
| Farmland   | -  | -  | -  |
| Total Real Estate  | 6  | 120  | 29   |
| Agricultural products  | -  | -  | -  |
| Commercial and Industrial                                    | 30   | 462  | 51   |
| Small Business Administration Loans                          | 7  | 63   | 42   |
| Direct finance leases  | 7  | 159  | 12   |
| Consumer loans   | 56   | 274  | 57   |
| Consumer Credit Cards  | -  | 2  | 1  |
| Total recoveries   | 106  | 1,080                                      | 192  |

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|                                   |           |  |           |  |           |
|-----------------------------------|-----------|--|-----------|--|-----------|
| Net loan charge offs (recoveries) | 3,274     |  | 19,257    |  | 3,019     |
| Ending Balance                    | \$ 21,464 |  | \$ 21,138 |  | \$ 24,096 |

**RATIOS**

|   |       |   |        |   |       |   |
|---|-------|---|--------|---|-------|---|
| Net Charge-offs to Average Loans and Leases (annualized)                | 1.69  | % | 2.26   | % | 1.40  | % |
| Allowance for Loan Losses to<br>Gross Loans and Leases at End of Period | 2.76  | % | 2.62   | % | 2.76  | % |
| Allowance for Loan Losses to<br>Non-Performing Loans                    | 40.02 | % | 46.00  | % | 46.66 | % |
| Net Loan Charge-offs to Allowance<br>for Loan Losses at End of Period   | 15.25 | % | 91.10  | % | 12.53 | % |
| Net Loan Charge-offs to<br>Provision for Loan Losses                    | 90.94 | % | 115.45 | % | 88.79 | % |

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

As shown in the table immediately above, the Company's provision for loan and lease losses increased by \$200,000, or 6%, for the first quarter of 2011 relative to the first quarter of 2010, while net loan balances charged off increased by \$255,000, or 8%, for the same comparative periods. Real estate loan charge-offs experienced the largest increase among our main loan categories, rising by \$1.0 million, or 175%, for the comparative quarters, with the increases spread among construction and land loans, owner-occupied commercial real estate loans, and equity lines. Including write-downs taken in the first quarter of 2011, we have taken a cumulative total of \$4.3 million in write-downs on collateral-dependent loans still on our books at March 31, 2011, most of which were on construction loans. SBA loans also experienced a small increase in charge-offs for the comparative quarters, but we had lower charge-offs for commercial loans, direct finance leases, and consumer loans. Material changes in the level of principal recoveries are not evident for any category. Since our allowance for loan and lease losses is maintained at a level to cover probable losses related to specifically identified loans as well as probable incurred losses in the remaining loan portfolio, any shortfall in the allowance created by loan charge-offs is typically covered by month-end, and always by quarter-end. Additional details on our provision for loan and lease losses and its relationship to actual charge-offs is contained above in the "Provision for Loan and Lease Losses" section.

The Company's allowance for loan and lease losses at March 31, 2011 represents management's best estimate of probable loan losses related to specifically identified loans, as well as probable incurred loan losses in the remaining loan portfolio. Fluctuations in credit quality, changes in economic conditions, or other factors could induce us to augment the allowance, however, and no assurance can be given that the Company will not experience substantial losses relative to the size of the allowance.

#### OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of business, the Company makes commitments to extend credit as long as there are no violations of any conditions established in the outstanding contractual arrangement. Unused commitments to extend credit totaled \$141 million at March 31, 2011 as compared to \$142 million at December 31, 2010, although it is not likely that all of these commitments will ultimately be drawn down. Unused commitments represented approximately 18% of gross loans outstanding at March 31, 2011 and at December 31, 2010. In addition to unused loan commitments, the Company had undrawn letters of credit totaling \$17 million at March 31, 2011 and at December 31, 2010.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will ever be used. For more information regarding the Company's off-balance sheet arrangements, see Note 8 to the financial statements located elsewhere herein.

