



United Security Bancshares

...response ability



ANNUAL REPORT

FISCAL YEAR 2018



United Security

MISSION

Protect and Enhance Shareholder Value by

- providing superior customer service;
- attracting and supporting high quality team members;
- supporting and celebrating the communities we serve;
- abiding by the highest standards of regulatory safety and soundness

UNITED SECURITY BANCSHARES

Corporate Profile

Headquartered in Fresno, California, United Security Bancshares was formed in 2001 as a bank holding company to provide commercial banking services through its wholly owned subsidiary, United Security Bank. Founded in 1987, United Security Bank is a state-chartered community bank, which operates eleven full-service branches, construction, and commercial and consumer lending operations in Fresno, Madera, Kern, and Santa Clara counties. United Security is a customer-oriented financial institution engaged in providing a wide range of competitively priced commercial banking services primarily to the business community and individuals located in the central and southern San Joaquin Valley, as well as the Campbell area in Santa Clara County.

At United Security Bancshares, we are committed to improving shareholder value and delivering the highest quality products and services while being responsive to the changing needs of our customers and business markets. Our primary business strategy is to increase market share in the local communities we serve, as well as to expand into new markets when sound business opportunities present themselves.

United Security Bancshares' common stock is traded on NASDAQ under the symbol "UBFO". For more information, please visit us at www.unitedsecuritybank.com.



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MESSAGE FROM THE PRESIDENT

To Our Shareholders, Customers and Friends,

2018 was a truly successful year for the Company as we once again grew core earnings and deposits, and saw total assets grow to a historic \$933.1 million.

Throughout 2018, we continued to enhance our customer-facing applications, such as our online and mobile banking platforms and sought new ways to expand our footprint by launching two new interactive teller machines (ITMs). These machines provide our customers with a virtual teller experience with expanded hours of operation. The addition of the ITM technology made the Company the first commercial bank to do so within our market.

We are continuously working to ensure our networks, data systems, and internal processes are secure and have taken the steps to reduce our vulnerability to cyber-attacks and fraud.

During 2018, we focused on executing our strategic plan, while navigating the challenges of regulatory compliance and complex accounting and reporting requirements. Despite these hurdles, the Company has increased profitability, enhanced shareholder value, maintained strong capital levels, and strengthened corporate governance achieving the success we've come to expect.

For the year ended December 31, 2018, we generated net income of \$14.0 million or \$0.83 per share basic and diluted, as compared to \$8.6 million or \$0.51 per share basic and diluted during 2017.

Total assets of the Company grew to \$933.1 million for the year ended December 31, 2018, reflecting an increase of \$127.2 million, or 15.8% over the prior year. Gross loans at year-end totaled \$587.9 million and deposits increased to

\$805.6 million, which was an increase of \$118.0 million, or 17.2% over the prior year.

The Company remains focused on credit quality and reported net loan recoveries for the second consecutive year. As a result of this strengthening credit quality, the allowance for credit losses totaled \$8.5 million at the end of 2018 representing 1.43% of the total loan portfolio.

Core Earnings

Core earnings are defined as net interest income plus noninterest income less "normalized" noninterest expense and provision for credit losses. Core earnings increased 32.4% in 2018 over core earnings in 2017.

Net interest income before provision for credit losses totaled \$33.9 million, reflecting an increase of 9.8% over the prior year. The Company's cost of funds remains low at 0.34%.

The Company's strengthening credit quality allowed us to recover \$1.8 million from the provision for credit losses for the year ended December 31, 2018 as compared to providing \$24,000 to the provision for the year ended December 31, 2017. Overall the total provision for credit losses as a percentage of total loans continues to decrease. This decrease is representative of our prudent underwriting standards.

Noninterest income is comprised primarily of customer service fees, but also includes other items such as income derived from the cash surrender value of bank-owned life insurance, rental income, as well as other gains or losses associated with the Company's assets. Customer service fees totaled \$3.5 million or 76.9% of the \$4.6 million

recorded in total noninterest income for the year ended December 31, 2018. Noninterest expense totaled \$20.9 million for the year ended December 31, 2018, an increase of 4.1% from \$19.8 million for the year ended December 31, 2017.

On the Horizon:

As the Company continues to grow, we will look for additional opportunities to improve the customer experience and enhance our shareholder value.

Our talented team of dedicated employees is committed to providing superior service to our customers.

We are grateful to our loyal customers who entrust us with their business and our shareholders for their support and partnership. We are enthusiastic about the possibilities that lie ahead and look forward to serving you for many years to come.

Sincerely,



Dennis R. Woods
Chairman of the Board & President



Robert M. Mochizuki
Lead Director

SELECTED FINANCIAL HIGHLIGHTS

(In thousands except per share data and ratios)

	For the Year Ended December 31,				
	2018	2017	2016	2015	2014
<u>Summary of Year-to-Date Earnings:</u>					
Interest income and loan fees	\$ 36,615	\$ 32,930	\$ 29,473	\$ 27,410	\$ 24,962
Interest expense	2,703	1,730	1,409	1,281	1,345
Net interest income	33,912	31,200	28,064	26,129	23,617
(Recovery of provision) provision for credit losses	(1,764)	24	(21)	(41)	(845)
Net interest income after (recovery of provision) provision for credit losses	35,676	31,176	28,085	26,170	24,462
Noninterest income	4,605	4,306	4,514	4,735	5,161
Noninterest expense	20,932	19,803	20,345	19,598	19,215
Income before taxes on income	19,349	15,679	12,254	11,307	10,408
Taxes on income	5,332	7,039	4,869	4,497	4,192
Net income	\$ 14,017	\$ 8,640	\$ 7,385	\$ 6,810	\$ 6,216
<u>Per Share Data*:</u>					
Net income- Basic	\$ 0.83	\$ 0.51	\$ 0.44	\$ 0.40	\$ 0.37
Net income - Diluted	\$ 0.83	\$ 0.51	\$ 0.44	\$ 0.40	\$ 0.37
Average shares outstanding - Basic	16,899,960	16,885,587	16,881,379	16,880,563	16,686,896
Average shares outstanding - Diluted	16,938,772	16,904,915	16,889,027	16,882,787	16,692,646
Book value per share	\$ 6.45	\$ 6.00	\$ 5.79	\$ 5.58	\$ 5.37
<u>Financial Position at Period-end:</u>					
Total assets	\$933,058	\$805,836	\$787,972	\$725,644	\$663,169
Total net loans and leases	579,419	593,123	561,931	505,663	446,824
Total deposits	805,643	687,693	676,629	621,805	565,373
Total shareholders' equity	109,240	101,353	96,654	89,635	82,826
<u>Selected Financial Ratios:</u>					
Return on average assets	1.61%	1.07%	0.98%	0.98%	0.93%
Return on average equity	13.23%	8.63%	7.86%	7.88%	7.8%
Average equity to average assets	12.14%	12.46%	12.43%	12.41%	11.88%
Net interest margin (1)	4.28%	4.27%	4.11%	4.22%	4.01%
Allowance for credit losses as a percentage of total nonperforming assets	38.81%	52.62%	47.15%	30.26%	36.41%
Net (recoveries) charge-offs to average loans)%	(0.06)%	0.14%	0.2%	(0.14)%	(0.08)%
Allowance of credit losses as a percentage of period-end loans	1.43%	1.54%	1.56%	1.88%	2.35%
Dividend payout ratio	33.76%	33.22%	—%	—%	—%

*Per share data for 2015 and 2014 has been retroactively restated for stock dividends.



Consolidated Balance Sheets

December 31, 2018 and 2017

(In thousands except shares)

	December 31, 2018	December 31, 2017
Assets		
Cash and noninterest-bearing deposits in other banks	\$ 28,949	\$ 35,237
Due from Federal Reserve Bank ("FRB")	191,388	72,697
Cash and cash equivalents	220,337	107,934
Investment securities (at fair value)		
Available for sale ("AFS") securities	66,426	41,985
Marketable equity securities	3,659	3,737
Total investment securities	70,085	45,722
Loans	587,933	601,351
Unearned fees and unamortized loan origination (fees) costs, net	(119)	1,039
Allowance for credit losses	(8,395)	(9,267)
Net loans	579,419	593,123
Premises and equipment – net	9,837	10,165
Accrued interest receivable	8,341	6,526
Other real estate owned (OREO)	5,745	5,745
Goodwill	4,488	4,488
Deferred tax assets - net	3,174	2,389
Cash surrender value of life insurance	20,244	19,752
Investment in limited partnerships	1,911	1,601
Other assets	9,477	8,391
Total assets	\$933,058	\$805,836
Liabilities & Shareholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing	\$292,720	\$307,299
Interest bearing	512,923	380,394
Total deposits	805,643	687,693
Accrued interest payable	57	44
Other liabilities	7,963	7,017
Junior subordinated debentures (at fair value)	10,155	9,730
Total liabilities	823,818	704,484
Commitments and contingencies (Note 13)		
Shareholders' Equity		
Common stock, no par value; 20,000,000 shares authorized; issued and outstanding: 16,946,622 at December 31, 2018 and 16,885,615 at December 31, 2017	58,624	57,880
Retained earnings	49,942	44,182
Accumulated other comprehensive income (loss)	674	(710)
Total shareholders' equity	109,240	101,352
Total liabilities and shareholders' equity	\$933,058	\$805,836
See notes to consolidated financial statements		

Consolidated Statements of Income

Years Ended December 31, 2018, 2017, and 2016

(In thousands except shares and EPS)

	December 31, 2018	December 31, 2017	December 31, 2016
Interest Income			
Interest and fees on loans	\$ 32,383	\$ 30,817	\$ 28,182
Interest on investment securities	1,146	901	825
Interest on deposits in FRB	3,086	1,207	458
Interest on deposits in other banks	—	5	8
Total interest income	36,615	32,930	29,473
Interest Expense			
Interest on deposits	2,278	1,426	1,167
Interest on other borrowed funds	425	304	242
Total interest expense	2,703	1,730	1,409
Net Interest Income	33,912	31,200	28,064
(Recovery of Provision) Provision for Credit Losses	(1,764)	24	(21)
Net Interest Income after (Recovery of Provision) Provision for Credit Losses	35,676	31,176	28,085
Noninterest Income			
Customer service fees	3,544	3,851	3,792
Increase in cash surrender value of bank-owned life insurance	520	534	530
Loss on fair value of marketable equity securities	(78)	—	—
Gain on proceeds from bank-owned life insurance	171	—	—
Loss on fair value of junior subordinated debentures	(424)	(882)	(518)
Other	872	803	710
Total noninterest income	4,605	4,306	4,514
Noninterest Expense			
Salaries and employee benefits	11,721	10,821	10,628
Occupancy expense	4,372	4,254	4,222
Data processing	171	119	148
Professional fees	1,617	1,433	1,493
Regulatory assessments	330	391	767
Director fees	321	289	284
Correspondent bank service charges	63	71	—
Loss on California tax credit partnership	25	109	158
Net cost (gain) on operation and sale of OREO	145	(150)	263
Other	2,167	2,466	2,382
Total noninterest expense	20,932	19,803	20,345
Income Before Provision for Taxes	19,349	15,679	12,254
Provision for Taxes on Income	5,332	7,039	4,869
Net Income	\$ 14,017	\$ 8,640	\$ 7,385
Net Income per common share			
Basic	\$ 0.83	\$ 0.51	\$ 0.44
Diluted	\$ 0.83	\$ 0.51	\$ 0.44
Shares on which net income per common share were based			
Basic	16,899,960	16,885,587	16,881,379
Diluted	16,938,772	16,904,915	16,889,027

See notes to consolidated financial statements

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2018, 2017, and 2016

<i>(In thousands)</i>	Year Ended December 31,		
	2018	2017	2016
Net Income	\$14,017	\$8,640	\$7,385
Unrealized holdings (losses) gains on securities	(362)	16	(648)
Unrealized gains (losses) on unrecognized post retirement costs	5	(6)	(22)
Unrealized gain on junior subordinated debentures	32	—	—
Other comprehensive (loss) income, before tax	(325)	10	(670)
Tax benefit (expense) related to securities	54	(6)	259
Tax (expense) benefit related to unrecognized post-retirement costs	(2)	3	9
Tax expense related to junior subordinated debentures	(9)	—	—
Total other comprehensive (loss) income	(282)	7	(402)
Comprehensive Income	\$13,735	\$8,647	\$6,983

See notes to consolidated financial statements

Consolidated Statements of Changes in Shareholders' Equity

Years Ended December 31, 2018, 2017, and 2016

	Common stock		Retained Earnings	Accumulated Other Comprehensive Income	Total
(In thousands except shares)	Number of Shares	Amount			
Balance January 1, 2016 (1)	16,051,406	\$52,572	\$37,265	\$(202)	\$ 89,635
(1) Excludes 15,019 unvested restricted shares					
Other comprehensive loss				(402)	(402)
Common stock dividends	651,725	3,949	(3,949)		—
Stock options exercised	2,463	6			6
Stock-based compensation expense		30			30
Net Income			7,385		7,385
Balance December 31, 2016 (2)	16,705,594	\$56,557	\$40,701	\$(604)	\$ 96,654
(2) Excludes 12,015 unvested restricted shares					
Other comprehensive income				7	7
Reclassification of income tax effects from accumulated other comprehensive income			113	(113)	—
Common stock dividends	167,082	1,220	(1,220)		—
Stock options exercised	2,514	6			6
Dividends on common stock (\$0.17 per share)			(2,870)		(2,870)
Dividends payable (\$0.07 per share)			(1,182)		(1,182)
Restricted stock units released	10,425				—
Stock-based compensation expense		97			97
Net Income			8,640		8,640
Balance December 31, 2017 (3)	16,885,615	\$57,880	\$44,182	\$(710)	\$101,352
(3) Excludes 46,511 unvested restricted shares					
Adoption of ASU 2016-01: reclassification of TRUPS to accumulated other comprehensive income			(1,482)	1,482	—
Adoption of ASU 2016-01: recognition of previously unrealized losses within marketable equity securities			(184)	184	—
Adjusted balance at January 1, 2018	16,885,615	\$57,880	\$42,516	\$ 956	\$101,352
Other comprehensive loss				(282)	(282)
Dividends on common stock (\$0.28 per share)			(4,732)		(4,732)
Dividends payable (\$0.11 per share)			(1,859)		(1,859)
Restricted stock units released	61,007				—
Stock-based compensation expense		744			744
Net Income			14,017		14,017
Balance December 31, 2018 (4)	16,946,622	\$58,624	\$49,942	\$ 674	\$109,240
(4) Excludes 59,217 unvested restricted shares					
See notes to consolidated financial statements					

Consolidated Statements of Cash Flows

Years Ended December 31, 2018, 2017, and 2016

(In thousands)

