



Report of Independent Auditors
and Consolidated Financial Statements for
**Regal Financial Bancorp, Inc.
and Subsidiary**

December 31, 2010 and 2009

MOSS ADAMS LLP

Certified Public Accountants | Business Consultants

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CONTENTS

	PAGE
REPORT OF INDEPENDENT AUDITORS	1
CONSOLIDATED FINANCIAL STATEMENTS	
Balance sheets	2
Statements of operations	3
Statements of changes in stockholders' equity	4
Statements of cash flows	5
Notes to financial statements	6-30

NOTE: This annual report serves as Regal Financial Bancorp, Inc.'s annual disclosure statement under the requirements of the Federal Deposit Insurance Corporation (FDIC). This statement has not been reviewed or confirmed for accuracy or relevance by the FDIC.

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders
Regal Financial Bancorp, Inc. and Subsidiary

We have audited the accompanying consolidated balance sheets of Regal Financial Bancorp, Inc. and Subsidiary (the Corporation) as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Regal Financial Bancorp, Inc. and Subsidiary as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Corporation will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Corporation's significant losses from operations, deterioration in the credit quality of its loan portfolio, increase in nonperforming assets, and decline in the level of its regulatory capital level to support operations raise substantial doubt about its ability to continue as a going concern. Management's plans regarding these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Moss Adams LLP

Everett, Washington
May 17, 2011

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS**

ASSETS

	DECEMBER 31,	
	2010	2009
CASH AND DUE FROM BANKS	\$ 1,922,332	\$ 4,653,605
FEDERAL FUNDS SOLD	817	2,643,416
Total cash and cash equivalents	1,923,149	7,297,021
INTEREST-BEARING DEPOSITS IN BANKS	20,286,656	18,607,917
INVESTMENTS		
Securities available-for-sale, at fair value	2,409,109	2,519,020
FEDERAL HOME LOAN BANK STOCK and PACIFIC COAST BANKERS' BANK STOCK, at cost	750,000	750,000
LOANS	87,164,934	114,072,130
Less allowance for loan losses	3,043,237	4,602,945
Total loans, net	84,121,697	109,469,185
BANK-OWNED LIFE INSURANCE, net	303,224	3,730,272
LEASEHOLDS AND EQUIPMENT, net	399,935	867,921
ACCRUED INTEREST RECEIVABLE	268,345	407,141
OTHER REAL ESTATE OWNED AND REPOSSESSED ASSETS	8,403,456	5,291,879
OTHER ASSETS	341,470	664,760
Total assets	<u>\$ 119,207,041</u>	<u>\$ 149,605,116</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

DEPOSITS		
Noninterest-bearing	\$ 7,329,052	\$ 8,542,389
Interest-bearing	105,490,944	131,622,800
Total deposits	112,819,996	140,165,189
ACCRUED INTEREST PAYABLE	472,684	1,213,038
OTHER LIABILITIES	619,415	521,029
Total liabilities	<u>113,912,095</u>	<u>141,899,256</u>
STOCKHOLDERS' EQUITY		
Common stock, no par value, 25,000,000 shares authorized, 6,499,281 and 1,931,677 issued and outstanding at 2010 and 2009, respectively	23,951,140	20,147,786
Accumulated deficit	(18,638,933)	(12,472,987)
Accumulated other comprehensive (loss) income	(17,261)	31,061
Total stockholders' equity	<u>5,294,946</u>	<u>7,705,860</u>
Total liabilities and stockholders' equity	<u>\$ 119,207,041</u>	<u>\$ 149,605,116</u>

REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS

	YEAR ENDED DECEMBER 31,	
	2010	2009
INTEREST INCOME		
Loans, including fees	\$ 5,696,908	\$ 7,318,173
Investments	43,679	90,466
Federal funds sold and interest-bearing deposits in banks	63,640	96,621
Total interest income	<u>5,804,227</u>	<u>7,505,260</u>
INTEREST EXPENSE		
Deposits	2,105,446	3,800,543
Borrowings	-	1,544
Total interest expense	<u>2,105,446</u>	<u>3,802,087</u>
NET INTEREST INCOME	3,698,781	3,703,173
PROVISION FOR LOAN LOSSES	<u>2,053,805</u>	<u>8,102,932</u>
NET INTEREST INCOME (LOSS) AFTER PROVISION FOR LOAN LOSSES	<u>1,644,976</u>	<u>(4,399,759)</u>
NONINTEREST INCOME		
Service fees	22,499	44,064
Increase in cash surrender value of bank-owned life insurance	135,061	140,573
Other income	62,751	135,170
Total noninterest income	<u>220,311</u>	<u>319,807</u>
NONINTEREST EXPENSES		
Salaries and employee benefits	2,330,367	2,373,582
Occupancy and equipment	1,586,485	1,286,462
Other real estate owned and repossessed assets, net	2,056,708	-
Other loan expenses	233,420	81,708
Professional fees	654,665	672,659
FDIC premiums	545,000	467,500
Data processing	244,000	283,000
State business taxes	114,500	136,000
Telephone	75,129	93,798
Other expenses	190,959	495,895
Total noninterest expenses	<u>8,031,233</u>	<u>5,890,604</u>
NET LOSS	<u>\$ (6,165,946)</u>	<u>\$ (9,970,556)</u>

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

	<u>Common Stock</u>		<u>Accumulated</u>	<u>Accumulated</u>	<u>Total</u>	<u>Comprehensive</u>
	<u>Shares</u>	<u>Amount</u>	<u>Deficit</u>	<u>Other</u>	<u>Stockholders'</u>	<u>Loss</u>
				<u>Income (Loss)</u>	<u>Equity</u>	<u>Loss</u>
BALANCE, December 31, 2008	1,676,927	\$ 19,102,788	\$ (2,502,431)	\$ 35,504	\$ 16,635,861	
Stock option expense	-	25,998	-	-	25,998	
Proceeds from issuance of common stock	254,750	1,019,000	-	-	1,019,000	
Net loss	-	-	(9,970,556)	-	\$ (9,970,556)	\$ (9,970,556)
Unrealized loss on securities available-for-sale	-	-	-	(4,443)	(4,443)	(4,443)
						<u>\$ (9,974,999)</u>
BALANCE, December 31, 2009	1,931,677	20,147,786	(12,472,987)	31,061	7,705,860	
Proceeds from issuance of common stock	4,320,104	3,555,854	-	-	3,555,854	
Stock in lieu of compensation	220,000	220,000	-	-	220,000	
Stock issued for services rendered	27,500	27,500	-	-	27,500	
Net loss	-	-	(6,165,946)	-	\$ (6,165,946)	\$ (6,165,946)
Unrealized loss on securities available-for-sale	-	-	-	(48,322)	(48,322)	(48,322)
						<u>\$ (6,214,268)</u>
BALANCE, December 31, 2010	<u>6,499,281</u>	<u>\$ 23,951,140</u>	<u>\$ (18,638,933)</u>	<u>\$ (17,261)</u>	<u>\$ 5,294,946</u>	