#### OTHER ASSETS

The balance of non-interest earning cash and due from banks was \$46 million at March 31, 2011, compared to \$42 million at December 31, 2010. Since the actual balance of cash and due from banks depends on the timing of collection of outstanding cash items (checks), it is subject to significant fluctuation in the normal course of business. While cash flows are normally predictable within limits, those limits are fairly broad and the Company manages its cash position through the utilization of overnight loans to and borrowings from correspondent banks, including the Federal Home Loan Bank of San Francisco. Should a large "short" overnight position persist for any length of time, the Company typically raises money through focused retail deposit gathering efforts or by adding brokered time deposits. If a "long" position is prevalent, the Company will, to the extent possible, let brokered deposits or other wholesale borrowings roll off as they mature.

Because of frequent balance fluctuations, a more accurate gauge of cash management efficiency is the average balance for the period. The \$39 million average of cash and due from banks for the first three months of 2011 was higher than

the \$34 million average for the fourth quarter of 2010 due to a higher level of cash activity in our branches, which has required the maintenance of higher levels of vault cash, and the addition of a branch in February 2011.

Net premises and equipment increased by \$418,000 during the first three months of 2011, primarily due to fixed asset additions related to our new Selma branch. "Other assets" were \$2.8 million lower, with the most significant changes including a lower level of foreclosed assets, a drop in our prepaid FDIC assessment subsequent to payments made in the first three months of 2011, and a decline in our net deferred tax asset. At March 31, 2011, the \$105 million balance of other assets includes as its largest components \$32 million in bank-owned life insurance (see discussion of BOLI in "Non-Interest Revenue and Operating Expense" section above), a \$10 million investment in low-income housing tax credit funds, approximately \$19 million in OREO and other foreclosed assets, an \$8 million investment in restricted stock, a deferred tax asset of close to \$13 million, current prepaid income taxes totaling \$2 million, accrued interest receivable totaling \$5 million, goodwill of about \$6 million, a prepaid FDIC assessment of \$4 million, and \$1 million in operating leases. Restricted stock is comprised primarily of FHLB stock that typically experiences balance fluctuations in conjunction with our level of FHLB borrowings. However, the FHLB of San Francisco suspended stock repurchases for a period of time and only recently started to repurchase stock at minimal levels, thus our \$8 million restricted stock investment is not expected to drop significantly even though our borrowings have declined. This stock is not deemed to be marketable or liquid and is thus not grouped with the Company's investments described above. The Company's goodwill is evaluated annually for potential impairment, and because the estimated fair value of the Company exceeded its book value (including goodwill) as of the measurement date and no impairment was indicated, no further testing was deemed necessary and it was determined that no goodwill impairment exists. Likewise, our net deferred tax asset is evaluated as of every reporting date pursuant to FASB guidance, and we have determined that no impairment exists.

## DEPOSITS AND INTEREST BEARING LIABILITIES

### DEPOSITS

Another key balance sheet component impacting the Company's net interest margin is our deposit base. Deposits provide liquidity to fund growth in earning assets, and the Company's net interest margin is improved to the extent that growth in deposits is concentrated in less volatile and typically less costly core deposits, which include demand deposit accounts, interest-bearing demand accounts (NOW accounts), savings accounts, money market demand accounts (MMDA's), and non-brokered time deposits under \$100,000. Information concerning average balances and rates paid on deposits by deposit type for the quarters ended March 31, 2011 and 2010 is contained in the Average Rates and Balances tables appearing above in the section titled "Net Interest Income and Net Interest Margin." A comparative schedule of the distribution of the Company's deposits at March 31, 2011 and December 31, 2010, by outstanding balance as well as by percentage of total deposits, is presented in the following Deposit Distribution table.