	December 31, 2018	December 31, 2017	December 31, 2016
Cash Flows From Operating Activities:			
Net Income	\$ 14,017	\$ 8,640	\$ 7,385
Adjustments to reconcile net income to cash provided by operating activities:			
(Recovery of provision) provision for credit losses	(1,764)	24	(21)
Depreciation and amortization	1,352	1,335	1,428
Amortization of investment securities	631	534	481
Accretion of investment securities	(5)	(8)	(28)
Increase in accrued interest receivable	(1,815)	(2,631)	(1,676)
Increase (decrease) in accrued interest payable	13	(32)	47
Decrease (increase) in unearned fees	1,159	36	(1,017)
(Increase) decrease in income taxes receivable	(316)	(734)	957
Stock-based compensation expense	744	97	30
(Recovery of provision) provision for deferred income taxes	(785)	906	2,199
Decrease in accounts payable and accrued liabilities	(940)	(39)	(146)
Gain on sale of investment in limited partnership	—	(3)	—
Gain on sale of other real estate owned	—	(336)	(37)
Unrealized loss on marketable equity securities	78	—	—
Loss on fair value option of junior subordinated debentures	424	882	518
Gain on bank owned life insurance	(171)	—	—
Increase in surrender value of life insurance	(520)	(534)	(530)
Loss on tax credit limited partnership interest	25	109	158
Gain on disposal of premises and equipment	(29)	(73)	—
Net increase in other assets	(974)	(618)	(290)
Net cash provided by operating activities	11,124	7,555	9,458
Cash Flows From Investing Activities:			
Net decrease in interest-bearing deposits with banks	—	650	878
Purchase of correspondent bank stock	(23)	(495)	(101)
Maturities and calls on available-for-sale securities	—	—	2,600
Principal payments on available-for-sale securities	9,678	11,260	4,687
Purchases of available-for-sale securities	(34,921)	—	(34,987)
Purchase of bank-owned life insurance/company-owned life insurance	—	—	(220)
Net decrease (increase) in loans	14,310	(31,251)	(51,465)
Cash proceeds from sales of other real estate owned	—	1,062	3,378
Payoff of senior liens on other real estate owned	—	—	(705)
Proceeds from Bank Owned Life Insurance	376	—	—
Capital expenditures for premises and equipment	(1,024)	(1,128)	(1,073)
(Investment in) distributions from limited partnership	(335)	(954)	1
Net cash used in investing activities	(11,939)	(20,856)	(77,007)
Cash Flows From Financing Activities:			
Net increase in demand deposit and savings accounts	100,349	49,226	20,993
Net increase (decrease) in time deposits	17,601	(38,159)	33,831
Proceeds from exercise of stock options	—	6	6
Dividends on common stock	(4,732)	(2,870)	—
Net cash provided by financing activities	113,218	8,203	54,830
Net increase (decrease) in cash and cash equivalents	112,403	(5,098)	(12,719)
Cash and cash equivalents at beginning of year	107,934	113,032	125,751
Cash and cash equivalents at end of year	\$220,337	\$107,934	\$113,032

See notes to consolidated statements

Notes to Consolidated Financial Statements

Years Ended December 31, 2018 and 2017

1. Organization and Summary of Significant Accounting and Reporting Policies

Basis of Presentation – The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and with prevailing practices within the banking industry. The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiaries, United Security Bank and subsidiary (the “Bank”) and USB Capital Trust II (the “Trust”). The Trust is deconsolidated pursuant to ASC 810. As a result, the Trust Preferred Securities are not presented on the Company’s consolidated financial statements as equity, but instead they are presented as Junior Subordinated Debentures and are presented as a separate liability category. (see Note 9 to the Company’s consolidated financial statements). Intercompany accounts and transactions have been eliminated in consolidation. In the following notes, references to the Bank are references to United Security Bank. References to the Company are references to United Security Bancshares, (including the Bank). United Security Bancshares operates as one business segment providing banking services to commercial establishments and individuals primarily in the San Joaquin Valley of California.

Nature of Operations – United Security Bancshares is a bank holding company, incorporated in the state of California for the purpose of acquiring all the capital stock of the Bank through a holding company reorganization (the “Reorganization”) of the Bank. The Reorganization, which was accounted for in a manner similar to a pooling of interests, was completed on June 12, 2001. Management believes the Reorganization has provided the Company greater operating and financial flexibility and has permitted expansion into a broader range of financial services and other business activities.

During July 2007 the Company formed USB Capital Trust II and issued \$15.0 million in Trust Preferred Securities with terms similar to those originally issued under USB Capital Trust I. During 2015, the Bank purchased \$3.0 million of the Company’s junior subordinated debentures related to the Company’s trust preferred securities at a fair value discount of 40%. Subsequently, the Company purchased

those shares from the Bank and canceled \$3.0 million in par value of the junior subordinated debentures, realizing a \$78,000 gain on redemption. The contractual principal balance of the Company’s debentures relating to its trust preferred securities is \$12.0 million as of December 31, 2018. (See Note 8. “Junior Subordinated Debt/Trust Preferred Securities”).

USB Investment Trust Inc was incorporated effective December 31, 2001, as a special purpose real estate investment trust (“REIT”) under Maryland law. The REIT is a subsidiary of the Bank and was funded with \$133.0 million in real estate-secured loans contributed by the Bank. USB Investment Trust was originally formed to give the Bank flexibility in raising capital, and reduce the expenses associated with holding the assets contributed to USB Investment Trust.

The Bank was founded in 1987 and currently operates eleven branches and one construction lending office in an area from eastern Madera County to western Fresno County, as well as Taft and Bakersfield in Kern County, and Campbell in Santa Clara County. The Bank’s primary source of revenue is interest income through providing loans to customers, who are predominantly small and middle-market businesses and individuals. The Bank engages in a full compliment of lending activities, including real estate mortgage, commercial and industrial, real estate construction, agricultural and consumer loans, with particular emphasis on short and medium term obligations.

The Bank offers a wide range of deposit instruments. These include personal and business checking accounts and savings accounts, interest-bearing negotiable order of withdrawal (NOW) accounts, money market accounts and time certificates of deposit. Most of the Bank’s deposits are attracted from individuals and from small and medium-sized business-related sources.

The Bank also offers a wide range of specialized services designed to attract and service the needs of commercial customers and account holders. These services include cashiers checks, travelers checks, money orders, and foreign drafts. In addition, the Bank offers Internet banking services to its commercial and retail customers. The Bank does not operate a trust department, however it makes arrangements with its correspondent bank to offer trust services to its customers upon request.

Use of Estimates in the Preparation of Financial Statements – The preparation of financial statements in

conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change, relate to the determination of the allowance for loan losses, determination of goodwill, fair value of junior subordinated debt and certain collateralized mortgage obligations, and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans.

Subsequent events – The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued.

Significant Accounting Policies – The Company follows accounting standards set by the Financial Accounting Standards Board, commonly referred to as “FASB.” FASB sets generally accepted accounting principles (GAAP) that the Company follows to ensure the consistent reporting of its consolidated financial condition, consolidated results of operations, and consolidated cash flows. References to GAAP issued by FASB in these footnotes are to *FASB Accounting Standards Codification*, sometimes referred to as the Codification or ASC. The following is a summary of significant policies:

- a. *Cash and cash equivalents* – Cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and repurchase agreements. At times throughout the year, balances can exceed FDIC insurance limits. Generally, federal funds sold and repurchase agreements are sold for one-day periods. The Bank did not have any repurchase agreements during 2018 or 2017, or at December 31, 2018 and 2017. All cash and cash equivalents have maturities when purchased of three months or less.
- b. *Securities* – Debt and equity securities classified as available for sale are reported at fair value, with unrealized gains and losses excluded from net income and reported, net of tax, as a separate component of comprehensive income and shareholders’ equity. Debt securities classified as held to maturity are carried at amortized cost. Gains and losses on disposition are reported using the specific identification method for

the adjusted basis of the securities sold. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

The Company classifies its securities as available for sale or held to maturity, and periodically reviews its investment portfolio on an individual security basis. Securities that are to be held for indefinite periods of time (including, but not limited to, those that management intends to use as part of its asset/liability management strategy, those which may be sold in response to changes in interest rates, changes in prepayments or any such other factors) are classified as securities available for sale. Securities which the Company has the ability and intent to hold to maturity are classified as held to maturity.

Investments with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed interest rate investments, from rising interest rates. At each financial statement date, management assesses each investment to determine if impaired investments are temporarily impaired or if the impairment is other-than-temporary based upon the positive and negative evidence available. Evidence evaluated includes, but is not limited to, industry analyst reports, credit market conditions, and interest rate trends. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between the amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: (1) OTTI related to credit loss, which must be recognized in the income statement; and (2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

- c. *Loans* – Interest income on loans is credited to income as earned and is calculated by using the simple interest method on the daily balance of the



principal amounts outstanding. Loans are placed on non-accrual status when principal or interest is past due for 90 days and/or when management believes the collection of amounts due is doubtful. For loans placed on nonaccrual status, the accrued and unpaid interest receivable may be reversed at management's discretion based upon management's assessment of collectability, and interest is thereafter credited to principal to the extent necessary to eliminate doubt as to the collectability of the net carrying amount of the loan.

Nonrefundable fees and related direct costs associated with the origination or purchase of loans are deferred and netted against outstanding loan balances. The net deferred fees and costs are generally amortized into interest income over the loan term using the interest method. Other credit-related fees, such as standby letter of credit fees, loan placement fees and annual credit card fees are recognized as noninterest income during the period the related service is performed.

- d. *Allowance for Credit Losses and Reserve for Unfunded Loan Commitments* – The allowance for credit losses is maintained to provide for losses that can reasonably be anticipated. The allowance is based on ongoing quarterly assessments of the probable losses inherent in the loan portfolio, and to a lesser extent, unfunded loan commitments. The reserve for unfunded loan commitments is a liability on the Company's consolidated financial statements and is included in other liabilities. The liability is computed using a methodology similar to that used to determine the allowance for credit losses, modified to take into account the probability of a drawdown on the commitment.

The allowance for credit losses is increased by provisions charged to operations during the current period and reduced by negative provisions and loan charge-offs, net of recoveries. Loans are charged against the allowance when management believes that the collection of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing loans, based on evaluations of the probability of collection. In evaluating the probability of collection, management is required to make estimates and assumptions that affect the reported amounts of loans, allowance for credit losses and the provision for credit losses charged to operations. Actual results

could differ significantly from those estimates. These evaluations take into consideration such factors as the composition of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrowers' ability to pay.

The Company's methodology for assessing the adequacy of the allowance for credit losses consists of several key elements, which include:

- the formula allowance
- specific allowances for problem graded loans identified as impaired
- and the unallocated allowance

The formula allowance is calculated by applying loss factors to outstanding loans. Loss factors are based on the Company's historical loss experience and on the internal risk grade of those loans and, may be adjusted for significant factors, including economic factors that, in management's judgment, affect the collectability of the portfolio as of the evaluation date. Management determines the loss factors for problem graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates loan losses over the previous quarters as determined by management (time horizons adjusted as business cycles or environment changes) and loss factors are adjusted to recognize and quantify the loss exposure from changes in market conditions and trends in the Company's loan portfolio. Those factors include 1) trends in delinquent and nonaccrual loans, 2) trends in loan volume and terms, 3) effects of changes in lending policies, 4) concentrations of credit, 5) competition, 6) national and local economic trends and conditions, 7) experience of lending staff, 8) loan review and Board of Directors oversight, 9) high balance loan concentrations, and 10) other business conditions. For purposes of this analysis, loans are grouped by internal risk classifications, which are "pass," "special mention," "substandard," "doubtful," and "loss." Certain loans are homogeneous in nature and are therefore pooled by risk grade. These homogeneous loans include consumer installment and home equity loans.

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in impaired loans. For impaired loans, specific allowances are determined based on the collateralized

value of the underlying properties, the net present value of the anticipated cash flows, or the market value of the underlying assets.

A loan is considered impaired when management determines that it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement. Impairment is measured by the difference between the original recorded investment in the loan and the estimated present value of the total expected future cash flows, discounted at the loan's effective rate, or the fair value of the collateral, less estimated selling costs, if the loan is collateral dependent.

The unallocated portion of the allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations, and other business conditions.

- e. *Premises and Equipment* – Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is computed principally on the straight-line method over the estimated useful lives of the assets. Estimated useful lives are as follows:

Buildings	31 years
Furniture and equipment	3-7 years

- f. *Other Real Estate Owned* – Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for credit losses. Subsequent declines in the fair value of other real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense.
- g. *Intangible Assets and Goodwill* – Intangible assets are comprised of core deposit intangibles, other specific identifiable intangibles, and goodwill acquired in branch acquisitions where the consideration given exceeded the fair value of the net assets acquired.

Goodwill amounts resulting from the acquisitions of Taft National Bank during April 2004, and Legacy Bank during February 2007 are considered to have an

indefinite life and are not amortized. At December 31, 2018, goodwill related to Taft National Bank totaled \$1.6 million, and goodwill related to Legacy Bank totaled \$2.9 million. Impairment testing of goodwill is performed at the reporting level during December of each year for Taft, and during March of each year for Legacy. During 2018 and 2017, the Company did not recognize impairment adjustments on the goodwill related to the Legacy or Taft Bank acquisitions.

- h. *Income Taxes* – Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities using the liability method, and 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. For the use in estimates the enacted tax rate of the period is utilized.
- i. *Net Income per Share* – Basic income per common share is computed based on the weighted average number of common shares outstanding. Diluted income per share includes the effect of stock options and other potentially dilutive securities using the treasury stock method to the extent they have a dilutive impact. Net income per share has been retroactively adjusted for all stock dividends declared. The number of potentially dilutive common shares included in quarterly diluted income per share is computed using the average market prices during the three months included in the reporting period under the treasury stock method. The number of potentially dilutive common shares included in year-to-date diluted income per share is a year-to-date weighted average of potentially dilutive common shares included in each quarterly diluted net income per share computation.
- j. *Cash Flow Reporting* – For purposes of reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing amounts due from banks, federal funds sold and securities purchased under agreements to resell. Federal funds and securities purchased under agreements to resell are generally sold for one-day periods. Net cash flows are reported for interest-bearing deposits with other banks, loans to customers, and deposits held for customers.
- k. *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 Company, (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 Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

- l. *Advertising Costs* – The Company expenses marketing costs as they are incurred. Advertising expense was \$85,000, \$154,000, and \$126,000 for the years ended December 31, 2018, 2017, and 2016, respectively.
- m. *Stock Based Compensation* – The Company has a stock-based employee compensation plan, which is described more fully in Note 11. The Company accounts for all share-based payments to employees, including grants of employee stock options and restricted stock units and awards, to be recognized in the financial statements based on the grant date fair value of the award. The fair value is amortized over the requisite service period (generally the vesting period). Included in salaries and employee benefits for the years ended December 31, 2018, 2017, and 2016 are \$744,000, \$97,000, and \$30,000, respectively, of share-based compensation. The related tax benefit, recorded in the provision for income taxes, was not significant. All share data contained within the financial statements has been retroactively restated for stock based transactions (i.e. stock splits and stock dividends.)
- n. *Federal Home Loan Bank stock and Federal Reserve Stock* – As a member of the Federal Home Loan Bank (FHLB), the Company is required to maintain an investment in capital stock of the FHLB. In addition, as a member of the Federal Reserve Bank (FRB), the Company is required to maintain an investment in capital stock of the FRB. The investments in both the FHLB and the FRB are carried at cost, which approximates their fair value, in the accompanying consolidated balance sheets under other assets and are subject to certain redemption requirements by the FHLB and FRB. Stock redemptions are at the discretion of the FHLB and FRB.