See accompanying notes.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	YEAR ENDED	
	DECEMBER 31,	
	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (6,165,946)	\$ (9,970,556)
Adjustments to reconcile net loss to net cash flows from operating activities		
Provision for loan losses	2,053,805	8,102,932
Amortization of loan fees	(76,237)	(191,521)
Amortization and depreciation	472,986	377,589
Net amortization of investment security premium	10,684	28,307
Net loss on sale of other real estate owned and repossessed assets	61,870	-
Stock issued in lieu of compensation and services	247,500	-
Write-down on other real estate owned and repossessed assets	1,657,641	-
Increase in cash surrender value of bank-owned life insurance	(135,061)	(140,549)
Stock option expense	-	25,998
Changes in operating assets and liabilities		
Accrued interest receivable	138,796	337,711
Other assets	323,290	(318,484)
Accrued interest payable	(740,354)	22,178
Other liabilities	98,386	(4,368)
Net cash from operating activities	<u>(2,052,640)</u>	<u>(1,730,763)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Net change in interest-bearing deposits in banks	(1,678,739)	(18,455,160)
Activity in available-for-sale securities		
Maturities, calls, and paydowns	3,100,905	1,505,019
Sales	1,000,000	-
Purchases	(4,050,000)	(2,686,795)
Net change in loans made to customers	16,314,714	11,117,289
Proceeds from surrender of bank-owned life insurance	3,562,109	-
Additions to premises and equipment, net	(5,000)	(10,663)
Improvements to other real estate owned and repossessed assets	-	(1,204,463)
Proceeds from sale of other real estate owned and repossessed assets	2,224,118	1,056,579
Net cash from investing activities	<u>20,468,107</u>	<u>(8,678,194)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net decrease in noninterest-bearing deposits	(1,213,337)	(1,595,447)
Net (decrease) increase in interest-bearing deposits	(26,131,856)	8,127,920
Proceeds from issuance of common stock	3,555,854	1,019,000
Repayments in other borrowings	-	(2,000,000)
Net cash from financing activities	<u>(23,789,339)</u>	<u>5,551,473</u>
NET CHANGE IN CASH AND CASH EQUIVALENTS	<u>(5,373,872)</u>	<u>(4,857,484)</u>
CASH AND CASH EQUIVALENTS, beginning of year	<u>7,297,021</u>	<u>12,154,505</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 1,923,149</u>	<u>\$ 7,297,021</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the period for interest	<u>\$ 2,845,800</u>	<u>\$ 3,779,909</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH TRANSACTIONS		
Loans transferred to other real estate owned	<u>\$ 7,055,206</u>	<u>\$ 4,327,403</u>
Unrealized loss on securities available-for-sale	<u>\$ 48,322</u>	<u>\$ 4,443</u>

Note 1 - Organization and Summary of Significant Accounting Policies

Nature of operations - Regal Financial Bancorp, Inc. and Subsidiary (the Corporation) provides a full range of banking services to individual and corporate customers through its office in Seattle, Washington. The Corporation closed its loan production offices in Boise, Idaho, and Las Vegas, Nevada, during 2009, and its Bellevue, Washington, and Kent, Washington, offices in November 2010. Its primary deposit products are savings and term certificate accounts, and its primary lending products are commercial, commercial mortgage, and construction loans. The Corporation is subject to significant competition from other financial institutions. The Corporation is also subject to the regulations of certain federal and state of Washington agencies and undergoes periodic examinations by those regulatory authorities.

Principles of consolidation - The consolidated financial statements include the accounts of Regal Financial Bancorp, Inc. and Regal Financial Bank (the Bank). All significant intercompany balances and transactions have been eliminated.

Consolidated financial statement presentation and use of estimates - The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and reporting practices applicable to the banking industry. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet, and revenues and expenses for the period. Actual results could differ from estimated amounts. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, valuation of other real estate owned and repossessed assets, and deferred tax assets.

Cash and cash equivalents - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold, all with maturities of 90 days or less. Generally, federal funds are purchased and sold for one-day periods. Investments in federal funds sold are made with major banks as approved by the Board of Directors.

Interest-bearing deposits in banks - Interest-bearing deposits in banks mature within one year and are carried at cost. The balances in these accounts may fluctuate and, at times, exceed the insured limit set by the Federal Deposit Insurance Corporation (FDIC), which potentially subjects the Corporation to credit risk.

Investment securities - Investment securities are classified into one of three categories: (1) held-to-maturity, (2) available-for-sale, or (3) trading. The Corporation had no held-to-maturity or trading securities at December 31, 2010 and 2009. Investment securities are categorized as held-to-maturity when the Corporation has the positive intent and ability to hold those securities to maturity. Securities that are held-to-maturity are stated at cost and adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income.

Note 1 - Organization and Summary of Significant Accounting Policies (continued)

Investment securities categorized as available-for-sale are generally held for investment purposes (to maturity), although unanticipated future events may result in the sale of some securities. Available-for-sale securities are recorded at estimated fair value, with the net unrealized gain or loss reported as “other comprehensive income (loss)” within the statement of stockholders’ equity. Realized gains or losses on dispositions are based on the net proceeds and the adjusted carrying amount of securities sold, using the specific identification method.

Management reviews investment securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) or permanent impairment, taking into consideration current market conditions; fair value in relationship to cost; extent and nature of the change in fair value; issuer rating changes and trends; whether management intends to sell a security or if it is likely that the Corporation will be required to sell the security before recovery of the amortized cost basis of the investment, which may be maturity; and other factors. For debt securities, if management intends to sell the security or it is likely that the Corporation will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If management does not intend to sell the security and it is not likely that the Corporation will be required to sell the security, but management does not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, i.e., the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive loss. Impairment losses related to all other factors are presented as separate categories within other comprehensive loss.