#### Deposit Distribution

(dollars in thousands, unaudited)

|                                    | March 31,<br>2011 | December 31,<br>2010 |
|------------------------------------|-------------------|----------------------|
| Demand                             | \$ 266,209        | \$ 251,908           |
| NOW                                | 174,773           | 184,360              |
| Savings                            | 82,547            | 74,682               |
| Money Market                       | 164,810           | 156,170              |
| CDAR's < \$100,000                 | 1,746             | 1,614                |
| CDAR's ≥ \$100,000                 | 30,418            | 31,652               |
| Customer Time Deposit < \$100,000  | 162,947           | 164,223              |
| Customer Time deposits ≥ \$100,000 | 193,255           | 187,665              |
| Brokered Deposits                  | 15,000            | -                    |
| Total Deposits                     | \$ 1,091,705      | \$ 1,052,274         |

#### Percentage of Total Deposits



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|                                    |        |   |        |   |
|------------------------------------|--------|---|--------|---|
| Demand                             | 24.38  | % | 23.94  | % |
| NOW                                | 16.01  | % | 17.52  | % |
| Savings                            | 7.56   | % | 7.10   | % |
| Money Market                       | 15.10  | % | 14.84  | % |
| CDAR's < \$100,000                 | 0.16   | % | 0.15   | % |
| CDAR's ≥ \$100,000                 | 2.79   | % | 3.01   | % |
| Customer Time Deposit < \$100,000  | 14.93  | % | 15.61  | % |
| Customer Time deposits > \$100,000 | 17.70  | % | 17.83  | % |
| Brokered Deposits                  | 1.37   | % | 0.00   | % |
| Total                              | 100.00 | % | 100.00 | % |

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Total deposit balances increased by \$39 million, or 4%, during the first three months of 2011. Furthermore, our deposit mix improved since much of that growth came in core non-maturity deposits, which were up by \$21 million, or 3%. The growth in non-maturity deposits is due in part to our ongoing deposit acquisition programs, including our highly successful direct mail initiatives. During the first three months of 2011 non-interest bearing demand deposits rose by \$14 million, or 6%; savings deposits were up \$8 million, or 11%; and money market deposit balances increased by \$9 million, or 6%. NOW deposits were the exception, declining by \$10 million, or 5%, subsequent to interest rate adjustments made on our online reward checking product. Customer time deposits under \$100,000 were down \$1 million, or 1%, while customer-sourced time deposits over \$100,000 increased by \$6 million, or 3%. CDAR's deposits, which are also primarily sourced from customers in our market areas, declined by a combined total of \$1 million, or 3%. In addition to our customer deposit activity during the first three months of 2011, we added \$15 million in wholesale-sourced brokered deposits with maturities in the two to four year range, for interest rate risk management purposes. Despite the addition of brokered deposits, management recognizes that maintaining a high level of core customer deposits is one of the keys to sustaining a strong net interest margin and we continue to focus energy toward that end.

#### OTHER INTEREST-BEARING LIABILITIES

The Company's other interest-bearing liabilities include overnight borrowings from other banks ("fed funds purchased"), borrowings from the Federal Home Loan Bank, securities sold under agreement to repurchase, and junior subordinated debentures that consist entirely of long-term borrowings from trust subsidiaries formed specifically to issue trust preferred securities (see Capital Resources section for a more detailed explanation of trust-preferred securities).

The Company uses overnight and short-term FHLB advances and overnight fed funds purchased on uncommitted lines from correspondent banks to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. The FHLB line is committed, but the amount of available credit is dependent on the level of pledged collateral. There were no borrowings under repurchase agreements at March 31, 2011 or December 31, 2010, but we had \$35,000 in overnight fed funds purchased on our books at March 31, 2011. We had no overnight FHLB advances at March 31, 2011 relative to \$10 million at the end of 2010, and term FHLB advances also declined by \$5 million during the first three months of 2011. As of March 31, 2011, term FHLB borrowings totaled \$15 million, comprised of \$15 million in the form of longer-term borrowings (original maturity over one year). The Company had \$31 million in junior subordinated debentures at March 31, 2011 and December 31, 2010.

#### OTHER NON-INTEREST BEARING LIABILITIES

Other non-interest bearing liabilities are principally comprised of accrued interest payable, accrued income taxes, other accrued but unpaid expenses, and certain clearing amounts. Other liabilities dropped by \$364,000, or 3%, during the first three months of 2011, due mainly to a reduction in accrued expenses that were paid subsequent to year-end.