While technically these are considered equity securities, there is no market for the FHLB or FRB stock. Therefore, the shares are considered as restricted investment securities. Management periodically evaluates the stock for other-than-temporary impairment. Management's determination of whether

these investments are impaired is based on its 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 or FRB as compared to the capital stock amount of the FHLB or FRB and the length of time this situation has persisted, (2) commitments by the FHLB or FRB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB or FRB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB or FRB, and (4) the liquidity position of the FHLB or FRB.

- o. *Comprehensive Income* – Comprehensive income is comprised of net income and other comprehensive income. Other comprehensive income includes items recorded directly to equity, such as unrealized gains and losses on securities available-for-sale, unrecognized costs of salary continuation defined benefit plans, and unrealized gains and losses on trust preferred securities. Comprehensive income is presented in the Consolidated Statements of Other Comprehensive Income.
- p. *Segment Reporting* – The Company's operations are solely in the financial services industry and include providing to its customers traditional banking and other financial services. The Company operates primarily in the San Joaquin Valley region of California. Management makes operating decisions and assesses performance based on an ongoing review of the Company's consolidated financial results. Therefore, the Company has a single operating segment for financial reporting purposes.
- q. *Revenue from Contracts with Customers* – The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation.

The Company's primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. The contracts evaluated that are in scope of Topic 606 are primarily related to service charges and fees on deposit accounts, debit card fees, ATM processing fees, and other service charges, commissions and fees. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers. The Company adopted Topic 606 using the modified retrospective method on all contracts not completed as of January 1, 2018. The adoption of Topic 606 did not result in a material change to the accounting for any of the in-scope revenue streams. As such, no cumulative effect adjustment was recorded.

r. *New Accounting Standards:*

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). The guidance affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements of financial instruments. ASU 2016-01 was effective for the Company on January 1, 2018 and resulted in separate classification of equity securities previously included in available for sale securities on the consolidated balance sheets with changes in the fair value of the equity securities captured in the consolidated statements of income. See Note 2 – Investment Securities for disclosures related to equity securities. Adoption of the standard also resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 14 – Fair

Value Disclosures for further information regarding the valuation of these loans. Additionally, adoption of the standard resulted in separately recognizing the instrument-specific credit risk associated with the Company's Junior Subordinated Debt. See Note 9 – Junior Subordinated Debt / Trust Preferred Securities for additional information.

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842). The FASB is issuing this Update to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the FASB Accounting Standards Codification® and creating Topic 842, Leases. This Update, along with IFRS 16, Leases, are the results of the FASB's and the International Accounting Standards Board's (IASB's) efforts to meet that objective and improve financial reporting. This ASU will be effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. The Company estimates the impact of this standard will be recognize as of January 1, 2019 a new \$3,388,000 lease right of use asset, and a new \$3,479,000 lease liability, which will be offset by a \$91,000 accrued rent asset. The Company does not expect any other significant impact from this ASU.

In July 2018, FASB issued ASU 2018-11, Leases (Topic 842), Targeted Improvements, which amends ASC 842, Leases. The amendments in this Update allow lessors to combine lease and associated nonlease components by class of underlying asset in contract that meet certain criteria. For a lessor to qualify for this practical expedient, the lease and related nonlease components must have the same timing and pattern of transfer, and the lease component, if accounted for on a stand-alone basis, would be classified as an operating lease. Additionally the Update provide with an optional method for adopting the new leasing guidance. The optional transition method allows entities to apply the new guidance at the adoption date by recognizing a cumulative-effect adjustment to the opening balance of the retained earnings, and not to restate the comparative periods presented. The Company has elected to use the practical expedient, and optional method of adoption as set-forth in this Update.



In June 2016, FASB issued ASU 2016-13, Financial Instruments- Credit Losses (Topic 326). The FASB is issuing this Update to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The Update requires enhanced disclosures and judgments in estimating credit losses and also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. This amendment is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company has formed a project team that is responsible for oversight of the Company's implementation strategy for compliance with provisions of the new standard. An external provider specializing in community bank loss driver and CECL reserving model design as well as other related consulting services has been retained, and the Company has begun to evaluate potential CECL modeling alternatives. As part of this process, the Company has determined potential loan pool segmentation and sub-segmentation under CECL, as well as evaluated the key economic loss drivers for each segment. The Company presently plans to generate and evaluate model scenarios under CECL in tandem with its current reserving processes for interim and annual reporting periods in 2019. While the Company is currently unable to reasonably estimate the impact of adopting this new guidance, management expects the impact of adoption will be significantly influenced by the composition and quality of the Company's loans and investment securities as well as the economic conditions as of the date of adoption. The Company also anticipates significant changes to the processes and procedures for calculating the reserve for credit losses and continues to evaluate the potential impact on the Company's consolidated financial statements.

In January 2017, FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350). The FASB is issuing this Update to eliminate the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge. Instead, entities will record an impairment charge based on the excess of a reporting unit's carrying amount over its fair value. This ASU will be effective for public business entities for annual periods beginning after December 15, 2019 (i.e. calendar periods beginning on January 1, 2020, and

interim periods therein. The Company does not expect any impact on the Company's consolidated financial statements resulting from the adoption of this Update.

In March 2017, FASB issued ASU 2017-08 – Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The provisions of the update require premiums recognized upon the purchase of callable debt securities to be amortized to the earliest call date in order to avoid losses recognized upon call. For public business entities that are SEC filers the amendments of the update will become effective in fiscal years beginning after December 15, 2018. The Company does not expect the requirements of this Update to have a material impact on the Company's financial position, results of operations or cash flows.

In August 2018, FASB issued ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement. The amendments in this Update modify the disclosure requirements on fair value measurements in Topic 820, Fair Value Measurement, based on the concepts within FASB's Concepts Statement, including the consideration of costs and benefits. The amendment calls for the removal, modification, and addition of certain disclosure aspects to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures. The amendments of the update will become effective in fiscal years beginning after December 15, 2019. The Company does not expect the requirements of this Update to have a material impact on the Company's financial position, results of operations or cash flows.

In October 2018, FASB issued ASU 2018-16, Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes. The amendments in this Update allow entities to designate a change in the benchmark interest rate utilized for fixed-rate financial instruments, from the previously utilized LIBOR rate. For public business entities amendments of the update will become effective in fiscal years beginning after December 15, 2019. The Company continues to review the potential impact resulting from such a change. As of December 31, 2018, the Company

continues to utilize the LIBOR rate for fixed-rate financial instruments.

Reclassifications – Certain reclassifications have been made to prior year financial statements to confirm to the classifications used in 2018. None of the reclassifications had an impact on equity or net income.

2. Investment Securities

Following is a comparison of the amortized cost and approximate fair value of investment securities at December 31, 2018 and December 31, 2017:

<i>(In thousands)</i>				
December 31, 2018				
<u>Securities available for sale:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
U.S. Government agencies	\$36,665	\$117	(255)	\$36,527
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	30,289	51	(441)	29,899
Total securities available for sale	\$66,954	\$168	\$(696)	\$66,426
December 31, 2017				
<u>Securities available for sale:</u>				
U.S. Government agencies	\$19,683	\$312	\$ (41)	\$19,954
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	22,391	56	(416)	22,031
Total securities available for sale	\$42,074	\$368	\$(457)	\$41,985

There were no sales of securities and no gross realized losses on available-for-sale securities and no gross gains during the years ended December 31, 2018, 2017, and 2016. There were no other-than-temporary impairment losses during the years ended December 31, 2018, 2017, and 2016.

The amortized cost and fair value of securities available for sale at December 31, 2018, by contractual maturity,

are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns. Mutual funds are included in the "due in one year or less" category below.

December 31, 2018		
<i>(In thousands)</i>	Amortized Cost	Fair Value (Carrying Amount)
Due in one year or less	\$ —	\$ —
Due after one year through five years	—	—
Due after five years through ten years	4,721	4,710
Due after ten years	31,944	31,816
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	30,289	29,900
	\$66,954	\$66,426

At December 31, 2018 and 2017, available-for-sale securities with an amortized cost of approximately \$58,790,000 and \$34,781,000 (fair value of \$58,263,000 and \$34,543,000) were pledged as collateral for FHLB borrowings, securitized deposits, and public funds balances, respectively.

The Company had no held-to-maturity or trading securities at December 31, 2018 and 2017.

Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other-than-temporary.

The following summarizes temporarily impaired investment securities at December 31, 2018 and 2017:

(In thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
December 31, 2018						
<u>Securities available for sale:</u>						
U.S. Government agencies	\$19,085	\$(148)	\$ 6,874	\$(107)	\$25,959	\$(255)
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	—	—	16,681	(441)	16,681	(441)
Total impaired securities	\$19,085	\$(148)	\$23,555	\$(548)	\$42,640	\$(696)
December 31, 2017						
<u>Securities available for sale:</u>						
U.S. Government agencies	\$ 1,728	\$ (3)	\$ 6,625	\$ (38)	\$ 8,353	\$ (41)
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	7,483	(154)	13,583	(262)	21,066	(416)
Total impaired securities	\$ 9,211	\$(157)	\$20,208	\$(300)	\$29,419	\$(457)

Temporarily impaired securities at December 31, 2018, were comprised of eight U.S. Government agency securities, and thirteen U.S. Government sponsored entities & agencies collateralized by mortgage obligations. Temporarily impaired securities at December 31, 2017, were comprised of four U.S. Government agency securities, and eleven U.S. Government sponsored entities & agencies collateralized by mortgage obligations.

The Company evaluates investment securities for other-than-temporary impairment ("OTTI") at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities of high credit quality are generally evaluated for OTTI under ASC Topic 320-10, "Investments – Debt and Equity Instruments." Certain purchased beneficial interests, including non-agency

mortgage-backed securities, asset-backed securities, and collateralized debt obligations, are evaluated under ASC Topic 325-40, "Beneficial Interest in Securitized Financial Assets."

In the first segment, the Company considers many factors in determining OTTI, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to the Company at the time of the evaluation.

The second segment of the portfolio uses the OTTI guidance that is specific to purchased beneficial interests

including private label mortgage-backed securities. Under this model, the Company compares the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. An OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

Other-than-temporary-impairment occurs when the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis, the other-than-temporary-impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, the other-than-temporary-impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary-impairment related to the credit loss is recognized in earnings, and is determined based on the difference between the present value of cash flows expected to be collected and the current amortized cost of the security. The amount of the total other-than-temporary-impairment related to other factors shall be recognized in other comprehensive (loss) income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary-impairment recognized in earnings shall become the new amortized cost basis of the investment.

At December 31, 2018, the decline in fair value of the eight U.S. government agency securities, and the thirteen U.S. government sponsored entities and agencies collateralized by mortgage obligations securities is attributable to changes in interest rates, and not credit quality. Because the Company does not have the intent to sell these impaired securities, and it is not more likely than not that it will be required to sell these securities before its anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired as of December 31, 2018.

As of December 31, 2017, marketable equity securities with a fair value of \$3,737,000 were recorded within investment securities available for sale with unrealized losses recorded through comprehensive income and accumulated other comprehensive income. As of January 1, 2018, the Company adopted Accounting Standard Update ("ASU") 2016-01 and reclassified its marketable equity securities from investments available for sale into a separate component of investment securities. The ASU requires marketable equity securities to be reported at fair value with changes recorded through earnings. As of January 1, 2018, unrealized losses of \$184,000 were reversed from accumulated other comprehensive income to retained earnings.

During the year ended December 31, 2018, the Company recognized \$78,000 of unrealized losses related to marketable equity securities held at December 31, 2018 in the consolidated statements of income.

The Company had no held-to-maturity or trading securities at December 31, 2018 or December 31, 2017.

3. Loans

Loans are comprised of the following.

<i>(In thousands)</i>	December 31,	
	2018	2017
Commercial and business loans	\$ 55,929	\$ 46,065
Government program loans	1,049	961
Total commercial and industrial	56,978	47,026
Real estate – mortgage:		
Commercial real estate	229,448	221,032
Residential mortgages	59,431	84,804
Home improvement and home equity loans	321	457
Total real estate mortgage	289,200	306,293
Real estate construction and development	108,795	122,970
Agricultural	61,149	59,481
Installment and student loans	71,811	65,581
Total loans	\$587,933	\$601,351

The Company's loans are predominantly in the San Joaquin Valley, and the greater Oakhurst/East Madera County area, as well as the Campbell area of Santa Clara County, although the Company does participate in loans with other financial institutions, primarily in the state of California.

Commercial and industrial loans represent 9.7% of total loans at December 31, 2018, and are generally made to support the ongoing operations of small-to-medium sized commercial businesses. Commercial and industrial loans have a high degree of industry diversification and provide, working capital, financing for the purchase of manufacturing plants and equipment, or funding for growth and general expansion of businesses. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of real estate mortgage loans generally comes from the cash flow of the borrower.

Real estate mortgage loans, representing 49.2% of total loans at December 31, 2018, are secured by trust deeds on primarily commercial property, but are also secured by trust deeds on single family residences. Repayment of real estate mortgage loans is generally from the cash flow of the borrower.

- Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and commercial properties, including: office buildings, shopping centers; apartments and motels; owner occupied buildings; manufacturing facilities and more. Commercial real estate mortgage loans can also be used to refinance existing debt. Although real estate associated with the business is the primary collateral for commercial real estate mortgage loans, the underlying real estate is not the source of repayment. Commercial real estate loans are made under the premise that the loan will be repaid from the borrower's business operations, rental income associated with the real property, or personal assets.
- Residential mortgage loans are provided to individuals to finance or refinance single-family residences. Residential mortgages are not a primary business line offered by the Company, and a majority are conventional mortgages that were purchased as a pool. Most residential mortgages originated by the Company are of a shorter term than conventional mortgages, with maturities ranging from three to fifteen years on average.
- Home Improvement and Home Equity loans comprise a relatively small portion of total real estate mortgage loans, and are offered to borrowers for the purpose of home improvements, although the proceeds may be used for other purposes. Home equity loans are

generally secured by junior trust deeds, but may be secured by 1st trust deeds.

Real estate construction and development loans, representing 18.5% of total loans at December 31, 2018, consist of loans for residential and commercial construction projects, as well as land acquisition and development, or land held for future development. Loans in this category are secured by real estate including improved and unimproved land, as well as single-family residential, multi-family residential, and commercial properties in various stages of completion. All real estate loans have established equity requirements. Repayment on construction loans is generally from long-term mortgages with other lending institutions obtained at completion of the project.

Agricultural loans represent 10.4% of total loans at December 31, 2018, and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Installment loans represent 12.2% of total loans at December 31, 2018 and generally consist of loans to individuals for household, family, student loans, and other personal expenditures such as credit cards, automobiles or other consumer items. See Note 4 – Student Loans for specific information on the student loan portfolio.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At December 31, 2018 and 2017, these financial instruments include commitments to extend credit of \$144,643,000 and

\$99,958,000, respectively, and standby letters of credit of \$1,183,000 and \$2,058,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The Company uses the same credit policies as it does for on-balance sheet instruments.