Federal Home Loan Bank stock - The Bank’s investment in Federal Home Loan Bank of Seattle (FHLB) stock is carried at par value (\$100 per share), which reasonably approximates its fair value. As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB stock based on specified percentages of its outstanding FHLB advances. The Bank may request redemption at par value of any stock in excess of the amount the Bank is required to hold. Stock redemptions are at the discretion of the FHLB.

At December 31, 2010 and 2009, the Bank had 4,050 shares of FHLB stock. FHLB stock is carried at par and does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions, and can only be purchased and redeemed at par. Due to ongoing turmoil in the capital and mortgage markets, the FHLB of Seattle has a risk-based capital deficiency largely as a result of write-downs on its private label mortgage-backed securities portfolios.

Note 1 - Organization and Summary of Significant Accounting Policies (continued)

The Bank evaluates FHLB stock for impairment. The determination of whether these investments are impaired is based on the Bank's assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB. Based on the above, the Corporation has determined there is not an other-than-temporary impairment on the FHLB stock investment as of December 31, 2010.

Pacific Coast Bankers' Bank stock - Pacific Coast Bankers' Bank stock (PCBB) represents an investment by the Corporation in the capital stock of PCBB and is carried at par value (\$150), which reasonably approximates fair value.

Loans held-for-sale - Loans originated and intended for sale in secondary markets are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. Gains or losses on the sale of such loans are based on the specific identification method. There were no loans held-for-sale at December 31, 2010 and 2009.

Loans - Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff generally are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in process of collection. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for loan losses - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

Note 1 - Organization and Summary of Significant Accounting Policies (continued)

The allowance for loan losses is evaluated on a regular basis by management, and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective because it requires estimates that are susceptible to significant revision as more information becomes available.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Additionally, state and federal regulations, upon examination, may require the Corporation to make additional provisions or adjustments to its allowance. Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment.

Transfers of financial assets - Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Other real estate owned and repossessed assets - Assets acquired through, or in lieu of, loan foreclosure are held-for-sale and are initially recorded at the lower of cost or estimated fair value at the date of foreclosure. Losses arising from the acquisition of property, in full or partial satisfaction of loans, are charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Leaseholds and equipment - Leaseholds and equipment are stated at cost and are amortized and depreciated using the straight-line method over the estimated useful lives of the related assets, which range from three to seven years. Total amortization and depreciation expense was \$472,986 and \$377,589 at December 31, 2010 and 2009, respectively.

Note 1 - Organization and Summary of Significant Accounting Policies (continued)

Bank-owned life insurance - The carrying amount of bank-owned life insurance (BOLI) approximates its fair value. Fair value of bank-owned life insurance is estimated using the cash surrender value, net of surrender charges. In December 2010, a portion of the BOLI was surrendered and the remaining amount was surrendered in January 2011.

Income taxes - The Corporation records its provision for income taxes under the liability method. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Deferred taxes result from temporary differences in the recognition of certain income and expense amounts between the Corporation's financial statements and its tax return. The principal items giving rise to these differences include net operating losses, valuation adjustments on foreclosed properties, and loan loss reserves. Because of unused net operating losses, the Corporation has not recognized a tax benefit. The Corporation files a consolidated tax return.

Financial instruments - In the ordinary course of business, the Corporation has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Federal funds purchased - In the ordinary course of business, the Corporation purchases federal funds from correspondent banks. The agreements result in an unsecured transaction whereby the Corporation purchases federal funds at an agreed-upon rate of interest (the federal funds rate) and repays with interest at maturity (usually the next business day).

Stock option plan - Stock-based compensation cost is recognized at the grant-date fair value and is based on awards that are ultimately expected to vest. The cost is recognized over the period during which an employee is required to provide services in exchange for the award. The tax benefit resulting from tax deductions in excess of the compensation cost recognized is classified as a financing activity in the statements of cash flows.

At December 31, 2010, the Corporation has one share-based compensation plan, which is more fully described in Note 12.

Comprehensive (loss) income - Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in the results of operations. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items are components of comprehensive income (loss). There were no reclassification adjustments realized in income in 2010 and 2009.

Advertising costs - The Corporation expenses advertising costs as they are incurred. Total advertising expenses were insignificant in 2010 and 2009.

Note 1 - Organization and Summary of Significant Accounting Policies (continued)

Fair value measurements - Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. It also establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. In determining fair value, the Corporation maximizes the use of observable inputs and minimizes the use of unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Corporation's estimates for market assumptions.

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability using one of the three valuation techniques. Inputs can be observable or unobservable. Observable inputs are those assumptions that market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from a source independent of the Corporation.

Unobservable inputs are assumptions based on the Corporation's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date.

All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy that gives the highest ranking to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest ranking to unobservable inputs (Level 3). Fair values for assets or liabilities classified as Level 2 are based on one or a combination of the following factors: (i) quoted prices for similar assets; (ii) observable inputs for the asset or liability, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data.

Subsequent events - Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. The Corporation recognizes in the consolidated financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the consolidated financial statements. The Corporation's consolidated financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before the consolidated financial statements are issued.

The Corporation has evaluated subsequent events through May 17, 2011, which is the date the consolidated financial statements are issued.

Note 2 - Regulatory Matters

FDIC order to cease and desist - On September 2, 2009, the Bank entered into a Stipulation and Consent to the Issuance of an Order to Cease and Desist (C&D order) with the FDIC and the Washington Department of Financial Institutions, Division of Banks (DFI). In the C&D order, the regulators alleged that the Bank had engaged in unsafe or unsound banking practices, operated with inadequate management and board supervision, operated with less than satisfactory capital in relation to the kind and quality of assets held by the Bank and with an inadequate loan loss reserve, and operated in violation of various banking laws and regulations. Under the terms of the C&D order, among others, the Bank cannot declare dividends without the prior written approval of the FDIC and the DFI. Other material provisions of the C&D order require the Bank to: (i) review the effectiveness of the Bank's current executive officers, (ii) strengthen the Bank's Board of Directors' oversight of management and operations of the Bank, (iii) maintain specified capital and liquidity ratios, (iv) improve the Bank's lending policies and procedures, and (v) prepare and submit progress reports to the FDIC and the DFI. The C&D order will remain in effect until modified or terminated by the FDIC and the DFI.

The C&D order does not restrict the Bank from transacting its normal banking business. The Bank will serve its customers in all areas including making loans, establishing lines of credit, accepting deposits, and processing banking transactions. All customer deposits remain fully insured to the highest limits set by FDIC. The FDIC and DFI did not impose any monetary penalties.