#### LIQUIDITY AND MARKET RISK MANAGEMENT

##### LIQUIDITY

Liquidity refers to the Company's ability to maintain cash flows that are adequate to fund operations and meet other obligations and commitments in a timely and cost-effective manner. The Company manages its liquidity in such a fashion as to be able to meet any unexpected changes in liquidity needs. Detailed cash flow projections are prepared on a monthly basis, with various scenarios applied to simulate our ability to meet liquidity needs under adverse conditions, and liquidity ratios are also calculated and reviewed on a regular basis. While these ratios are merely

indicators and are not measures of actual liquidity, they are monitored closely and we are focused on maintaining adequate liquidity resources to draw upon should the need arise.

The Company, on occasion, experiences short-term cash needs as the result of loan growth or deposit outflows, or other asset purchases or liability repayments. To meet short-term needs, the Company can borrow overnight funds from other financial institutions, or solicit brokered deposits if deposits are not immediately obtainable from local sources. Availability on lines of credit from correspondent banks, including the Federal Home Loan Bank, totaled \$126 million at March 31, 2011. An additional \$127 million in credit is available from the Federal Home Loan Bank if the Company pledges additional collateral in a like amount and maintains the required amount of FHLB stock. The Company is also eligible to borrow approximately \$66 million at the Federal Reserve Discount Window, if necessary, based on pledged assets at March 31, 2011. Further, funds can be obtained by drawing down the Company's correspondent bank deposit accounts, or by liquidating unpledged investments or other readily saleable assets. In addition, the Company can raise immediate cash for temporary needs by selling under agreement to repurchase those investments in its portfolio which are not pledged as collateral. As of March 31, 2011, unpledged securities, plus pledged securities in excess of current pledging requirements, comprised \$323 million of the Company's investment portfolio balances. Other forms of balance sheet liquidity include but are not necessarily limited to fed funds sold, vault cash, and balances due from banks. The Company experienced a significant shift from contingent liquidity to actual balance sheet liquidity in 2010, due to the arrangement of a letter of credit from the FHLB for certain pledging requirements in place of investment securities. The FHLB letter of credit totaled \$167 million at March 31, 2011. Management is of the opinion that its investments and other potentially liquid assets, along with other standby funding sources it has arranged, are more than sufficient to meet the Company's current and anticipated short-term liquidity needs.

The Company's primary liquidity and average loans to assets ratios were 39% and 58%, respectively, at March 31, 2011, as compared to internal policy guidelines of "greater than 8%" and "less than 78%." The liquidity ratio is calculated with the balance of cash and due from banks, plus available investment securities and committed available-for-sale loans as the numerator, and non-collateralized deposits and short-term liabilities as the denominator. Other liquidity ratios reviewed by management and the Board include average net loans to core deposits, net non-core funding dependence, and reliance on wholesale funding, all of which were well within policy guidelines at March 31, 2011. Strong growth in core deposits combined with loan runoff and growth in investments has had a positive impact on our liquidity position in recent periods, although no assurance can be provided that this will continue to be the case.

#### INTEREST RATE RISK MANAGEMENT

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company does not engage in the trading of financial instruments, nor does it have exposure to currency exchange rates. Our market risk exposure is primarily that of interest rate risk, and we have established policies and procedures to monitor and limit our earnings and balance sheet exposure to changes in interest rates. The principal objective of interest rate risk management (sometimes referred to as "asset/liability management") is to manage the financial components of the Company's balance sheet in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. To identify areas of potential exposure to rate changes, the Company performs an earnings simulation analysis and a market value of portfolio equity calculation on a monthly basis.

The Company uses Sendero modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest income, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports balances, interest rates, maturity dates and re-pricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investments, loans, deposits and borrowed funds. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), economic (based on current trends and econometric models) or stable (unchanged from current actual levels).