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. Substantially all of these commitments are at floating interest rates based on the Prime rate. Commitments generally have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

Loans to directors, officers, principal shareholders and their affiliates are summarized below:

<i>(In thousands)</i>	December 31,	
	2018	2017
Aggregate amount outstanding, beginning of year	\$3,729	\$5,838
New loans or advances during year	4,380	440
Repayments during year	(701)	(2,549)
Aggregate amount outstanding, end of year	\$7,408	\$3,729
Undisbursed commitments, end of year	\$4,740	\$7,470

Past Due Loans

The Company monitors delinquency and potential problem loans on an ongoing basis through weekly reports to the Loan Committee and monthly reports to the Board of Directors.

The following is a summary of delinquent loans at December 31, 2018 (in thousands):

December 31, 2018	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and business loans	\$ —	\$ —	\$ —	\$ —	\$ 55,929	\$ 55,929	\$ —
Government program loans	—	—	—	—	1,049	1,049	—
Total commercial and industrial	—	—	—	—	56,978	56,978	—
Commercial real estate loans	—	—	389	389	229,059	229,448	—
Residential mortgages	32	—	—	32	59,399	59,431	—
Home improvement and home equity loans	—	—	—	—	321	321	—
Total real estate mortgage	32	—	389	421	288,779	289,200	—
Real estate construction and development loans	—	—	8,825	8,825	99,970	108,795	—
Agricultural loans	—	—	—	—	61,149	61,149	—
Installment and student loans	130	139	—	269	71,362	71,631	—
Overdraft protection lines	—	—	—	—	41	41	—
Overdrafts	—	—	—	—	139	139	—
Total installment and student loans	130	139	—	269	71,542	71,811	—
Total loans	\$162	\$139	\$9,214	\$9,515	\$578,418	\$587,933	\$ —

The following is a summary of delinquent loans at December 31, 2017 (in thousands):

December 31, 2017	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and business loans	\$ —	\$ —	\$ 212	\$ 212	\$ 45,853	\$ 46,065	\$ —
Government program loans	—	—	—	—	961	961	—
Total commercial and industrial	—	—	212	212	46,814	47,026	—
Commercial real estate loans	779	—	—	779	220,253	221,032	—
Residential mortgages	—	—	94	94	84,710	84,804	—
Home improvement and home equity loans	—	—	—	—	457	457	—
Total real estate mortgage	779	—	94	873	305,420	306,293	—
Real estate construction and development loans	—	—	360	360	122,610	122,970	360
Agricultural loans	—	—	—	—	59,481	59,481	—
Installment and student loans	—	—	—	—	65,446	65,446	125
Overdraft protection lines	—	—	—	—	38	38	—
Overdrafts	—	—	—	—	97	97	—
Total installment and student loans	—	—	—	—	65,581	65,581	125
Total loans	\$779	\$ —	\$ 666	\$1,445	\$599,906	\$601,351	\$485

Nonaccrual Loans

Commercial, construction and commercial real estate loans are placed on non-accrual status under the following circumstances:

- When there is doubt regarding the full repayment of interest and principal.
- When principal and/or interest on the loan has been in default for a period of 90-days or more, unless the asset is both well secured and in the process of collection that will result in repayment in the near future.
- When the loan is identified as having loss elements and/or is risk rated "8" Doubtful.

Other circumstances which jeopardize the ultimate collectability of the loan include certain troubled debt restructurings, identified loan impairment, and certain loans to facilitate the sale of OREO.

Loans meeting any of the preceding criteria are placed on non-accrual status and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

All loans, outside of student loans, where principal or interest is due and unpaid for 90 days or more are placed on nonaccrual and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income. See Note 4 – Student Loans for specific information on the student loan portfolio.

When a loan is placed on non-accrual status and subsequent payments of interest (and principal) are received, the interest received may be accounted for in two separate ways.

Cost recovery method: If the loan is in doubt as to full collection, the interest received in subsequent payments is diverted from interest income to a valuation reserve and treated as a reduction of principal for financial reporting purposes.

Cash basis: This method is only used if the recorded investment or total contractual amount is expected to be fully collectible, under which circumstances the subsequent payments of interest is credited to interest income as received.

Loans on non-accrual status are usually not returned to accruing status unless and until all delinquent principal and/or interest has been brought current, there is no identified element of loss, and current and continued satisfactory performance is expected (loss of the contractual amount not the carrying amount of the loan). Repayment ability is generally demonstrated through the timely receipt of at least six monthly payments on a loan with monthly amortization.

There were no remaining undisbursed commitments to extend credit on nonaccrual loans at December 31, 2018 and 2017.

The following is a summary of nonaccrual loan balances at December 31, 2018 and 2017 (in thousands).

	December 31,	
	2018	2017
Commercial and business loans	\$ —	\$ 212
Government program loans	—	—
Total commercial and industrial	—	212
Commercial real estate loans	389	454
Residential mortgages	—	288
Home improvement and home equity loans	—	—
Total real estate mortgage	389	742
Real estate construction and development loans	11,663	4,342
Agricultural loans	—	—
Installment and student loans	—	—
Total installment and student loans	—	—
Total loans	\$12,052	\$5,296

Impaired Loans

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, including principal and interest, according to the contractual terms of the loan agreement.

The Company applies its normal loan review procedures in making judgments regarding probable losses and loan impairment. The Company evaluates for impairment those loans on nonaccrual status, graded doubtful, graded substandard or those that are troubled debt restructures. The primary basis for inclusion in impaired status under generally accepted accounting pronouncements is that it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement.

A loan is not considered impaired if there is merely an insignificant delay or shortfall in the amounts of payments and the Company expects to collect all amounts due, including interest accrued, at the contractual interest rate for the period of the delay.

Review for impairment does not include large groups of smaller balance homogeneous loans that are collectively evaluated to estimate the allowance for loan losses. The Company's present allowance for loan losses methodology, including migration analysis, captures required reserves for these loans in the formula allowance.

For loans determined to be impaired, the Company evaluates impairment based upon either the fair value of underlying collateral, discounted cash flows of expected payments, or observable market price.

- For loans secured by collateral including real estate and equipment, the fair value of the collateral less selling costs will determine the carrying value of the loan. The difference between the recorded investment in the loan and the fair value, less selling costs, determines the amount of impairment. The Company uses the measurement method based on fair value of collateral when the loan is collateral dependent and foreclosure is probable. For loans that are not considered collateral dependent, a discounted cash flow methodology is used.
- The discounted cash flow method of measuring the impairment of a loan is used for impaired loans that are not considered to be collateral dependent. Under this method, the Company assesses both the amount and timing of cash flows expected from impaired loans. The estimated cash flows are discounted using the loan's effective interest rate. The difference between the amount of the loan on the Bank's books and the discounted cash flow amounts determines the amount of impairment to be provided. This method is used for most of the Company's troubled debt restructurings or other impaired loans where some payment stream is being collected.

- The observable market price method of measuring the impairment of a loan is only used by the Company when the sale of loans or a loan is in process.

The method for recognizing interest income on impaired loans is dependent on whether the loan is on nonaccrual status or is a troubled debt restructure. For income recognition, the existing nonaccrual and troubled debt restructuring policies are applied to impaired loans. Generally, except for certain troubled debt restructurings which are performing under the restructure agreement,

the Company does not recognize interest income received on impaired loans, but reduces the carrying amount of the loan for financial reporting purposes.

Loans other than certain homogeneous loan portfolios are reviewed on a quarterly basis for impairment. Impaired loans are written down to estimated realizable values by the establishment of specific reserves for loan utilizing the discounted cash flow method, or charge-offs for collateral-based impaired loans, or those using observable market pricing.

The following is a summary of impaired loans at December 31, 2018 (in thousands).

December 31, 2018	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance (1)	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment (2)	Interest Recognized (2)
Commercial and business loans	\$ 2,513	\$ 470	\$2,054	\$ 2,524	\$ 787	\$ 2,955	\$179
Government program loans	291	292	—	292	—	254	20
Total commercial and industrial	2,804	762	2,054	2,816	787	3,209	199
Commercial real estate loans	1,305	389	919	1,308	394	1,370	60
Residential mortgages	2,028	391	1,646	2,037	75	2,412	117
Home improvement and home equity loans	—	—	—	—	—	—	—
Total real estate mortgage	3,333	780	2,565	3,345	469	3,782	177
Real estate construction and development loans	11,663	11,663	—	11,663	—	9,144	331
Agricultural loans	543	—	818	818	520	1,014	81
Installment and student loans	41	41	—	41	—	48	5
Total installment and student loans	41	41	—	41	—	48	5
Total impaired loans	\$18,384	\$13,246	\$5,437	\$18,683	\$1,776	\$17,197	\$793

(1) The recorded investment in loans includes accrued interest receivable of \$299.

(2) Information is based on the twelve month period ended December 31, 2018.

The following is a summary of impaired loans at December 31, 2017 (in thousands).

December 31, 2017	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance (1)	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment (2)	Interest Recognized (2)
Commercial and business loans	\$ 3,255	\$ 381	\$2,887	\$ 3,268	\$ 534	\$ 3,791	\$229
Government program loans	49	50	—	50	—	219	5
Total commercial and industrial	3,304	431	2,887	3,318	534	4,010	234
Commercial real estate loans	1,233	—	1,245	1,245	385	1,138	79
Residential mortgages	3,040	1,199	1,852	3,051	103	2,745	142
Home improvement and home equity loans	—	—	—	—	—	—	—
Total real estate mortgage	4,273	1,199	3,097	4,296	488	3,883	221
Real estate construction and development loans	5,951	5,972	—	5,972	—	6,660	418
Agricultural loans	1,200	1	1,203	1,204	866	1,179	48
Installment and student loans	—	—	—	—	—	241	—
Total installment and student loans	—	—	—	—	—	241	—
Total impaired loans	\$14,728	\$7,603	\$7,187	\$14,790	\$1,888	\$15,973	\$921

(1) The recorded investment in loans includes accrued interest receivable of \$62.

(2) Information is based on the twelve month period ended December 31, 2017.

In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms for a reasonable period of time, income is recognized under the accrual method.

Troubled Debt Restructurings

Under the circumstances, when the Company grants a concession to a borrower as part of a loan restructuring, the restructuring is accounted for as a troubled debt restructuring (TDR). TDRs are reported as a component of impaired loans.

A TDR is a type of restructuring in which the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession (either imposed by court order, law, or agreement between the borrower and the Bank) to the borrower that it would not otherwise consider. Although the restructuring may take different forms, the Company's objective is to maximize recovery of its investment by granting relief to the borrower.

A TDR may include, but is not limited to, one or more of the following:

- A transfer from the borrower to the Company of receivables from third parties, real estate, other assets, or an equity interest in the borrower is granted to fully or partially satisfy the loan.
- A modification of terms of a debt such as one or a combination of:
 - The reduction (absolute or contingent) of the stated interest rate.
 - The extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
 - The reduction (absolute or contingent) of the face amount or maturity amount of debt as stated in the instrument or agreement.
 - The reduction (absolute or contingent) of accrued interest.

For a restructured loan to return to accrual status there needs to be, among other factors, at least 6 months successful payment history. In addition, the Company performs a financial analysis of the credit to determine whether the borrower has the ability to continue to meet payments over the remaining life of the loan. This includes, but is not limited to, a review of financial statements and cash flow analysis of the borrower. Only after

determination that the borrower has the ability to perform under the terms of the loans, will the restructured credit be considered for accrual status. Although the Company does not have a policy which specifically addresses when a loan may be removed from TDR classification, as a matter of practice, loans classified as TDRs generally remain classified as such until the loan either reaches maturity or its outstanding balance is paid off.

The following tables illustrate TDR activity for the periods indicated (dollars in thousands):

	Year ended December 31, 2018				
	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and business loans	—	\$—	\$—	—	\$ —
Government program loans	—	—	—	—	—
Commercial real estate term loans	—	—	—	1	393
Single family residential loans	—	—	—	—	—
Home improvement and home equity loans	—	—	—	—	—
Real estate construction and development loans	—	—	—	1	310
Agricultural loans	—	—	—	—	—
Installment and student loans	—	—	—	—	—
Overdraft protection lines	—	—	—	—	—
Total loans	—	\$—	\$—	2	\$703

	Year Ended December 31, 2017				
	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and business loans	1	\$ 69	\$ 69	—	\$ —
Government program loans	1	178	178	—	—
Commercial real estate term loans	—	—	—	—	—
Single family residential loans	2	404	404	—	—
Home improvement and home equity loans	—	—	—	—	—
Real estate construction and development loans	1	790	790	1	288
Agricultural loans	3	2,112	2,112	—	—
Installment and student loans	—	—	—	—	—
Overdraft protection lines	—	—	—	—	—
Total loans	8	\$3,553	\$3,553	1	\$288

The following tables summarize TDR activity by loan category for the years ended December 31, 2018 and 2017 (in thousands).

Twelve Months Ended December 31, 2018	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Student Loans	Total
Beginning balance	\$436	\$1,233	\$2,542	\$—	\$5,951	\$1,200	\$—	\$11,362
Defaults	—	(393)	—	—	(310)	—	—	(703)
Principal (reductions) additions	(249)	511	(513)	—	(2,803)	(388)	—	(3,442)
Charge-offs	(112)	(46)	—	—	—	—	(158)	(37)
Ending balance	\$ 75	\$1,305	\$2,029	\$—	\$2,838	\$ 812	\$—	\$ 7,059
Allowance for loan loss	\$ —	\$ 394	\$ 75	\$—	\$ —	\$ 520	\$—	\$ 989

Twelve Months Ended December 31, 2017	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Student Loans	Total
Beginning balance	\$1,356	\$1,454	\$2,368	\$—	\$6,267	\$ —	\$965	\$12,410
Defaults	—	—	—	—	(288)	—	—	(288)
Additions	247	—	404	—	790	2,112	—	3,553
Principal (reductions) additions	(1,139)	(221)	(221)	—	(818)	(912)	(965)	(4,276)
Charge-offs	(28)	—	(9)	\$—	\$ —	\$ —	\$ —	(37)
Ending balance	\$ 436	\$1,233	\$2,542	\$—	\$5,951	\$1,200	\$ —	\$11,362
Allowance for loan loss	\$ 9	\$ 385	\$ 109	\$—	\$ —	\$ 866	\$ —	\$ 1,369

The Company makes various types of concessions when structuring TDRs including rate reductions, payment extensions, and forbearance. At December 31, 2018, the Company had 17 restructured loans totaling \$7,059,000, as compared to 25 restructured loans totaling \$11,362,000 at December 31, 2017. The Company had no unfunded commitments standing for TDRs at December 31, 2018 and December 31, 2017.

Credit Quality Indicators

As part of its credit monitoring program, the Company utilizes a risk rating system which quantifies the risk the Company estimates it has assumed during the life of a loan. The system rates the strength of the borrower and

the facility or transaction, and is designed to provide a program for risk management and early detection of problems.