FDIC consent order - On November 30, 2009, the Bank entered into a Stipulation to the Issuance of a Consent Order (Consent order) with the FDIC. In the Consent order, the FDIC alleged that the Bank engaged in unsafe and unsound banking practices relating to its compliance management systems, its Bank Secrecy Act and anti-money laundering program, and its oversight of third-party relationships. The Consent order required the Bank to, among others, improve board oversight over the Bank's compliance program, designate a qualified compliance officer, improve its compliance training program, immediately cease providing ACH services to third-party processors, and conduct all residential mortgage loan transactions in compliance with the Real Estate Settlement Procedures Act.

Compliance efforts - The Bank continues to be actively engaged in responding to the concerns raised in both FDIC orders. All conditions of the C&D order have been satisfied with the exception of those related to capital. The Bank has engaged an investment banker to assist with capital raise activities. There can be no assurances the Bank will be able to raise additional capital.

All conditions of the Consent order have been satisfied and the Bank believes that it has materially addressed the regulators' requirements.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 - Regulatory Matters (continued)

Going concern - The consolidated financial statements have been prepared assuming the Corporation will continue as a going concern, which contemplates the realization of assets and the discharge of liabilities in the normal course of business. There can be no assurances that the Corporation's efforts to raise capital will be successful. The significant losses from operations, deterioration in the credit quality of the loan portfolio, increase in nonperforming assets, and the decline in the regulatory capital level to support operations raise substantial doubt about the Corporation's ability to continue as a going concern. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Note 3 - Restricted Assets

Federal Reserve Board regulations require that the Corporation maintain certain minimum reserve balances either as cash on hand or on deposit with the Federal Reserve Bank, based on a percentage of deposits. The amounts of such balances for the years ended December 31, 2010 and 2009, were approximately \$0 and \$83,000, respectively.

Note 4 - Investment Securities

Amortized cost and approximate fair values of investment securities are summarized as follows:

	Amortized Cost	Gross Unrealized		Estimated Fair Value
		Gains	Losses Less Than 12 Months	
2010				
Available-for-sale securities				
U.S. Government agency mortgage-backed securities	<u>\$ 2,426,370</u>	<u>\$ 23,290</u>	<u>\$ (40,551)</u>	<u>\$ -</u>
				<u>\$ 2,409,109</u>
2009				
Available-for-sale securities				
Obligations of U.S. Government agencies	\$ 1,254,272	\$ 4,078	\$ (77)	\$ -
U.S. Government agency mortgage-backed securities	578,108	27,309	-	-
Corporate	<u>655,579</u>	<u>-</u>	<u>(249)</u>	<u>-</u>
				<u>655,330</u>
Total securities available-for-sale	<u>\$ 2,487,959</u>	<u>\$ 31,387</u>	<u>\$ (326)</u>	<u>\$ -</u>
				<u>\$ 2,519,020</u>

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 4 - Investment Securities (continued)

The fair value of temporarily impaired securities, the amount of unrealized losses, and the length of time these unrealized losses existed as of December 31 are as follows:

	Less Than 12 Months		More Than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
2010						
U.S. Government agency mortgage-backed securities	\$ 2,049,832	\$ (40,551)	\$ -	\$ -	\$ 2,049,832	\$ (40,551)
2009						
Obligations of U.S. Government agencies	\$ 249,923	\$ (77)	\$ -	\$ -	\$ 249,923	\$ (77)
Corporate	655,330	(249)	-	-	655,330	(249)
Total	<u>\$ 905,253</u>	<u>\$ (326)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 905,253</u>	<u>\$ (326)</u>

The Corporation had one security and two securities in an unrealized loss position at December 31, 2010 and 2009, respectively. The Corporation has evaluated these securities and determined that the decline in value is temporary. Management does not intend to sell and it is likely that management will not be required to sell the securities prior to their anticipated recovery, and the decline in fair value is largely due to changes in interest rates and other market conditions. Therefore, the Bank does not consider these investments to be other-than-temporarily impaired at December 31, 2010 and 2009.

The amortized cost and estimated fair value of investment securities at December 31, 2010, by contractual or expected maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available-for-Sale	
	Amortized Cost	Estimated Fair Value
Due in one to four years	\$ 376,540	\$ 399,829
Due in five to ten years	2,049,830	2,009,280
	<u>\$ 2,426,370</u>	<u>\$ 2,409,109</u>

There was one sale of a security totaling \$1,000,000 in December 2010, with no gain or loss recognized. There were no sales of securities available-for-sale for the year ended December 31, 2009.

At December 31, 2010 and 2009, securities with an estimated fair value of \$2,409,109 and \$2,519,020, respectively, were pledged to secure public deposits.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 5 - Loans

The major classifications of loans are summarized as follows:

	<u>2010</u>	<u>2009</u>
Commercial	\$ 25,266,652	\$ 32,872,562
Real estate - commercial	50,986,656	63,799,089
Real estate - home equity line of credit	1,570,814	1,714,585
Construction and land	9,364,561	15,707,158
Consumer	<u>129,420</u>	<u>181,133</u>
	87,318,103	114,274,527
Deferred loan fees	(153,169)	(202,397)
Allowance for loan losses	<u>(3,043,237)</u>	<u>(4,602,945)</u>
Total loans, net	<u>\$ 84,121,697</u>	<u>\$ 109,469,185</u>

The allowances for loan losses and changes during the period are as follows:

Balance at the beginning of the year	\$ 4,602,945	\$ 2,017,748
Provision charged to operating expenses for loan losses	2,053,805	8,102,932
Loans charged off	(4,068,543)	(5,842,189)
Recoveries	<u>455,030</u>	<u>324,454</u>
Balance at end of year	<u>\$ 3,043,237</u>	<u>\$ 4,602,945</u>

Following is a summary of information pertaining to impaired loans:

Impaired loans not requiring a valuation allowance	\$ 8,070,198	\$ 14,391,991
Impaired loans with a valuation allowance	<u>5,689,469</u>	<u>4,157,794</u>
Total impaired loans	<u>\$ 13,759,667</u>	<u>\$ 18,549,785</u>
Valuation allowance related to impaired loans	<u>\$ 730,456</u>	<u>\$ 1,020,090</u>
Total nonaccrual loans	<u>\$ 9,312,097</u>	<u>\$ 15,743,098</u>
Total loans past due 90 days or more and still accruing	<u>\$ 252,380</u>	<u>\$ 38,212</u>
Average investment in impaired loans	<u>\$ 13,146,912</u>	<u>\$ 9,067,422</u>
Interest income recognized on impaired loans	<u>\$ 602,243</u>	<u>\$ 500,865</u>
Interest income recognized on a cash basis on impaired loans	<u>\$ 602,243</u>	<u>\$ 500,865</u>
Troubled debt restructurings included in impaired loans	<u>\$ 6,526,618</u>	<u>\$ 4,397,710</u>