The Company uses seven standard interest rate scenarios in conducting its simulations: "stable," upward shocks of 100, 200 and 300 basis points, and downward shocks of 100, 200, and 300 basis points. Our policy is to limit any projected decline in net interest income relative to the stable rate scenario for the next 12 months to less than 5% for a 100 basis point (b.p.) shock, 10% for a 200 b.p. shock, and 15% for a 300 b.p. shock in interest rates. Per updated regulatory guidance, we also apply an upward shock of 400 b.p. for net interest income simulations and include the results in internal management reports. As of March 31, 2011 the Company had the following estimated net interest income sensitivity profile, without factoring in any potential negative impact on spreads resulting from competitive pressures:

|                                      | Immediate Change in Rate |           |           |           |           |           |
|--------------------------------------|--------------------------|-----------|-----------|-----------|-----------|-----------|
|                                      | -300 b.p.                | -200 b.p. | -100 b.p. | +100 b.p. | +200 b.p. | +300 b.p. |
| Change in Net Int. Inc. (in \$000's) | \$ -5,108                | \$ -3,770 | \$ -2,363 | \$ -381   | \$ -259   | \$ +1,128 |
| % Change                             | -9.77 %                  | -7.21 %   | -4.52 %   | -0.73 %   | -0.50 %   | +2.16 %   |

Our current interest rate risk profile indicates that a drop in interest rates could have a negative impact on our net interest margin, although we consider the likelihood of further rate decreases to be minimal in the current environment. If there were an immediate and sustained downward adjustment of 100 basis points in interest rates, all else being equal, net interest income over the next twelve months would likely be \$2.4 million lower, a drop of 4.52% compared to net interest income under a stable rate scenario. The unfavorable variance increases when rates drop 200 or 300 basis points, due to the fact that certain deposit rates which are already relatively low (on NOW accounts and savings accounts, for example), and rates on other low-cost interest-bearing liabilities, hit a natural floor of close to zero while variable-rate loan yields continue to drop. This effect is exacerbated by the fact that prepayments on fixed-rate loans tend to increase as rates decline, although our model assumptions include a presumed floor for our internal prime rate that partially offsets other negative pressures.

An increase in interest rates could also have an unfavorable effect on net interest income. However, if not for the fact that many of our variable-rate loans are currently at rate floors our balance sheet would be slightly asset-sensitive, meaning that, all else being equal, net interest income would increase as rates go up. Because of those rate floors, our model projects that if there were an immediate increase of 100 basis points in interest rates, the Company's net interest income would be \$381,000 lower than in a flat rate scenario due to the re-pricing lag that occurs while variable rates are increasing to floored levels. As rates rise further and loan rates lift from their floors, net interest income will benefit.

The economic (or "fair") value of financial instruments on the Company's balance sheet will also vary under the interest rate scenarios previously discussed. This variance is essentially a gauge of longer-term exposure to interest rate risk. It is measured by simulating changes in the Company's economic value of equity (EVE), which is calculated by subtracting the fair value of liabilities from the fair value of assets. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at current replacement interest rates for each account type, while the fair value of non-financial accounts is assumed to equal book value for all rate scenarios. An economic value simulation is a static measure for balance sheet accounts at a given point in time, but this measurement can change substantially over time as the characteristics of the Company's balance sheet evolve and as interest rate and yield curve assumptions are updated.

The amount of change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including the stated interest rate or spread relative to current market rates or spreads, the likelihood of prepayment, whether the rate is fixed or floating, and the maturity date of the instrument. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical patterns and management's best estimates. We have found that model results are highly sensitive to changes in the assumed decay rate for non-maturity deposits, in particular. The table below shows estimated changes in the Company's EVE as of March 31, 2011, under different interest rate scenarios relative to a base case of current interest rates:

#### Immediate Change in Rate

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|                                  | -300 b.p.  | -200 b.p.  | -100 b.p.  | +100 b.p. | +200 b.p. | +300 b.p. |
|----------------------------------|------------|------------|------------|-----------|-----------|-----------|
| Change in<br>EVE (in<br>\$000's) | \$ -51,525 | \$ -51,266 | \$ -24,569 | \$ +4,356 | \$ +3,235 | \$ +7,355 |
| % Change                         | -16.84 %   | -16.76 %   | -8.03 %    | +1.42 %   | +1.06 %   | +2.40 %   |

The table shows that our EVE will likely deteriorate in declining rate scenarios, but will generally benefit from rising rates. The changes in EVE are not symmetrical, however, due to the optionality inherent in certain financial instruments. Our EVE profile has changed substantially in recent periods, moving from unfavorable exposure to a benefit under rising rates, due in part to model adjustments to non-maturity deposit decay rates which better reflect historical patterns. Effectively, lower decay rates mean that we have a longer period to benefit from low-cost deposits, which are even more valuable when the cost of replacing them becomes greater, as would be the case in a rising rate environment. The updated EVE simulations also reflect greater exposure to declining rates, due in part to the acceleration of loan prepayments. In recent periods, we have intentionally focused on variable rate loans and longer-maturity funding in an attempt to benefit from the eventuality of rising rates, but this has also increased our exposure to declining rates.