For each new credit approval, credit extension, renewal, or modification of existing credit facilities, the Company assigns risk ratings utilizing the rating scale identified in this policy. In addition, on an on-going basis, loans and credit facilities are reviewed for internal and external influences impacting the credit facility that would warrant a change in the risk rating. Each loan credit facility is to be given a risk rating that takes into account factors that materially affect credit quality.

When assigning risk ratings, the Company evaluates two risk rating approaches, a facility rating and a borrower rating as follows.

Facility Rating:

The facility rating is determined by the analysis of positive and negative factors that may indicate that the quality of a particular loan or credit arrangement requires that it be rated differently from the risk rating assigned to the borrower. The Company assesses the risk impact of these factors:

Collateral – The rating may be affected by the type and quality of the collateral, the degree of coverage, the economic life of the collateral, liquidation value and the Company's ability to dispose of the collateral.

Guarantees – The value of third party support arrangements varies widely. Unconditional guaranties from persons with demonstrable ability to perform are more substantial than that of closely related persons to the borrower who offer only modest support.

Unusual Terms – Credit may be extended on terms that subject the Company to a higher level of risk than indicated in the rating of the borrower.

Borrower Rating:

The borrower rating is a measure of loss possibility based on the historical, current and anticipated financial characteristics of the borrower in the current risk environment. To determine the rating, the Company considers at least the following factors:

- Quality of management
- Liquidity
- Leverage/capitalization
- Profit margins/earnings trend
- Adequacy of financial records
- Alternative funding sources
- Geographic risk
- Industry risk
- Cash flow risk
- Accounting practices
- Asset protection
- Extraordinary risks

The Company assigns risk ratings to loans other than consumer loans and other homogeneous loan pools based on the following scale. The risk ratings are used when determining borrower ratings as well as facility

ratings. When the borrower rating and the facility ratings differ, the lowest rating applied is:

- *Grades 1 and 2* – These grades include loans which are given to high quality borrowers with high credit quality and sound financial strength. Key financial ratios are generally above industry averages and the borrower's strong earnings history or net worth. These may be secured by deposit accounts or high-grade investment securities.
- *Grade 3* – This grade includes loans to borrowers with solid credit quality with minimal risk. The borrower's balance sheet and financial ratios are generally in line with industry averages, and the borrower has historically demonstrated the ability to manage economic adversity. Real estate and asset-based loans assigned this risk rating must have characteristics, which place them well above the minimum underwriting requirements for those departments. Asset-based borrowers assigned this rating must exhibit extremely favorable leverage and cash flow characteristics, and consistently demonstrate a high level of unused borrowing capacity.
- *Grades 4 and 5* – These include "pass" grade loans to borrowers of acceptable credit quality and risk. The borrower's balance sheet and financial ratios may be below industry averages, but above the lowest industry quartile. Leverage is above and liquidity is below industry averages. Inadequacies evident in financial performance and/or management sufficiency are offset by readily available features of support, such as adequate collateral, or good guarantors having the liquid assets and/or cash flow capacity to repay the debt. The borrower may have recognized a loss over three or four years, however recent earnings trends, while perhaps somewhat cyclical, are improving and cash flows are adequate to cover debt service and fixed obligations. Real estate and asset-borrowers fully comply with all underwriting standards and are performing according to projections would be assigned this rating. These also include grade 5 loans which are "leveraged" or on management's "watch list." While still considered pass loans (loans given a grade 5), the borrower's financial condition, cash flow or operations evidence more than average risk and short term weaknesses, these loans warrant a higher than average level of monitoring, supervision and attention from the Company, but do not reflect

credit weakness trends that weaken or inadequately protect the Company's credit position. Loans with a grade rating of 5 are not normally acceptable as new credits unless they are adequately secured or carry substantial endorser/guarantors.

- *Grade 6* – This grade includes “special mention” loans which are loans that are currently protected but are potentially weak. This generally is an interim grade classification and should usually be upgraded to an Acceptable rating or downgraded to Substandard within a reasonable time period. Weaknesses in special mention loans may, if not checked or corrected, weaken the asset or inadequately protect the Company's credit position at some future date. Special mention loans are often loans with weaknesses inherent from the loan origination, loan servicing, and perhaps some technical deficiencies. The main theme in special mention credits is the distinct probability that the classification will deteriorate to a more adverse class if the noted deficiencies are not addressed by the loan officer or loan management.
- *Grade 7* – This grade includes “substandard” loans which are inadequately supported by the current sound net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well-defined weakness or weaknesses that may impair the regular liquidation of the debt.

Substandard loans exhibit a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Substandard loans also include impaired loans.

- *Grade 8* – This grade includes “doubtful” loans which exhibit the same characteristics as the Substandard loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include a proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.
- *Grade 9* – This grade includes loans classified “loss” which are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off the asset even though partial recovery may be achieved in the future.

The following tables summarize the credit risk ratings for commercial, construction, and other non-consumer related loans for December 31, 2018 and 2017. The Company did not carry any loans graded as loss at December 31, 2018 or December 31, 2017.

December 31, 2018 (In thousands)	Real Estate				
	Commercial and Industrial	Commercial Real Estate	Construction and Development	Agricultural	Total
Grades 1 and 2	\$ 324	\$ 2,881	\$ —	\$ 80	\$ 3,285
Grade 3	—	1,028	—	—	1,028
Grades 4 and 5 – pass	53,843	222,970	97,132	60,256	434,201
Grade 6 – special mention	48	2,180	—	—	2,228
Grade 7 – substandard	2,763	389	11,663	813	15,628
Grade 8 – doubtful	—	—	—	—	—
Total	\$56,978	\$229,448	\$108,795	\$61,149	\$456,370

December 31, 2017 <i>(In thousands)</i>	Real Estate				Total
	Commercial and Industrial	Commercial Real Estate	Construction and Development	Agricultural	
Grades 1 and 2	\$ 342	\$ 2,954	\$ —	\$ 70	\$ 3,366
Grade 3	251	1,569	—	—	1,820
Grades 4 and 5 – pass	43,264	207,568	104,549	56,817	412,198
Grade 6 – special mention	—	8,487	720	994	10,201
Grade 7 – substandard	3,169	454	17,701	1,600	22,924
Grade 8 – doubtful	—	—	—	—	—
Total	\$47,026	\$221,032	\$122,970	\$59,481	\$450,509

The Company follows consistent underwriting standards outlined in its loan policy for consumer and other homogeneous loans but, does not specifically assign a risk rating when these loans are originated. Consumer loans are monitored for credit risk and are considered “pass” loans until some issue or event requires that the credit be downgraded to special mention or worse.

The following tables summarize the credit risk ratings for consumer related loans and other homogeneous loans for December 31, 2018 and 2017 (in thousands).

	December 31, 2018				December 31, 2017			
	Residential Mortgages	Home Improvement and Home Equity	Installment and Student Loans	Total	Residential Mortgages	Home Improvement and Home Equity	Installment and Student Loans	Total
Not graded	\$49,563	\$300	\$70,990	\$120,853	\$69,249	\$433	\$63,565	\$133,247
Pass	9,186	21	780	9,987	13,899	24	2,011	15,934
Special Mention	470	—	—	470	643	—	—	643
Substandard	212	—	41	253	1,013	—	5	1,018
Doubtful	—	—	—	—	—	—	—	—
Total	\$59,431	\$321	\$71,811	\$131,563	\$84,804	\$457	\$65,581	\$150,842

Allowance for Loan Losses

The Company analyzes risk characteristics inherent in each loan portfolio segment as part of the quarterly review of the adequacy of the allowance for loan losses. The following summarizes some of the key risk characteristics for the eleven segments of the loan portfolio (Consumer loans include three segments):

Commercial and industrial loans – Commercial loans are subject to the effects of economic cycles and tend to exhibit increased risk as economic conditions deteriorate, or if the economic downturn is prolonged. The Company considers this segment to be one of higher risk given the size of individual loans and the balances in the overall portfolio.

Government program loans – This is a relatively a small part of the Company’s loan portfolio, but has historically had a high percentage of loans that have migrated from pass to substandard given their vulnerability to economic cycles.

Commercial real estate loans – This segment is considered to have more risk in part because of the vulnerability of commercial businesses to economic cycles as well as the exposure to fluctuations in real estate prices because most of these loans are secured by real estate. Losses in this segment have however been historically low because most of the loans are real estate secured, and the bank maintains appropriate loan-to-value ratios.

Residential mortgages – This segment is considered to have low risk factors both from the Company and peer statistics.

These loans are secured by first deeds of trust. The losses experienced over the past sixteen quarters are isolated to approximately six loans and are generally the result of short sales.

Home improvement and home equity loans – Because of their junior lien position, these loans have an inherently higher risk level. Because residential real estate has been severely distressed in the recent past, the anticipated risk for this loan segment has increased.

Real estate construction and development loans – This segment of loans is considered to have a higher risk profile due to construction and market value issues in conjunction with normal credit risks.

Agricultural loans – This segment is considered to have risks associated with weather, insects, and marketing issues. In addition, concentrations in certain crops or certain agricultural areas can increase risk. Additionally, from time

to time, California experiences severe droughts, which could significantly harm the business of our customers and the credit quality of the loans to those customers. We closely monitor the water resources and the related issues affecting our customers, and will remain vigilant for signs of deterioration within the loan portfolio in an effort to manage credit quality and work with borrowers where possible to mitigate any losses.

Installment and student loans (Includes consumer loans, student loans, overdrafts, and overdraft protection lines) – This segment is higher risk because many of the loans are unsecured. Additionally, in the case of student loans, there are increased risks associated with liquidity as there is a significant time lag between funding of a student loan and eventual repayment. The Company is still evaluating the impact of ReliaMax's insolvency and the elimination of the Surety Bond on the Company's allowance for loan loss related to student loans.

The following summarizes the activity in the allowance for credit losses by loan category for the years ended December 31, 2018 and 2017 (in thousands).

December 31, 2018	Commercial and Industrial	Real Estate Mortgage	Real Estate Construction and Development Loans	Agricultural	Installment and Student Loans	Unallocated	Total
Beginning balance	\$1,408	\$1,182	\$2,903	\$1,631	\$ 887	\$1,256	\$9,267
Provision (recovery of provision) for credit losses	(739)	(149)	(479)	(500)	766	(663)	(1,764)
Charge-offs	(98)	(47)	—	—	(409)	—	(554)
Recoveries	1,102	29	—	—	315	—	1,446
Net recoveries (charge-offs)	1,004	(18)	—	—	(94)	—	892
Ending balance	\$1,673	\$1,015	\$2,424	\$1,131	\$1,559	\$593	\$8,395
Period-end amount allocated to:							
Loans individually evaluated for impairment	787	469	—	520	—	—	1,776
Loans collectively evaluated for impairment	886	546	2,424	611	1,559	593	6,619
Ending balance	\$1,673	\$1,015	\$2,424	\$1,131	\$1,559	\$ 593	\$8,395

December 31, 2017	Commercial and Industrial	Real Estate Mortgage	Real Estate Construction and Development Loans	Agricultural	Installment and Student Loans	Unallocated	Total
Beginning balance	\$1,843	\$1,430	\$3,378	\$ 666	\$ 888	\$ 697	\$8,902
Provision (recovery of provision) for credit losses	(493)	(320)	(475)	944	(191)	559	24
Charge-offs	(122)	(23)	—	—	(18)	—	(163)
Recoveries	180	95	—	21	208	—	504
Net recoveries (charge-offs)	58	72	—	21	190	—	341
Ending balance	\$1,408	\$1,182	\$2,903	\$1,631	\$887	\$1,256	\$9,267
Period-end amount allocated to:							
Loans individually evaluated for impairment	534	488	—	866	—	—	1,888
Loans collectively evaluated for impairment	874	694	2,903	765	887	1,256	7,379
Ending balance	\$1,408	\$1,182	\$2,903	\$1,631	\$ 887	\$1,256	\$9,267

The following summarizes information with respect to the loan balances at December 31, 2018 and 2017.

<i>(In thousands)</i>	December 31, 2018		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans
Commercial and business loans	\$ 2,524	\$ 53,405	\$ 55,929
Government program loans	292	757	1,049
Total commercial and industrial	2,816	54,162	56,978
Commercial real estate loans	1,308	228,140	229,448
Residential mortgage loans	2,037	57,394	59,431
Home improvement and home equity loans	—	321	321
Total real estate mortgage	3,345	285,855	289,200
Real estate construction and development loans	11,663	97,132	108,795
Agricultural loans	818	60,331	61,149
Installment and student loans	41	71,770	71,811
Total loans	\$18,683	\$569,250	\$587,933

December 31, 2017

<i>(In thousands)</i>	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans
Commercial and business loans	\$ 3,268	\$ 42,797	\$ 46,065
Government program loans	50	911	961
Total commercial and industrial	3,318	43,708	47,026
Commercial real estate loans	1,245	219,787	221,032
Residential mortgage loans	3,051	81,753	84,804
Home improvement and home equity loans	—	457	457
Total real estate mortgage	4,296	301,997	306,293
Real estate construction and development loans	5,972	116,998	122,970
Agricultural loans	1,204	58,277	59,481
Installment and student loans	—	65,581	65,581
Total loans	\$14,790	\$586,561	\$601,351

4. Student Loans

Included in installment loans are \$68,221,000 and \$59,853,000 in student loans at December 31, 2018 and 2017 made to medical and pharmacy school students. Upon graduation the loan is automatically placed on deferment for 6 months. This may be extended up to 48 months for graduates enrolling in Internship, Medical Residency or Fellowship. As approved the student may receive additional deferment for hardship or administrative reasons in the form of forbearance for a maximum of 24 months throughout the life of the loan. Accrued interest on loans that had not entered repayment status totaled \$5,494,000 at December 31, 2018 and \$4,261,000 at December 31, 2017. At December 31, 2018 there were 595 loans within repayment, deferment, and forbearance which represented \$15,526,000, \$1,945,000, and \$7,336,000, respectively. At December 31, 2017, there were 180 loans within repayment, deferment, and forbearance which represented \$6,473,000, \$1,128,000 and \$1,981,000, respectively. As of December 31, 2017 the student loan portfolio was insured through a surety bond issued by ReliaMax Surety Company which provided us a reasonable expectation of collection. As such the allowance calculated for the portfolio was included within the calculation of our general reserves. In June 2018, ReliaMax Surety Company was declared insolvent by the South Dakota Division of Insurance and is now in liquidation. As a result of the

insolvency, we assessed the risks within the student loan portfolio and determined that along with the calculation of the general reserve of \$880,000 an additional allowance of \$640,000 was appropriate for a total reserve against the student loan portfolio of \$1,520,000 as of December 31, 2018. At December 31, 2017 the reserve against the student loan portfolio was \$772,000. There were no TDR's within the portfolio as of December 31, 2018 or 2017.