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 6 - Other Real Estate Owned and Repossessed Assets

The following table presents a rollforward of other real estate owned and repossessed assets for the years ended December 31:

	<u>2010</u>	<u>2009</u>
Beginning balance	\$ 5,291,879	\$ 816,592
Loans transferred to other real estate owned and repossessed assets	7,055,206	4,327,403
Capitalized improvements	-	1,204,463
Sales	(2,224,118)	(1,056,579)
Write-downs, net	(1,657,641)	-
Net loss on sales	<u>(61,870)</u>	<u>-</u>
Ending balance	<u>\$ 8,403,456</u>	<u>\$ 5,291,879</u>

Other real estate owned consisted primarily of land and commercial real estate. Repossessed assets consisted of collateralized notes receivable.

Note 7- Leaseholds and Equipment

Corporation leaseholds and equipment are classified as follows:

Leasehold improvements	\$ 1,308,042	\$ 1,308,042
Furniture, fixtures, and office equipment	<u>1,706,234</u>	<u>1,701,233</u>
	3,014,276	3,009,275
Less accumulated depreciation and amortization	<u>(2,614,341)</u>	<u>(2,141,354)</u>
	<u>\$ 399,935</u>	<u>\$ 867,921</u>

Note 8 - Deposits

Deposits consisted of the following:

Savings accounts	\$ 5,928,471	\$ 9,673,274
Certificates of deposit under \$100,000	47,737,943	38,106,809
Certificates of deposit over \$100,000	35,347,576	77,851,153
Demand accounts		
Noninterest-bearing	7,329,052	8,542,389
Interest-bearing	1,612,293	1,934,621
Money market accounts	<u>14,864,661</u>	<u>4,056,943</u>
	<u>\$ 112,819,996</u>	<u>\$ 140,165,189</u>

The Corporation held brokered deposits of \$6,107,863 and \$11,054,553 at December 31, 2010 and 2009, respectively, included in certificates of deposit.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 8 - Deposits (continued)

At December 31, 2010, scheduled maturities of certificates of deposit are as follows:

<u>YEAR ENDING DECEMBER 31,</u>	
2011	\$ 62,964,313
2012	18,295,318
2013	1,230,888
2014	99,000
2015	<u>496,000</u>
	<u><u>\$ 83,085,519</u></u>

Note 9- Credit Arrangements

The Corporation is a member of the Federal Home Loan Bank of Seattle and, as such, has a credit line subject to sufficient holdings of Federal Home Loan Bank stock and pledged collateral to support the advances. Borrowings generally provide for interest at the then-current published rates. The Corporation was eligible to borrow up to \$6,954,000 at December 31, 2010. There were no amounts outstanding under this line at December 31, 2010 or 2009.

The Corporation has pledged certain collateral to secure its credit line. The collateral pool includes investment securities, residential and commercial real estate loans, and government-guaranteed loans. The Corporation has pledged collateral with the Federal Home Loan Bank through a physical possession collateral arrangement.

The Corporation has pledged certain eligible collateral to the Federal Reserve Bank to support additional borrowings under the discount window. The Corporation was eligible to borrow up to \$3,315,000 at December 31, 2010. There were no borrowings outstanding on this line at December 31, 2010 or 2009.

Committed lines of credit agreements totaling approximately \$100,000 were available to the Corporation from unaffiliated banks at December 31, 2010 and 2009. Such lines generally provide for interest at the lending bank's prime rate or other money market rates. There were no borrowings outstanding under these credit arrangements at December 31, 2010 and 2009, respectively.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 10 - Income Taxes

The nature and components of the Corporation's net deferred tax assets established at an estimated tax rate of 34% are as follows:

	2010	2009
Deferred tax asset		
Allowance for loan losses	\$ 1,746,000	\$ 827,000
Net operating loss carryforward	1,719,000	3,211,000
Property and equipment depreciation	229,000	113,000
Nonaccrual interest	65,000	70,000
Valuation of other real estate owned	676,000	-
Other, net	31,000	69,000
	4,466,000	4,290,000
Deferred tax liability		
Prepaid expenses	43,000	30,000
Deferred loan costs	122,000	122,000
	165,000	152,000
Net deferred tax asset	4,301,000	4,138,000
Less valuation allowance on net deferred tax asset	(4,301,000)	(4,138,000)
	\$ -	\$ -

Pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of net operating loss and credit carryforwards may be limited in the event a cumulative change in ownership of more than 50 percent occurs within a three-year period. The Corporation determined that such an ownership change occurred as of September 30, 2010, as a result of stock issuances. Based on preliminary calculations, this ownership change resulted in estimated limitations on the utilization of net operating loss carryforwards. The Corporation estimates that approximately \$5,800,000 of the federal net operating loss carryforward deferred tax asset will be effectively eliminated. Pursuant to Section 382, a portion of the limited net operating loss carryforwards becomes available for use each year. The Corporation estimates that approximately \$229,000 of the restricted net operating loss carryforwards become available each year.

Prior to the impact of the preliminary Section 382 analysis, the Corporation has federal net operating loss carryforwards of approximately \$10,840,000 at December 31, 2010. Federal net operating loss carryforwards, to the extent not used, will begin to expire in 2022.

The Corporation has not recognized a net deferred tax asset due to the uncertainty surrounding its ultimate value to the Corporation.

The Corporation adopted the provisions of FASB ASC 740 that require the application of a more-likely-than-not recognition criterion on January 1, 2009. The Corporation had no unrecognized tax benefits that would require an adjustment to the January 1, 2009, beginning balance of accumulated deficit. The Corporation had no unrecognized tax benefits at January 1, 2009, and at December 31, 2010 and 2009.

REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 10 - Income Taxes (continued)

The Corporation recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2010 and 2009, the Corporation recognized no interest and penalties.

The Corporation files income tax returns in the U.S. federal jurisdiction. With few exceptions, the Corporation is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2007.