## CAPITAL RESOURCES

At March 31, 2011, the Company had total shareholders' equity of \$161.5 million, comprised of \$63.6 million in common stock, \$1.7 million in additional paid-in capital, \$94.3 million in retained earnings, and \$2.0 million in accumulated other comprehensive income. Total shareholders' equity at the end of 2010 was \$159.6 million. The \$1.9 million increase in shareholders' equity during the first quarter was due in part to the addition of \$1.5 million in net earnings, less \$839,000 in dividends paid. Accumulated other comprehensive income, representing the change in the mark-to-market differential of our investment securities (net of the tax impact), also increased by \$1.1 million due to increasing market values, and the increase in capital related to stock options was \$74,000.

The Company uses a variety of measures to evaluate its capital adequacy, with risk-based capital ratios calculated separately for the Company and the Bank. Management reviews these capital measurements on a quarterly basis and takes appropriate action to ensure that they meet or surpass established internal and external guidelines. The Company and the Bank are both classified as "well capitalized," the highest rating of the categories defined under the Bank Holding Company Act and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. Each of the federal regulators has established risk based and leverage capital guidelines for the bank holding companies or banks it regulates, which set total capital requirements and define capital in terms of "core capital elements," or Tier 1 capital; and "supplemental capital elements," or Tier 2 capital. Tier 1 capital is generally defined as the sum of the core capital elements less goodwill and certain other deductions, notably the unrealized net gains or losses (after tax adjustments) on available-for-sale investment securities carried at fair market value. The following items are defined as core capital elements: (i) common shareholders' equity; (ii) qualifying non-cumulative perpetual preferred stock and related surplus (and, in the case of holding companies, senior perpetual preferred stock issued to the U.S. Treasury Department pursuant to the Troubled Asset Relief Program); (iii) qualified minority interests in consolidated subsidiaries and similar items; and (iv) qualifying trust preferred securities up to a specified limit. All of the \$30 million in junior subordinated debentures on the Company's balance sheet at March 31, 2011 was included in Tier 1 capital, however no assurance can be given that these debentures, which were issued in conjunction with trust preferred securities, will continue to be treated as Tier 1 capital in the future.

Tier 2 capital can include: (i) the allowance for loan and lease losses (but not more than 1.25% of an institution's risk-weighted assets); (ii) perpetual preferred stock and related surplus not qualifying as Tier 1 capital; (iii) hybrid capital instruments, perpetual debt and mandatory convertible debt instruments; (iv) a certain level of unrealized gains on available-for-sale equity securities; and (v) qualifying subordinated debt and redeemable preferred stock (but not more than 50% of Tier 1 capital). Because of the limitation on the allowance for loan and lease losses, only \$11.5 million, or 53%, of our total allowance is currently included in Tier 2 capital. The maximum amount of Tier 2 capital that is allowable for risk-based capital purposes is limited to 100% of Tier 1 capital, net of goodwill. The following table sets forth the Company's and the Bank's regulatory capital ratios as of the dates indicated.

## Regulatory Capital Ratios

|  | March 31,<br>2011 | December 31,<br>2010 |
|--|-------------------|----------------------|
| <b>Sierra Bancorp</b>                        |                   |                      |
| Total Capital to Total Risk-weighted Assets  | 21.20 %           | 20.33 %              |
| Tier 1 Capital to Total Risk-weighted Assets | 19.94 %           | 19.06 %              |
| Tier 1 Leverage Ratio                        | 14.11 %           | 13.84 %              |
| <b>Bank of the Sierra</b>                    |                   |                      |
| Total Capital to Total Risk-weighted Assets  | 20.19 %           | 19.31 %              |
| Tier 1 Capital to Total Risk-weighted Assets | 18.93 %           | 18.04 %              |
| Tier 1 Leverage Ratio                        | 13.38 %           | 13.07 %              |

At the current time, there are no commitments that would necessitate the use of material amounts of the Company's capital.