We utilize Reunion Student Loan Finance Corporation ("RSLFC") as our third-party servicer for the student loan portfolio. RSLFC provides servicing for the student loan portfolio, including application administration, processing, approval, documenting, funding, and collection. They also provide file custodial responsibilities. Except in cases where applicants/loans do not meet program requirements, or extreme delinquency, we are reliant on RSLFC for complete program management. We pay RSLFC a monthly servicing fee based on the principal balance outstanding. Interest income on the student loan portfolio offsets this expense, and is presented net of expense within loan interest income.

The following tables summarize the credit quality indicators for outstanding student loans as of December 31, 2018 and December 31, 2017 (in 000's, except for number of borrowers):

	December 31, 2018			December 31, 2017		
	Number of Loans	Amount	Accrued Interest	Number of Loans	Amount	Accrued Interest
School	1,056	\$42,852	\$5,494	1,216	\$48,825	\$3,973
Grace	23	562	81	55	1,446	166
Repayment	366	15,526	118	201	6,473	40
Deferment	48	1,945	79	32	1,128	45
Forbearance	181	7,336	212	50	1,981	37
Claim	—	—	—	—	—	—
Total	1,674	\$68,221	\$5,984	1,554	\$59,853	\$4,261

School – The time in which the borrower is still actively in school at least half time. No payments are expected during this stage, though the borrower may begin immediate payments.

Grace – A six month period of time granted to the borrower immediately upon graduation, or if deemed no longer an active student. Interest continues to accrue. Upon completion of the six month grace period the loan is transferred to repayment status. Additionally, if applicable, this status may represent a borrower activated to military duty while in their in-school period, they will be allowed to return to that status once their active duty has expired. The borrower must return to an at least half time status within six months of the active duty end date in order to return to an in-school status.

Repayment – The time in which the borrower is no longer actively in school at least half time, and has not received an approved grace, deferment, or forbearance. Regular payment is expected from these borrowers under an allotted payment plan.

Deferment – May be granted up to 48 months for borrowers who have begun the repayment period on their loans but are (1) actively enrolled in an eligible school at least half time, or (2) are actively enrolled in an approved and verifiable medical residency, internship, or fellowship program.

Forbearance – The period of time during which the borrower may postpone making principal and interest payments, which may be granted for either hardship or administrative reasons. Interest will continue to accrue on loans during periods of authorized forbearance. If the borrower is delinquent at the time the forbearance

is granted, the delinquency will be covered by the forbearance and all accrued and unpaid interest from the date of delinquency or if none, from the date of beginning of the forbearance period, will be capitalized at the end of each forbearance period. The term of the loan will not change and payments may be increased to allow the loan to pay off in the required time frame. A forbearance that results in only a delay in payment considered insignificant, is not a concessionary change in terms provided the borrower affirms the obligation. Forbearance is not an uncommon status designation, this designation is standard industry practice, and is consistent with the succession of students migrating to employed medical professionals.

Claim – Occurs after a loan has been delinquent for a period of time in which the servicer believes payment may not be received. A claim can be filed at any point in the delinquency, but typically not until 180 – 210 days. ReliaMax Surety Company was declared insolvent by the South Dakota Division of Insurance and is now in liquidation. No future claims will be filed with ReliaMax.

Student Loan Aging

Student loans are generally charged off at the end of the month during which an account becomes 120 days contractually past due. Accrued but unpaid interest related to charged off student loans is reversed and charged against interest income. As of December 31, 2018, \$26,000 in accrued interest receivable was reversed, due to charge-offs of \$388,000 within the student loan portfolio.

The following tables summarize the student loan aging for loans in repayment and forbearance as of December 31, 2018 and December 31, 2017 (in 000's, except for number of borrowers):

	December 31, 2018		December 31, 2017	
	Number of Borrowers	Amount	Number of Borrowers	Amount
Current or less than 31 days	248	\$22,534	148	\$8,237
31 – 60 days	2	130	2	92
61 – 90 days	4	140	—	—
91 – 120 days	1	58	3	125
Total	255	\$22,862	153	\$8,454

5. Premises and Equipment

The components of premises and equipment are as follows:

(In thousands)	December 31,	
	2018	2017
Land	\$ 968	\$ 968
Buildings and improvements	15,756	15,648
Furniture and equipment	10,492	9,642
	27,216	26,258
Less accumulated depreciation and amortization	(17,379)	(16,093)
Total premises and equipment	\$ 9,837	\$10,165

Total depreciation expense on Company premises and equipment totaled \$1,352 and \$1,335, for the years ended December 31, 2018 and 2017, respectively, and is included in occupancy expense in the accompanying consolidated statements of operations.

6. Investment in Limited Partnership

The Bank owns limited interests in private limited partnerships that acquire affordable housing properties in California that generate Low Income Housing Tax Credits under Section 42 of the Internal Revenue Code of 1986, as amended. The Bank's limited partnership investment is accounted for under the equity method. The Bank's noninterest expense associated with the utilization and expiration of these tax credits for the years ended December 31, 2018, 2017, and 2016 was \$25,000, \$109,000, and \$158,000 respectively. These limited partnership investments are expected to generate tax credits of approximately \$1.8 million over the life of the investment. No tax credits were available for income tax purposes for the years ended December 31, 2018, 2017, and 2016.

The Bank owns a 3.67% interest in a limited partnership which provides private capital for small to mid-sized businesses used to finance later stage growth, strategic acquisitions, ownership transitions, and recapitalizations, or mezzanine capital. At December 31, 2018 and December 31, 2017, the total investment in limited partnerships was \$1,911,000, and \$1,601,000, respectively. The investment was accounted for under the equity method. Income for the years ended December 31, 2018, 2017, and 2016 was \$0, \$7,200, and \$900 respectively. Remaining unfunded commitments as of December 31, 2018 totaled \$3,089,000.

7. Deposits

Deposits include the following.

<i>(In thousands)</i>	December 31, 2018	December 31, 2017
Noninterest-bearing deposits	\$292,720	\$307,299
Interest-bearing deposits:		
NOW and money market accounts	340,445	234,154
Savings accounts	90,046	81,408
Time deposits:		
Under \$250,000	60,875	51,687
\$250,000 and over	21,557	13,145
Total interest-bearing deposits	512,923	380,394
Total deposits	\$805,643	\$687,693

At December 31, 2018, the scheduled maturities of all certificates of deposit and other time deposits are as follows:

<i>(In thousands)</i>	December 31, 2018	December 31, 2017
One year or less	\$66,407	\$48,704
More than one year, but less than or equal to two years	12,834	13,460
More than two years, but less than or equal to three years	993	738
More than three years, but less than or equal to four years	1,279	508
More than four years, but less than or equal to five years	819	1,422
Greater than five years	100	—
	\$82,432	\$64,832

Deposit balances representing overdrafts reclassified as loan balances totaled \$139,000 and \$293,000 as of December 31, 2018 and 2017, respectively.

Deposits of directors, officers and other related parties to the Bank totaled \$7,222,000 and \$8,747,000 at December 31, 2018 and 2017, respectively. The rates paid on these deposits were similar to those customarily paid to the Bank's customers in the normal course of business.

8. Short-term Borrowings/Other Borrowings

At December 31, 2018, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling \$287,446,000, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$4,119,000. At December 31, 2018, the Company had uncollateralized lines of credit with Pacific Coast Bankers Bank ("PCBB") and Union Bank totaling \$10,000,000 each and a Fed Funds line of \$20,000,000 with Zions First National Bank. At December 31, 2018, and for the year then ended, the Company had

no outstanding borrowing balances. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time. These lines of credit have interest rates that are generally tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by the Company's stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of December 31, 2018, \$4,338,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, \$421,393,000 in real estate-secured loans were pledged at December 31, 2018, as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling \$287,446,000. At December 31, 2018, the Company had no outstanding borrowing balances.

The Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling \$305,236,000, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$13,363,000 at December 31, 2017. At December 31, 2017, the Company had uncollateralized

lines of credit with Pacific Coast Bankers Bank ("PCBB") and Union Bank totaling \$10,000,000 each and a Fed Funds line of \$20,000,000 with Zions First National Bank. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by the Company's stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of December 31, 2017, \$17,049,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, \$473,364,000 in secured and unsecured loans were pledged at December 31, 2017, as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling \$305,236,000. At December 31, 2017, and for the year then ended, the Company had no outstanding borrowing balances.

All lines of credit are on an "as available" basis and can be revoked by the grantor at any time.

9. Junior Subordinated Debt/Trust Preferred Securities

During July 2007, the Company formed USB Capital Trust II, a wholly-owned special purpose entity, for the purpose of issuing Trust Preferred Securities. USB Capital Trust II is a Variable Interest Entity (VIE) and a deconsolidated entity pursuant to ASC 810. On July 23, 2007, USB Capital Trust II issued \$15 million in Trust Preferred securities. The securities have a thirty-year maturity and bear a floating rate of interest (repricing quarterly) of 1.29% over the three-month LIBOR rate (initial coupon rate of 6.65%). Interest will be paid quarterly. Concurrent with the issuance of the Trust Preferred securities, USB Capital Trust II used the proceeds of the Trust Preferred securities offering to purchase a like amount of junior subordinated debentures of the Company. The Company will pay interest on the junior subordinated debentures to USB Capital Trust II, which represents the sole source of dividend distributions to the holders of the Trust Preferred securities. The Company may redeem the junior subordinated debentures at anytime at par.

The Company elected the fair value measurement option for all the Company's new junior subordinated debentures issued under USB Capital Trust II.

Effective September 30, 2009 and beginning with the quarterly interest payment due October 1, 2009, the Company elected to defer interest payments on the Company's \$15.0 million of junior subordinated debentures relating to its trust preferred securities. The terms of the debentures and trust indentures allow for

the Company to defer interest payments for up to 20 consecutive quarters without default or penalty. During the period that the interest deferrals were elected, the Company continued to record interest expense associated with the debentures. As of June 30, 2014, the Company ended the extension period, paid all accrued and unpaid interest, and is currently making quarterly interest payments. At December 31, 2018 and 2017, the Company had \$113,000 and \$80,000, respectively, in accrued and unpaid interest on the junior subordinated debt.

During August 2015, the Bank purchased \$3.0 million of the Company's junior subordinated debentures related to the Company's trust preferred securities at a fair value discount of 40%. Subsequently, in September 2015, the Company purchased those shares from the Bank and canceled \$3.0 million in par value of the junior subordinated debentures, realizing a \$78,000 gain on redemption. The contractual principal balance of the Company's debentures relating to its trust preferred securities is \$12.0 million, with a recorded value of \$9.6 million, as of December 31, 2018.

Effective January 1, 2018, the Company elected ASU 2016-01 which modified the recognition and measurement of Financial Assets and Liabilities. Upon adoption of the standard, the fair value determined for the period would be disaggregated and the portion of the total change in the fair value, resulting from a change in the instrument-specific credit risk, would be separately presented within other comprehensive income. The remaining change in the fair value determined for the period, resulting from changes in the LIBOR rate, would continue to be presented as a component of noninterest income on the consolidated statements of income. As of January 1, 2018 a cumulative effect adjustment of \$1,482,000 was made to accumulated other comprehensive income.

At December 31, 2018 the Company performed a fair value measurement analysis on its junior subordinated debt using a cash flow model approach to determine the present value of those cash flows. The cash flow model utilizes the forward 3-month LIBOR curve to estimate future quarterly interest payments due over the thirty-year life of the debt instrument. These cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for additional credit and liquidity risks associated with the junior subordinated debt. We believe the 5.86% discount rate used represents what a market participant would consider under the circumstances based on current

market assumptions. At December 31, 2018, the total cumulative gain recorded on the debt is \$2,400,000.

The net fair value calculation performed as of December 31, 2018 resulted in a pretax loss adjustment of \$392,000 (\$278,000, net of tax) for the twelve months ended December 31, 2018, compared to a pretax loss adjustment of \$882,000 (\$519,000, net of tax) for the twelve months ended December 31, 2017. As part of the adoption of ASU 2016-01, for the twelve months ended December 31, 2018, net fair value gains and losses are separately identified as the portion attributed to non-instrument specific credit risk, recognized as a component of noninterest income on

the consolidated statements of income, and instrument specific credit risk, recognized in other comprehensive income.

For the twelve months ended December 31, 2018, the net \$392,000 (\$278,000, net of tax) fair value loss adjustment was separately presented as a \$424,000 loss (\$301,000, net of tax) recognized on the consolidated statements of income, and a \$32,000 gain (\$23,000, net of tax) associated with the instrument specific credit risk recognized in other comprehensive income. The adoption of ASU 2016-01's resulting impact on basic and diluted earnings per share was less than \$0.01.

10. Taxes on Income

The tax effects of significant items comprising the Company's net deferred tax assets (liabilities) are as follows:

(In thousands)	December 31,	
	2018	2017
Deferred tax assets:		
Credit losses not currently deductible	\$2,925	\$3,055
Deferred compensation	1,319	1,300
Depreciation	178	324
Accrued reserves	95	90
Write-down on other real estate owned	89	35
Unrealized gain on AFS	195	196
Unrealized gain on retirement obligation	155	104
Interest on nonaccrual loans	187	29
Other	830	361
Total deferred tax assets	5,973	5,494
Deferred tax liabilities:		
State Tax	(251)	(152)
FHLB dividend	(46)	(46)
Loss on limited partnership investment	(870)	(873)
Deferred gain ASC 825 – fair value option	(91)	(896)
Fair value adjustments for purchase accounting	(98)	(99)
Unrealized loss on TRUPs	(631)	—
Deferred loan costs	(695)	(835)
Specific reserve charge-offs	(54)	(43)
Prepaid expenses	(63)	(161)
Total deferred tax liabilities	(2,799)	(3,105)
Net deferred tax assets	\$3,174	\$2,389

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. The Company did not record a valuation allowance at December 31, 2018 or December 31, 2017.

Income tax expense for the years ended December 31, consist of the following:

(In thousands)

2018	Federal	State	Total
Current	\$3,890	\$2,227	\$6,117
Deferred	(314)	(471)	(785)
	<u>\$3,576</u>	<u>\$1,756</u>	<u>\$5,332</u>
2017			
Current	\$4,745	\$1,388	\$6,133
Deferred	(881)	1,787	906
	<u>\$3,864</u>	<u>\$3,175</u>	<u>\$7,039</u>
2016			
Current	\$2,642	\$ 28	\$2,670
Deferred	941	1,258	2,199
	<u>\$3,583</u>	<u>\$1,286</u>	<u>\$4,869</u>

A reconciliation of the statutory federal income tax rate to the effective income tax rate is as follows:

	Years Ended December 31,		
	2018	2017	2016
Statutory federal income tax rate	21.0%	34.0%	34.0%
State franchise tax, net of federal income tax benefit	7.2	6.2	6.9
Tax Cuts and Jobs Act impact on deferred re-measurement	0.0	6.3	0.0
Other	(0.7)	(1.6)	(1.2)
	<u>27.5%</u>	<u>44.9%</u>	<u>39.7%</u>

At December 31, 2018, the Company has no remaining federal and state net operating loss carry-forwards.