Note 11 - Stockholders' Equity

Warrants - At December 31, 2010 and 2009, there were warrants outstanding to purchase 27,000 shares of the Corporation's common stock at \$10 per share, which were issued in connection with the Corporation's initial offering. The warrants have a term of 10 years and expire on April 18, 2012. Management believes the fair value allocated to the warrants is not significant. Management has allocated all proceeds to the stock.

At December 31, 2010, there were warrants outstanding to purchase 1,567,000 shares of the Corporation's common stock at \$1 per share. The warrants were issued in connection with the Corporation's 2010 private offering. The warrants will expire at the close of the Corporation's next formal offering. No warrants were redeemed during 2010. Management believes the fair value allocated to the warrants is not significant. Management has allocated all proceeds to the stock.

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

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

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 11 - Stockholders' Equity (continued)

The following table sets forth actual regulatory capital amounts and ratios for the Corporation and the Bank, as well as the minimum capital adequacy requirements applicable generally to all financial institutions as of the dates indicated. At December 31, 2010, the Corporation and the Bank did not meet the minimum regulatory capital required for capital adequacy for total capital to risk-weighted assets. The Bank is required to maintain higher ratios than the general requirements indicated in the table due to regulatory enforcement orders to which it is subject. At December 31, 2010, the Bank was not in compliance with a regulatory directive for maintaining Tier 1 capital to average assets of at least 10%. Also, the Bank has received notification from the FDIC that it is considered "undercapitalized." The Corporation and the Bank recognize the need for additional capital and have embarked on a capital plan as further described in Note 2.

The Corporation's and the Bank's actual capital amounts and ratios are presented in the table (in thousands).

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2010						
Total capital						
(to risk-weighted assets)						
Consolidated	\$ 6,451	7.24%	\$ 7,134	≥ 8.00%	NA	NA
Bank	\$ 6,438	7.22%	\$ 7,133	≥ 8.00%	\$ 8,916	≥ 10.00%
Tier I capital						
(to risk-weighted assets)						
Consolidated	\$ 5,312	5.96%	\$ 3,567	≥ 4.00%	NA	NA
Bank	\$ 5,299	5.94%	\$ 3,566	≥ 4.00%	\$ 5,349	≥ 6.00%
Tier I capital						
(to average assets)						
Consolidated	\$ 5,312	4.41%	\$ 4,818	≥ 4.00%	NA	NA
Bank	\$ 5,299	4.40%	\$ 4,818	≥ 4.00%	\$ 6,022	≥ 5.00%
As of December 31, 2009						
Total capital						
(to risk-weighted assets)						
Consolidated	\$ 9,228	7.61%	\$ 9,698	≥ 8.00%	NA	NA
Bank	\$ 9,217	7.60%	\$ 9,697	≥ 8.00%	\$ 12,121	≥ 0.00%
Tier I capital						
(to risk-weighted assets)						
Consolidated	\$ 7,675	6.33%	\$ 4,849	≥ 4.00%	NA	NA
Bank	\$ 7,664	6.32%	\$ 4,848	≥ 4.00%	\$ 7,273	≥ 6.00%
Tier I capital						
(to average assets)						
Consolidated	\$ 7,675	4.55%	\$ 6,749	≥ 4.00%	NA	NA
Bank	\$ 7,664	4.54%	\$ 6,749	≥ 4.00%	\$ 8,436	≥ 5.00%

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 12 - Stock Compensation Plan

The stockholders of the Corporation approved a share-based compensation plan (the Plan) to promote the best interest of the Corporation and its stockholders by providing an incentive to employees and directors. The Plan permits the grant of incentive stock options and restricted stock. The compensation cost charged against earnings for the Plan was \$220,000 for 2010, of which \$0 related to stock options and \$220,000 related to restricted stock. The compensation cost charged against income for the Plan was \$25,998 for 2009, which related to stock options. The Plan did not have restricted stock awards during 2009. There was no income tax benefit recognized in the income statement related to this share-based compensation expense. There was no compensation cost capitalized in 2010 or 2009. The number of shares that may be issued under the Plan cannot exceed 15% of shares outstanding of common stock of the Corporation less stock options outstanding (as adjusted by stock dividends and stock splits). As of December 31, 2010, there were 689,392 awards available for future grant.

Stock option plan - The Corporation had an employee stock option plan (the 2002 Plan), as amended, which was stockholder-approved, and permitted the grant of incentive stock options for employees and nonqualified stock options for directors. Option awards were generally granted with an exercise price equal to the market price of the Corporation's stock at the date of grant; those option awards generally vested and became exercisable in incremental percentages from three to five years of continuous service from the grant date and expire after 10 years. Certain option and share awards provided for accelerated vesting if there was a change in control (as defined in the Plan).

The fair value of each option award was estimated on the date of grant using the Black-Scholes-Merton valuation model. Expected volatility was based on historical volatility of the Corporation's stock and other factors. The expected term of options granted was evaluated by a calculation that factored in the contractual term and vesting period, and considered different employee segments. The risk-free interest rate for periods within the contractual life of the option was based on the U.S. Treasury yield curve in effect at the time of grant.

A summary of stock option transactions is as follows:

	Granted Options for Common Stock	Weighted- Average Exercise Price of Shares Under Plan	Weighted- Average Remaining Contractual Term
Outstanding at December 31, 2009	76,500	<u>\$ 14.87</u>	
Granted	-	-	
Exercised	-	-	
Forfeited	(11,000)	16.75	
Expired	-	-	
Outstanding at December 31, 2010	<u>65,500</u>	<u>\$ 14.56</u>	<u>3.15</u>
Options exercisable at December 31, 2010	<u>65,100</u>	<u>\$ 14.53</u>	<u>3.14</u>

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 12 - Stock Compensation Plan (continued)

There were no options granted or exercised in 2010 or 2009. As of December 31, 2010, there was no unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan.

Restricted stock plan - On March 31, 2010, the Corporation obtained approval from its Board of Directors for a new stock-based compensation plan (the 2010 Restricted Stock Plan). The options available for grant under the 2002 Plan were approved to be granted under the 2010 Restricted Stock Plan as restricted stock grants. The awards issued during 2010 immediately vested and were issued to recipients.