PART I – FINANCIAL INFORMATION

Item 3

QUALITATIVE & QUANTITATIVE DISCLOSURES  
ABOUT MARKET RISK

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

PART I – FINANCIAL INFORMATION

Item 4

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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

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

Changes in Internal Controls

There were no significant changes in the Company’s internal controls over financial reporting that occurred in the first quarter of 2011 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

## PART II - OTHER INFORMATION

## ITEM 1: LEGAL PROCEEDINGS

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

## ITEM 1A: RISK FACTORS

There were no material changes from the risk factors disclosed in the Company's Form 10-K for the fiscal year ended December 31, 2010.

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

## (c) Stock Repurchases

The following table provides information concerning the Company's repurchases of its Common Stock during the first quarter of 2011:

|   | January | February | March   |
|---|---------|----------|---------|
| Total shares purchased  | 0       | 0        | 0       |
| Average per share price   | N/A     | N/A      | N/A     |
| Number of shares purchased as part of publicly announced plan or program    | N/A     | N/A      | N/A     |
| Maximum number of shares remaining for purchase under a plan or program (1) | 100,669 | 100,669  | 100,669 |

(1) The current stock repurchase plan became effective July 1, 2003 and has no expiration date. The repurchase program initially provided that up to 250,000 shares of Sierra Bancorp's common stock could be purchased by the Company from time to time. That amount was supplemented by 250,000 shares on May 19, 2005, another 250,000 shares on March 16, 2006, and an additional 500,000 shares on April 19, 2007.

## ITEM 3 : DEFAULTS UPON SENIOR SECURITIES

Not applicable

## ITEM 4 : (REMOVED AND RESERVED)

## ITEM 5 : OTHER INFORMATION

Not applicable

ITEM 6 : EXHIBITS

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

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(1)Filed as Exhibit 3.1 to the Form 10-Q filed with the SEC on August 7, 2009 and incorporated herein by reference.

(2)Filed as an Exhibit to the Form 8-K filed with the SEC on February 21, 2007 and incorporated herein by reference.

(3)Filed as an Exhibit to the Registration Statement of Sierra Bancorp on Form S-4 filed with the Securities and Exchange Commission (“SEC”) (Registration No. 333-53178) on January 4, 2001 and incorporated herein by reference.

(4)Filed as Exhibits 10.5 and 10.7 to the Form 10-Q filed with the SEC on May 15, 2003 and incorporated herein by reference.

(5)Filed as an Exhibit to the Form 8-K filed with the SEC on August 11, 2005 and incorporated herein by reference.

(6)

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Filed as Exhibits 10.10, 10.12, and 10.15 through 10.20 to the Form 10-K filed with the SEC on March 15, 2006 and incorporated herein by reference.

- (7) Filed as Exhibits 10.9 through 10.11 to the Form 10-Q filed with the SEC on May 14, 2004 and incorporated herein by reference.
- (8) Filed as Exhibits 10.26 through 10.28 to the Form 10-Q filed with the SEC on August 9, 2006 and incorporated herein by reference.
- (9) Filed as Exhibit 10.20 to the Form 10-K filed with the SEC on March 15, 2007 and incorporated herein by reference.
- (10) Filed as an Exhibit to the Form 8-K filed with the SEC on January 8, 2007 and incorporated herein by reference.
- (11) Computation of earnings per share is incorporated by reference to Note 6 of the Financial Statements included herein.

SIGNATURES

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

May 9, 2011  
Date

/s/ James C. Holly  
SIERRA BANCORP  
James C. Holly  
President &  
Chief Executive Officer

May 9, 2011  
Date

/s/ Kenneth R. Taylor  
SIERRA BANCORP  
Kenneth R. Taylor  
Chief Financial Officer &  
Chief Accounting Officer