The Company periodically reviews its tax positions under the accounting standards related to uncertainty in income taxes, which defines the criteria that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term, "more likely than not", means a likelihood of more than 50 percent. In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority and all available information is known to the taxing authority.

The Company's 2017 results include the impact of the enactment of the Tax Cuts and Jobs Act, which was

signed into law on December 22, 2017. The law includes significant changes to the U.S. corporate tax system, including a Federal corporate rate change reduction from 34% to 21%. In 2017, the Company applied this newly enacted corporate federal income tax of 21%, resulting in approximately a \$986,000 increase to tax expense due to a write-down in the deferred tax asset.

The Company and its subsidiary file income tax returns in the U.S federal jurisdiction, and several states within the U.S. There are no filings in foreign jurisdictions. During 2014, the Company began the process to amend its state tax returns for the years 2009 through 2012 to file a combined report on a unitary basis with the Company and USB Investment Trust. The amended return for 2009 was filed during 2014, the 2010 return was filed during 2015, and the amended returns for 2011 and 2012 were filed in 2016. The Company is no longer subject to examination for years before 2014.

The Company's policy is to recognize any interest or penalties related to uncertain tax positions in income tax expense. Interest and penalties recognized during the periods ended December 31, 2018 and 2017 were insignificant.

11. Stock Based Compensation

Options and restricted stock units and awards have been granted to officers and key employees at an exercise price equal to estimated fair value at the date of grant as determined by the Board of Directors. All options, units, and awards granted are service awards, and as such are based solely upon fulfilling a requisite service period (the vesting period). At December 31, 2018, the Company had two stock based compensation plans.

In May 2005, the Company adopted the United Security Bancshares 2005 Stock Option Plan (2005 Plan) for which 34,601 shares remain reserved for issuance for options already granted to employees and directors under incentive and nonstatutory agreements. The 2005 plan expired in May 2015. While outstanding arrangements to issue shares under this plan, including options, continue in force until their expiration, no new options will be granted under this plan.

In May 2015, the Company adopted the United Security Bancshares 2015 Equity Incentive Award Plan (2015 Plan). The 2015 Plan provides for the granting of up to 758,000 shares of authorized and unissued shares of common stock in the form of stock options, restricted

stock units, and restricted stock awards. The 2015 Plan requires that the exercise price may not be less than the fair value of the stock at the date the option is granted, and that the option price must be paid in full at the time it is exercised.

The options granted (incentive stock options for employees and non-qualified stock options for Directors) have an exercise price at the prevailing market price on the date of grant. All options granted are exercisable 20% each year commencing one year after the date of grant and expire ten years after the date of grant. Restricted stock awards are granted at the prevailing market price of the Company's stock and typically vest over a five-year period. Restricted stock awards are subject to forfeiture if employment terminates prior to vesting. The cost of these awards is recognized over the vesting period of the awards based on the fair value of our common stock on the date of the grant.

Under the 2005 Plan, 34,601 granted options are outstanding (34,601 incentive stock options and 0 nonqualified stock options) as of December 31, 2018, of which 33,485 are vested. No options were granted under this plan during the year ended December 31, 2018.

Under the 2015 Plan, 119,217 granted stock instruments are outstanding as of December 31, 2018, of which 12,000 are exercisable. Of the 119,217 granted stock instruments, 59,217 are restricted stock units.

A summary of the status of the Company's stock option plan and changes during the year are presented below:

	Shares (a)	Weighted Average Exercise Price
Options outstanding December 31, 2017	94,601	\$7.87
Granted during the year	—	—
Exercised during the year	—	—
Forfeited during the year	—	—
Options outstanding December 31, 2018	94,601	\$7.87

A summary of the status of the Company's restricted stock and changes during the year are presented below:

	Shares (a)	Weighted Average Grant- Date Fair Value
Non-vested units at December 31, 2017	46,511	\$ 9.57
Granted during the year	108,799	10.51
Vested during the year	61,007	10.39
Forfeited during the year	35,086	10.71
Non-vested units at December 31, 2018	59,217	\$ 9.77

Included in total outstanding options at December 31, 2018, are 45,485 exercisable shares at a weighted average price of \$5.54, a weighted average remaining contract term of 7.24 years and intrinsic value of \$205,000.

Included in salaries and employee benefits for the years ended December 31, 2018, 2017, and 2016, is \$744,000, \$97,000, and \$30,000 of share-based compensation, respectively. The related tax benefit on share-based

compensation recorded in the provision for income taxes was not material to any year.

As of December 31, 2018, 2017, and 2016, there was \$321,000, \$418,000, and \$30,000, respectively, of total unrecognized compensation expense related to nonvested stock options. This cost is expected to be recognized over a weighted average period of approximately 7.24 years.

A summary of the status of the Company's stock option values and activity is presented below:

	December 31, 2018	December 31, 2017
Weighted average grant-date fair value per share of stock options granted	\$ —	\$ 7.18
Total fair value of stock options vested	\$12,788	\$17,845
Total intrinsic value of stock options exercised	\$ —	\$12,383

As of December 31, 2018, 2017, and 2016, there was \$537,000, \$439,000, and \$35,000, respectively, of total unrecognized compensation expense related to restricted stock. This cost is expected to be recognized over a weighted-average period of approximately 6.59 years.

The Bank determines fair value of stock options at grant date using the Black-Scholes-Merton pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividend yield and the risk-free interest rate over the expected life of the option. The Bank determines fair value of restricted stock based on the quoted stock price as of the grant date.

The weighted average assumptions used in the pricing model are noted in the table below. The expected term of options granted is derived from management's experience, which is based upon historical data on employee exercise and post-vesting behavior. The risk free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatility is based on the historical volatility of the Bank's stock over a period commensurate with the expected term of the options. The Company believes that historical volatility is indicative of expectations about its future volatility over the expected term of the options.

The Bank expenses the fair value of the option on a straight-line basis over the vesting period for each separately vesting portion of the award. The Bank

estimates forfeitures and only recognizes expense for those shares expected to vest. Based upon historical evidence, the Company has determined that because options are granted to a limited number of key employees rather than a broad segment of the

employee base, expected forfeitures, if any, are not material. The Company granted 61,007 restricted stock units and no stock options during 2018. The Company granted 41,917 restricted stock units and 60,000 options during 2017.

The assumptions used for the 2018, 2017, and 2016 awards are as follows:*

	Year Ended December 31, 2017	Year Ended December 31, 2016
Risk Free Interest Rate	1.94%	—%
Expected Dividend Yield	—%	—%
Expected Life in Years	10 years	0 years
Expected Price Volatility	62.60%	—%

* No stock option grants in 2018.

The Black-Scholes-Merton option valuation model requires the input of highly subjective assumptions, including the expected life of the stock based award and stock price volatility. The assumptions listed above represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, the Bank's recorded stock-based compensation expense could have been materially different from that previously reported in proforma disclosures. In addition, the Bank is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If the Bank's actual forfeiture rate is materially different from the estimate, the share-based compensation expense could be materially different.

12. Employee Benefit Plans

401K Plan

The Company has a Cash or Deferred 401(k) Stock Ownership Plan (the "401(k) Plan") organized under Section 401(k) of the Code. All employees of the Company are initially eligible to participate in the 401(k) Plan upon the first day of the month after date of hire. Under the terms of the plan, the participants may elect to make contributions to the 401(k) Plan as determined by the Board of Directors. Participants are automatically vested 100% in all employee contributions. Participants may direct the investment of their contributions to

the 401(k) Plan in any of several authorized investment vehicles. The Company contributes funds to the Plan up to 4% of the employees' eligible annual compensation. Company contributions are immediately 100% vested at the time of contribution. The Company made matching contributions of \$266,000, \$255,000, and \$280,000 to the 401(k) Plan for the years ended December 31, 2018, 2017, and 2016, respectively.

Salary Continuation Plan

The Company has an unfunded, non-qualified Salary Continuation Plan for senior executive officers and certain other key officers of the Company, which provides additional compensation benefits upon retirement for a period of at least 15 years. Future compensation under the Plan is earned by the employees for services rendered through retirement and vests over a period of 12 to 32 years. In 2015, the Company entered into Salary Continuation agreements with three officers of the Bank. The Company purchased company owned life insurance (COLI) policies on the life of the officers in connection with the Salary Continuation agreements. Life insurance premium expense totaled \$43,000 for the insurance policies purchased. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the Plan. The Company's current benefit liability is determined based upon vesting and the present value of the benefits at a corresponding discount rate.

The discount rate used is an equivalent rate for high-quality investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which averages approximately 20 years. At December 31, 2018 and 2017, \$4,141,000 and \$4,084,000, respectively, had been accrued to date, based on a discounted cash flow using an average discount rate of 3.66% and 3.04%, respectively, and is included in other liabilities on the consolidated balance sheets. In connection with the implementation of the Salary Continuation Plans, the Company purchased single premium universal life insurance policies on the life of each of the key employees covered under the Plan. The Company is the owner and beneficiary of these insurance policies. The cash surrender value of the policies was \$7,199,000 and \$6,817,000 at December 31, 2018 and 2017, respectively, and is included on the consolidated balance sheet in cash surrender value of life insurance. Income on these policies, net of expense, totaled approximately \$477,000, \$485,000, and \$465,000 for the years ended December 31, 2018, 2017, and 2016, respectively. Although the Plan is unfunded, the Company intends to utilize the proceeds of such policies to settle the Plan obligations. Under Internal Revenue Service regulations, the life insurance policies are the property of the Company and are available to satisfy the Company's general creditors.

Pursuant to the guidance contained in ASC Topic 715 "Compensation," the Company is required to recognize in accumulated other comprehensive (loss) income, the amounts that have not yet been recognized as components of net periodic benefit costs. These unrecognized costs arise from changes in estimated interest rates used in the calculation of net liabilities under the Plan.

As of December 31, 2018, 2017, and 2016, the Company had approximately \$459,000, \$462,000, and \$383,000, respectively in unrecognized net periodic benefit costs arising from changes in interest rates used in calculating the current post-retirement liability required under the Plan. This amount represents the difference between the plan liabilities calculated under net present value calculations, and the net plan liabilities actually recorded on the Company's books at December 31, 2018, 2017, and 2016.

Salary continuation expense is included in salaries and benefits expense, and totaled \$254,000, \$223,000, and

\$137,000 for the years ended December 31, 2018, 2017, and 2016, respectively.

Officer Supplemental Life Insurance Plan

The Company owns single premium Bank-owned life insurance policies (BOLI) and Company owned life insurance policies (COLI) on certain officers with a portion of the death benefits available to the officers' beneficiaries. The BOLI and COLI initial net cash surrender value is equivalent to the premium paid, and it adds income through non-taxable increases in its cash surrender value, net of the cost of insurance, plus any death benefits ultimately received by the Company. The cash surrender value of these insurance policies totaled \$13,045,000 and \$12,935,000 at December 31, 2018 and 2017, and is included on the consolidated balance sheet in cash surrender value of life insurance. These policies resulted in income, net of expense, of approximately \$477,000, \$485,000, and \$465,000 for the years ended December 31, 2018, 2017, and 2016, respectively.

13. Commitments and Contingent Liabilities

Lease Commitments: The Company leases land and premises for its branch banking offices and administration facilities. The initial terms of these leases expire at various dates through 2025. Under the provisions of most of these leases, the Company has the option to extend the leases beyond their original terms at rental rates adjusted for changes reported in certain economic indices or as reflected by market conditions. The total expense on land and premises leased under operating leases was \$933,000, \$922,000, and \$862,000 for the years ended December 31, 2018, 2017, and 2016, respectively.

Future minimum rental commitments under existing non-cancelable leases as of December 31, 2018 are as follows:

(In thousands):

2019	\$ 593
2020	544
2021	349
2022	330
2023	296
Thereafter	627
	<u>\$2,739</u>

Financial Instruments with Off-Balance Sheet Risk: The Company is party to financial instruments with off-balance sheet risk which arise in the normal course of business. These instruments may contain elements of credit risk, interest rate risk and liquidity risk, and include commitments to extend credit and standby letters of credit. The credit risk associated with these instruments is essentially the same as that involved in extending credit to customers and is represented by the contractual amount indicated in the table below:

(In thousands)	Contractual amount – December 31,	
	2018	2017
Commitments to extend credit	\$144,643	\$99,958
Standby letters of credit	1,183	2,058

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. Substantially all of these commitments are at floating interest rates based on the Prime rate, and most have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis, and the amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties. Many of the commitments are expected to expire without being drawn upon and, as a result, the total commitment amounts do not necessarily represent future cash requirements of the Company.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Company's letters of credit are short-term guarantees and generally have terms from less than one month to approximately 3 years. At December 31, 2018, the maximum potential amount of future undiscounted payments the Company could be required to make under outstanding standby letters of credit totaled \$1,183,000.

In the ordinary course of business, the Company becomes involved in litigation arising out of its normal business activities. Management, after consultation with legal counsel, believes that the ultimate liability, if any, resulting from the disposition of such claims would not be material to the financial position of the Company.

14. Fair Value Measurements and Disclosure

The following summary disclosures are made in accordance with the guidance provided by ASC Topic 825 "Fair Value Measurements and Disclosures" (formerly Statement of Financial Accounting Standards No. 107, "Disclosures about Fair Value of Financial Instruments,") which requires the disclosure of fair value information about both on- and off-balance sheet financial instruments where it is practicable to estimate that value.

Generally accepted accounting guidance clarifies the definition of fair value, describes methods used to appropriately measure fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. This guidance applies whenever other accounting pronouncements require or permit fair value measurements.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels (Level 1, Level 2, and Level 3). Level 1 inputs are unadjusted quoted prices in active markets (as defined) for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability, and reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

The table below is a summary of fair value estimates for financial instruments and the level of the fair value hierarchy within which the fair value measurements are categorized at the periods indicated:

December 31, 2018					
<i>(In thousands)</i>	Carrying Amount	Estimated Fair Value	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Financial Assets:					
Cash and cash equivalents	\$220,337	\$220,337	\$220,337	\$ —	\$ —
Investment securities	70,085	70,085	3,659	66,426	—
Loans	579,419	566,195	—	—	566,195
Accrued interest receivable	8,341	8,341	—	8,341	—
Financial Liabilities:					
Deposits:					
Noninterest-bearing	292,720	292,720	292,720	—	—
NOW and money market	340,445	340,445	340,445	—	—
Savings	90,046	90,046	90,046	—	—
Time deposits	82,432	81,745	—	—	81,745
Total deposits	805,643	804,956	723,211	—	81,745
Junior subordinated debt	10,155	10,155	—	—	10,155
Accrued interest payable	57	57	—	57	—

December 31, 2017					
<i>(In thousands)</i>	Carrying Amount	Estimated Fair Value	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Financial Assets:					
Cash and cash equivalents	\$107,934	\$107,934	\$107,934	\$ —	\$ —
Investment securities	45,722	45,722	3,737	41,985	—
Loans	593,123	588,938	—	—	588,938
Accrued interest receivable	6,526	6,526	—	6,526	—
Financial Liabilities:					
Deposits:					
Noninterest-bearing	307,299	307,299	307,299	—	—
NOW and money market	234,154	234,154	234,154	—	—
Savings	81,408	81,408	81,408	—	—
Time deposits	64,832	64,387	—	—	64,387
Total deposits	687,693	687,248	622,861	—	64,387
Junior subordinated debt	9,730	9,730	—	—	9,730
Accrued interest payable	44	44	—	44	—

The Company performs fair value measurements on certain assets and liabilities as the result of the application of current accounting guidelines. Some fair value measurements, such as available-for-sale securities (AFS) and junior subordinated debt are performed on a recurring basis, while others, such as collateral dependent impaired loans, other real estate owned, goodwill and other intangibles, are performed on a nonrecurring basis.