A summary of nonvested restricted stock transactions is as follows:

	Granted Awards of Common Stock	Weighted- Average Grant- Date Fair Value
Outstanding at December 31, 2009	-	\$ -
Granted	220,000	1.00
Vested	(220,000)	1.00
Forfeited	-	-
Expired	-	-
Outstanding at December 31, 2010	-	\$ -

Note 13 - Benefit Plan

The Corporation provided a salary continuation plan (SCP) covering certain management personnel. The post-retirement benefit provided by the SCP was designed to supplement participating officers' retirement benefits received from Social Security. The plan was dissolved during 2010 and there is no outstanding liability at December 31, 2010. The liability associated with this plan was \$170,287 at December 31, 2009.

The Corporation provides its employees with a 401(k) plan, whereby employees may defer a portion of their wages and have the monies placed in the plan trust. The Corporation is not required and did not elect to make discretionary contributions to the plan in 2010 or 2009.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 14 - Lease Commitments

Operating lease commitments - The Corporation leases office premises for its operations. The Corporation has a lease in Seattle expiring in 2013. The lease requires the Corporation to pay its pro rata share of building operating expenses. The Corporation has an additional lease in Seattle that expires in January 2021, with no additional renewal terms currently specified. The Corporation leases space in Bellevue, Washington, with the current lease term expiring in 2014.

The following is a schedule of future minimum lease payments required under initial or remaining noncancelable lease terms in excess of one year.

<u>YEAR ENDING DECEMBER 31,</u>	<u>AMOUNT</u>
2011	\$ 507,643
2012	507,643
2013	314,030
2014	222,368
2015	222,368
Thereafter	<u>1,111,838</u>
	<u><u>\$ 2,885,890</u></u>

Subsequent to year-end, the Corporation entered into a sublease agreement for its Bellevue location. A loss of \$84,000 was recognized at the time the lease agreement was signed. The terms follow the terms of the main lease and have a three-year term that expires in 2014.

The Corporation subleases a portion of its spaces to three independent parties. Minimum lease payments of \$617,834 are due in the future under noncancelable subleases. The Corporation received sublease income of \$277,707 and \$281,798 for the years ended December 31, 2010 and 2009, respectively.

Rental expense, including maintenance fees charged to operations, was \$958,542 and \$993,685 for the years ended December 31, 2010 and 2009, respectively.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 15 - Related-Party Transactions

Certain directors, executive officers, and principal stockholders are Bank customers and have had banking transactions with the Bank. All loans and commitments included in such transactions were made in compliance with applicable laws on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons, and do not involve more than the normal risk of collectibility or present any other unfavorable features. The following summarizes these transactions with directors, executive officers, principal stockholders, and companies with which they are associated at December 31:

	<u>2010</u>	<u>2009</u>
Loans outstanding	\$ 2,257,085	\$ 4,514,299
New loans	1,986,185	200,000
Repayments	<u>(487,638)</u>	<u>(2,457,214)</u>
Loans outstanding	<u><u>\$ 3,755,632</u></u>	<u><u>\$ 2,257,085</u></u>

Aggregate deposits with related parties at December 31, 2010 and 2009, totaled approximately \$17,205,335 and \$12,715,906, respectively.

Note 16 - Significant Group Concentrations of Credit Risk

Most of the Bank's business activity is with customers located within King County, Washington. The Bank originates commercial, real estate, construction, and consumer loans. Approximately 60% of the Bank's loan portfolio is secured by real estate. Generally, loans are secured by accounts receivable, inventory, deposit accounts, personal property, or real estate. Rights to collateral vary and are legally documented to the extent practicable. The ultimate collectibility of a substantial portion of the loan portfolio is susceptible to changes in economic and market conditions in the region.

The contractual amounts of credit-related financial instruments, such as commitments to extend credit, represent the amounts of potential accounting loss should the contract be fully drawn upon, the customer defaults, and the value of any existing collateral becomes worthless.

Note 17 - Financial Instruments

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, standby letters of credit, and financial guarantees. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of the Bank's involvement in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit, standby letters of credit, and financial guarantees written is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Commitments to extend credit, standby letters of credit, and financial guarantees - Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Bank's experience has been that approximately 90% of loan commitments are drawn upon by customers. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank maintains various levels of collateral supporting those commitments for which collateral is deemed necessary.

The Bank has not been required to perform on any financial guarantees in 2010 or 2009. As of December 31, 2010, there were no outstanding obligations related to financial guarantees. The Bank has not incurred any losses on its commitments in 2010 or 2009.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 17 - Financial Instruments (continued)

A summary of the notional amounts of the Bank's financial instruments with off-balance-sheet risk is as follows:

	<u>2010</u>	<u>2009</u>
Commitments to extend credit	\$ 2,110,021	\$ 2,650,152
Standby letters of credit	\$ 50,000	\$ 50,000

Note 18 - Contingencies

At periodic intervals, the state of Washington and the FDIC routinely examine the Corporation's financial statements as part of their legally prescribed oversight of the banking system. Based on these examinations, the regulators can direct the Corporation's financial statements to be adjusted in accordance with their findings.

Various legal claims may arise from time to time in the normal course of business, which, in the opinion of management, have no current material effect on the Corporation's consolidated financial statements. Specifically, Regal Financial Bank is involved in a lawsuit as follows:

Perkumpulan Investor Crisis Center Dressel - WBG v. Danny M.K. Wong, et al., Case No. C09-1786 MAT ("Perkumpulan II")

On December 16, 2009, the Corporation, the Bank, its then Chief Executive Officer, and some Board members, as well as former Directors (together the Regal Defendants), were named as defendants in a lawsuit filed by Perkumpulan Investors Crisis Center Dressel - WBG v. Danny M. K. Wong, et al. This is the second complaint filed by a related group that alleges claims of RICO, aiding and abetting common law fraud, and breaches of fiduciary duty, negligence and conspiracy, against the Corporation, the Bank, and its then Chief Executive Officer. Negligence claims are also asserted against certain Director defendants. Plaintiffs seek to hold the Corporation, the Bank, its then Chief Executive Officer, jointly and separately liable for \$153 million in losses. The first complaint was dismissed by the district court on October 30, 2009, and this decision sustained on appeal by the US Court of Appeals on September 15, 2010.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 18 - Contingencies (continued)

The successor complaint was filed by a “Perkumpulan,” which is an Indonesian word meaning association or club. The Complaint alleges that the Perkumpulan’s 3,481 members are Indonesians who invested in an alleged Ponzi scheme, operated in Indonesia by officers and directors of Dressel BVI and some related companies. As in the first lawsuit, however, the association purports to represent a group of Indonesian investors who, to the best of the Corporation’s knowledge, neither invested in nor ever had any banking relationship with the Corporation or the Bank. The matter is currently scheduled for trial on January 12, 2012. The Corporation intends to vigorously defend itself against the allegations. As of the date of this report, the Corporation and the Bank have not entered into any agreements and the amount of loss, if any, is not estimable at the date of this report.

Note 19 - Fair Value of Financial Instruments

Assets and liabilities measured at fair value on a recurring basis - Assets and liabilities are considered to be fair valued on a recurring basis if fair value is measured regularly (i.e., daily, weekly, monthly, or quarterly). The following table shows the Corporation’s assets and liabilities measured at fair value on a recurring basis:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
2010				
Available-for-sale securities				
U.S. Government agency mortgage-backed securities	\$ -	\$ 2,409,109	\$ -	\$ 2,409,109
2009				
Available-for-sale securities				
Obligations of U.S. Government agencies	\$ -	\$ 1,258,273	\$ -	\$ 1,258,273
U.S. Government agency mortgage-backed securities	\$ -	\$ 605,417	-	\$ 605,417
Corporate	\$ -	\$ 655,330	\$ -	\$ 655,330

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 19 - Fair Value of Financial Instruments (continued)

Assets measured at fair value on a nonrecurring basis - Assets and liabilities are considered to be fair valued on a nonrecurring basis if the fair value measurement of the instrument does not necessarily result in a change in the amount recorded on the balance sheet. Generally, nonrecurring valuation is the result of the application of other accounting pronouncements that require assets or liabilities to be assessed for impairment or recorded at the lower of cost or fair value. The following table presents the Corporation's assets measured at fair value on a nonrecurring basis.

	Level 1	Level 2	Level 3	Total	Total Loss
2010					
Impaired loans ⁽¹⁾	\$ -	\$ -	\$ 13,759,667	\$ 13,759,667	\$ (2,378,257)
Other real estate owned and repossessed assets ⁽²⁾			8,403,456	8,403,456	(1,719,511)
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 22,163,123</u>	<u>\$ 22,163,123</u>	<u>\$ (4,097,768)</u>
2009					
Impaired loans ⁽¹⁾	\$ -	\$ -	\$ 18,549,785	\$ 18,549,785	\$ (4,590,994)
Other real estate owned and repossessed assets ⁽²⁾			5,291,879	5,291,879	-
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 23,841,664</u>	<u>\$ 23,841,664</u>	<u>\$ (4,590,994)</u>

⁽¹⁾ Total loss represents impairment and charge-offs recognized during the year.

⁽²⁾ The loss represents the net decrease in the fair value of the real estate during the year.

The Bank considers loans impaired when it is probable the Bank will not be able to collect all amounts as scheduled under a loan agreement. Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or, as a practical expedient, at the loan's observable market price or the fair value of the collateral, if the loan is collateral dependent. Changes in these values are recorded in income as an adjustment to the allowance for loan losses.

Other real estate owned, in the preceding table, represents real estate that has been foreclosed and adjusted to fair value. At the time of foreclosure, these assets are recorded at the lower of the carrying amount of the loan or fair value less costs to sell, which becomes the asset's new basis. Any write-downs based on the asset's fair value at the date of foreclosure are charged to the allowance for loan losses. Management periodically performs valuations to determine if the asset's fair value has further declined. Fair value adjustments are recorded as a reduction to noninterest expense.

**REGAL FINANCIAL BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 19 - Fair Value of Financial Instruments (continued)

The fair value estimates that follow are subjective in nature and involve uncertainties and matters of significant judgment; therefore, they are not necessarily indicative of the amounts the Corporation could realize in a current market exchange. The Corporation has not included certain material items in its disclosure, such as the value of the long-term relationships with the Corporation's lending and deposit clients, since this is an intangible and not a financial instrument. Additionally, the estimates do not include any tax ramifications. There may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows that could materially affect the results. For all of these reasons, the aggregation of the fair value calculations presented herein do not represent, and should not be construed to represent, the underlying value of the Corporation.

The following table presents a summary of the fair value of the Corporation's financial instruments.

	December 31, 2010		December 31, 2009	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial assets				
Cash and cash equivalents	\$ 1,923,149	\$ 1,923,000	\$ 7,297,021	\$ 7,297,000
Interest-bearing deposits in banks	\$ 20,286,656	\$ 20,287,000	\$ 18,607,917	\$ 18,608,000
Securities available-for-sale	\$ 2,409,109	\$ 2,409,000	\$ 2,519,020	\$ 2,519,000
Federal Home Loan Bank stock and Pacific Coast Bankers' Bank stock	\$ 750,000	\$ 750,000	\$ 750,000	\$ 750,000
Loans, net	\$ 84,121,697	\$ 78,726,000	\$ 109,469,185	\$ 105,237,000
Bank-owned life insurance, net	\$ 303,224	\$ 303,000	\$ 3,730,272	\$ 3,730,000
Accrued interest receivable	\$ 268,345	\$ 268,000	\$ 407,141	\$ 407,000
Financial liabilities				
Deposit accounts	\$ 112,819,996	\$ 113,489,000	\$ 140,165,189	\$ 140,025,000
Accrued interest payable	\$ 472,684	\$ 473,000	\$ 1,213,038	\$ 1,213,000

The following methods and assumptions were used by the Corporation in estimating fair value disclosures for financial instruments:

Cash and cash equivalents - The carrying amount represents fair value.

Interest-bearing deposits in banks - The carrying amounts of interest-bearing deposits maturing within 90 days approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Securities available-for-sale - Fair values are based on quoted market prices or dealer quotations.

Note 19 - Fair Value of Financial Instruments (continued)

Federal Home Loan Bank stock - The fair value is based upon the redemption value of the stock, which approximates its carrying value.

Pacific Coast Bankers' Bank stock - The fair value is based upon the redemption value of the stock, which approximates its carrying value.

Bank-owned life insurance - The estimated fair value approximates the cash surrender value of the policies.

Loans - Fair values are estimated using current market interest rates to discount future cash flows. Interest rates used to discount the cash flows are based on the U.S. Treasury yields or other market interest rates with appropriate spreads. The spread over the Treasury yields or other market rates is used to account for liquidity and higher servicing costs. Prepayment rates are based on expected future prepayment rates or, where appropriate and available, market prepayment rates.

Deposit liabilities - The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Accrued interest - The carrying amounts of accrued interest approximate fair value.

Off-balance-sheet commitments - The fair value of the Bank's off-balance-sheet commitments is not considered significant.