The Company's Level 1 financial assets consist of money market funds and highly liquid mutual funds for which fair values are based on quoted market prices. The Company's Level 2 financial assets include highly liquid debt instruments of U.S. government agencies, collateralized mortgage obligations, and debt

obligations of states and political subdivisions, whose fair values are obtained from readily-available pricing sources for the identical or similar underlying security that may, or may not, be actively traded. The Company's Level 3 financial assets include certain impaired loans, other real estate owned, goodwill, and intangible assets where the assumptions may be made by us or third parties about assumptions that market participants would use in pricing the asset or liability. From time to time, the Company recognizes transfers between Level 1, 2, and 3 when a change in circumstances warrants a transfer. There were no transfers in or out of Level 1 and Level 2 fair value measurements during the year ended December 31, 2018.

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of December 31, 2018 (in 000's):

Description of Assets	December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities (2):				
U.S. Government agencies	\$36,527	\$ —	\$36,527	\$ —
U.S Govt collateralized mortgage obligations	29,899	—	29,899	—
Total AFS securities	66,426	—	66,426	—
Marketable equity securities – mutual funds (2)	3,659	3,659	—	—
Impaired Loans (1):				
Real estate mortgage	389	—	—	389
Total impaired loans	389	—	—	389
Total	\$70,474	\$3,659	\$66,426	\$ 389

Description of Liabilities	December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt (2)	\$10,155	\$ —	\$ —	\$10,155
Total	\$10,155	\$ —	\$ —	\$10,155

(1) Nonrecurring

(2) Recurring

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of December 31, 2017 (in 000's):

Description of Assets	December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities (2):				
U.S. Government agencies	\$19,954	\$ —	\$19,954	\$ —
U.S Govt collateralized mortgage obligations	22,031	—	22,031	—
Total AFS securities	41,985	—	41,985	—
Marketable equity securities – mutual funds (2)	3,737	3,737	—	—
Total	\$45,722	\$3,737	\$41,985	\$ —

Description of Liabilities	December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt (2)	\$ 9,730	\$ —	\$ —	\$9,730
Total	\$ 9,730	\$ —	\$ —	\$9,730

(1) Nonrecurring

(2) Recurring

The Company did not record a write-down on other real estate owned during the years ended December 31, 2018 and 2017. A write-down of \$188,000 was recorded during the year ended December 31, 2016.

The following table presents quantitative information about Level 3 fair value measurements for the Company's assets measured at fair value on a non-recurring basis at December 31, 2018 (in 000's). There were no assets measured at fair value on a non-recurring basis at December 31, 2017.

December 31, 2018				
Financial Instrument	Fair Value	Valuation Technique	Unobservable Input	Adjustment Percentage
Impaired Loans:				
Real estate mortgage	\$389	Fair Value of Collateral Method for Collateral Dependent Loans	Adjustment for difference between appraised value and net realizable value	9.43%

The following methods and assumptions were used in estimating the fair values of financial instruments:

Cash and Cash Equivalents – The carrying amounts reported in the balance sheets for cash and cash equivalents approximate their estimated fair values.

Investments – Available for sale securities are valued based upon open-market price quotes obtained from reputable third-party brokers that actively make a market in those securities. Market pricing is based upon specific CUSIP identification for each individual

security. To the extent there are observable prices in the market, the mid-point of the bid/ask price is used to determine fair value of individual securities. If that data is not available for the last 30 days, a Level 2-type matrix pricing approach based on comparable securities in the market is utilized. Level-2 pricing may include using a forward spread from the last observable trade or may use a proxy bond like a TBA mortgage to come up with a price for the security being valued. Changes in fair market value are recorded through other

comprehensive loss as the securities are available for sale.

Loans – Fair values of variable rate loans, which reprice frequently and with no significant change in credit risk, are based on carrying values adjusted for credit risk. Fair values for all other loans, except impaired loans, are estimated using discounted cash flows over their remaining maturities, using interest rates at which similar loans would currently be offered to borrowers with similar credit ratings and for the same remaining maturities. The allowance for loan loss is considered to be a reasonable estimate of loan discount for credit quality concerns. In accordance with ASU 2016-01, the fair value of loans as of December 31, 2018 are based on the notion of exit price. The fair value of loans as of December 31, 2017 was measured based on the notion of entry price.

Impaired Loans – Fair value measurements for collateral dependent impaired loans are performed pursuant to authoritative accounting guidance and are based upon either collateral values supported by appraisals and observed market prices. Collateral dependent loans are measured for impairment using the fair value of the collateral. Changes are recorded directly as an adjustment to current earnings.

Other Real Estate Owned – Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned (OREO) are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Deposits – In accordance with authoritative accounting guidance, fair values for transaction and savings accounts are equal to the respective amounts payable on demand at December 31, 2018 and 2017 (i.e. carrying amounts). The Company believes that the fair value of these deposits is clearly greater than that prescribed under authoritative accounting guidance. Fair values of fixed-maturity certificates of deposit were estimated using the rates currently offered for deposits with similar remaining maturities.

Junior Subordinated Debt – The fair value of the junior subordinated debt was determined based upon a discounted cash flows model utilizing observable

market rates and credit characteristics for similar debt instruments. In its analysis, the Company used characteristics that market participants generally use, and considered factors specific to (a) the liability, (b) the principal (or most advantageous) market for the liability, and (c) market participants with whom the reporting entity would transact in that market. For the year ended December 31, 2018, cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for credit and liquidity risks associated with similar junior subordinated debt and circumstances unique to the Company. The Company believes that the subjective nature of these inputs, due primarily to the current economic environment, require the junior subordinated debt to be classified as a Level 3 fair value.

Accrued Interest Receivable and Payable – The carrying value of these instruments is a reasonable estimate of fair value.

Off-balance sheet Instruments – Off-balance sheet instruments consist of commitments to extend credit, standby letters of credit and derivative contracts. The contract amounts of commitments to extend credit and standby letters of credit are disclosed in Note 13. Fair values of commitments to extend credit are estimated using the interest rate currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present counterparties' credit standing. There was no material difference between the contractual amount and the estimated value of commitments to extend credit at December 31, 2018 and 2017.

Fair values of standby letters of credit are based on fees currently charged for similar agreements. The fair value of commitments generally approximates the fees received from the customer for issuing such commitments. These fees are not material to the Company's consolidated balance sheet and results of operations.

The following tables provide a reconciliation of liabilities at fair value using significant unobservable inputs (Level 3) on a recurring basis during the period (in 000's):

Reconciliation of Liabilities:

Beginning balance
Total losses included in earnings
Total gains included in OCI
Capitalized interest
Ending balance
The amount of total losses for the period included in earnings attributable to the change in unrealized gains or losses relating to liabilities still held at the reporting date

December 31, 2018	December 31, 2017	December 31, 2016
Junior Subordinated Debt	Junior Subordinated Debt	Junior Subordinated Debt
\$ 9,730	\$8,832	\$8,300
424	882	518
(32)	—	—
33	16	1,050
\$10,155	\$9,730	\$8,832
\$ 424	\$ 882	\$ 518

The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's liabilities classified as Level 3 and measured at fair value on a recurring basis at December 31, 2018 and 2017:

December 31, 2018				December 31, 2017			
Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average	Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average
Subordinated Debt	Discounted cash flow	Discount Rate	5.86%	Subordinated Debt	Discounted cash flow	Discount Rate	5.81%

Management believes that the credit risk adjusted spread utilized in the fair value measurement of the junior subordinated debentures carried at fair value is indicative of the nonperformance risk premium a willing market participant would require under current market conditions, that is, the inactive market. Management attributes the change in fair value of the junior subordinated debentures during the period to market changes in the nonperformance expectations and pricing of this type of debt, and not as a result of changes to our entity-specific credit risk. The narrowing of the credit risk adjusted spread above the Company's contractual spreads has primarily contributed to the negative fair value adjustments. Generally, an increase in the credit risk adjusted spread and/or a decrease in the three month LIBOR swap curve will result in positive fair value adjustments (and decrease the fair value measurement). Conversely, a decrease in the credit risk adjusted spread and/or an increase in the three month LIBOR swap curve will result in negative fair value adjustments (and increase the fair value measurement).

15. Regulatory Matters

Capital Adequacy – The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements adopted by the Board of Governors of the Federal Reserve System (the “Board of Governors”). Failure to meet minimum capital requirements can initiate certain mandates and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements and results of operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the consolidated Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt

corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by the capital adequacy guidelines require insured institutions to maintain a minimum leverage ratio of Tier 1 capital (the sum of common stockholders' equity, noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries, minus intangible assets, identified losses and investments in certain subsidiaries, plus unrealized losses or minus unrealized gains on available for sale securities) to total assets. Institutions which have received the highest composite regulatory rating and which are not experiencing or anticipating significant growth are required to maintain a minimum leverage capital ratio of 3% of Tier 1 capital to total

assets. All other institutions are required to maintain a minimum leverage capital ratio of at least 100 to 200 basis points above the 3% minimum requirement.

The Company has adopted a capital plan that includes guidelines and trigger points to ensure sufficient capital is maintained at the Bank and the Company, and that capital ratios are maintained at a level deemed appropriate under regulatory guidelines given the level of classified assets, concentrations of credit, ALLL, current and projected growth, and projected retained earnings. The capital plan also contains contingency strategies to obtain additional capital as required to fulfill future capital requirements for both the Bank, as a separate legal entity, and the Company on a consolidated basis.

The following table shows the Company's and the Bank's regulatory capital and regulatory capital ratios at December 31, 2018, 2017, and 2016 as compared to the applicable capital adequacy guidelines:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<i>(In thousands)</i>						
As of December 31, 2018 (Company):						
Total Capital (to Risk Weighted Assets)	\$123,525	17.80%	\$55,519	8.00%	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	114,848	16.55%	41,639	6.00%	N/A	N/A
Common Equity Tier 1 (to Risk Weighted Assets)	105,157	15.15%	31,230	4.50%	N/A	N/A
Tier 1 Leverage (to Average Assets)	114,848	12.15%	37,570	4.00%	N/A	N/A
As of December 31, 2018 (Bank):						
Total Capital (to Risk Weighted Assets)	\$122,850	17.70%	\$55,519	8.00%	\$69,399	10.00%
Tier 1 Capital (to Risk Weighted Assets)	114,173	16.45%	41,639	6.00%	55,519	8.00%
Common Equity Tier 1 (to Risk Weighted Assets)	114,173	16.45%	31,230	4.50%	45,109	6.50%
Tier 1 Leverage (to Average Assets)	114,173	12.16%	37,570	4.00%	46,963	5.00%
As of December 31, 2017 (Company):						
Total Capital (to Risk Weighted Assets)	\$115,265	17.54%	\$52,511	8.00%	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	107,043	16.29%	39,383	6.00%	N/A	N/A
Common Equity Tier 1 (to Risk Weighted Assets)	97,313	14.81%	29,537	4.50%	N/A	N/A
Tier 1 Leverage (to Average Assets)	107,043	13.01%	32,732	4.00%	N/A	N/A
As of December 31, 2017 (Bank):						
Total Capital (to Risk Weighted Assets)	\$113,653	17.31%	\$52,511	8.00%	\$65,638	10.00%
Tier 1 Capital (to Risk Weighted Assets)	105,431	16.06%	39,383	6.00%	52,511	8.00%
Common Equity Tier 1 (to Risk Weighted Assets)	105,431	16.06%	29,537	4.50%	42,665	6.50%
Tier 1 Leverage (to Average Assets)	105,431	12.90%	32,732	4.00%	40,865	5.00%

Federal regulations require FDIC-insured depository institutions, including the Bank, to meet several minimum capital standards: a common equity Tier 1 capital to risk-based assets ratio; a Tier 1 capital to risk-based assets ratio; a total capital to risk-based assets; and a Tier 1 capital to total assets leverage ratio. The existing capital requirements were effective January 1, 2015 and are the result of a final rule implementing regulatory amendments based on recommendations of the Basel Committee on Banking Supervision and certain requirements of the Dodd-Frank Act.

The capital standards require the maintenance of common equity Tier 1 capital, Tier 1 capital and Total capital to risk-weighted assets of at least 4.5%, 6% and 8%, respectively. The regulations also establish a minimum required leverage ratio of at least 4% Tier 1 capital. Common equity Tier 1 capital is generally defined as common stockholders' equity and retained earnings. Tier 1 capital is generally defined as common equity Tier 1 and Additional Tier 1 capital. Additional Tier 1 capital generally includes certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries. Total capital includes Tier 1 capital (common equity Tier 1 capital plus Additional Tier 1 capital) and Tier 2 capital. Tier 2 capital is comprised of capital instruments and related surplus meeting specified requirements, and may include cumulative preferred stock and long-term perpetual preferred stock, mandatory convertible securities, intermediate preferred stock and subordinated debt. Also included in Tier 2 capital is the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets and, for institutions that have exercised an opt-out election regarding the treatment of Accumulated Other Comprehensive Income ("AOCI"), up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Institutions that have not exercised the AOCI opt-out have AOCI incorporated into common equity Tier 1 capital (including unrealized gains and losses on available-for-sale securities). Calculation of all types of regulatory capital is subject to deductions and adjustments specified in the regulations.

In determining the amount of risk-weighted assets for purposes of calculating risk-based capital ratios, an institution's assets, including certain off-balance sheet assets (e.g., recourse obligations, direct credit substitutes, residual interests), are multiplied by a risk weight factor

assigned by the regulations based on the risk deemed inherent in the type of asset. Higher levels of capital are required for asset categories believed to present greater risk. For example, a risk weight of 0% is assigned to cash and U.S. government securities, a risk weight of 50% is generally assigned to prudently underwritten first lien one to four-family residential mortgages, a risk weight of 100% is assigned to commercial and consumer loans, a risk weight of 150% is assigned to certain past due loans and a risk weight of between 0% to 600% is assigned to permissible equity interests, depending on certain specified factors.

In addition to establishing the minimum regulatory capital requirements, the regulations limit capital distributions and certain discretionary bonus payments to management if the institution does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets above the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirement is being phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented at 2.5% on January 1, 2019. Institutions that do not maintain the required capital buffer will become subject to progressively most stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to executive management.

Under regulatory guidelines, the \$15 million in Trust Preferred Securities issued by USB Capital Trust II in July of 2007 qualifies as Tier 1 capital up to 25% of Tier 1 capital. Any additional portion of Trust Preferred Securities qualifies as Tier 2 capital. During 2015, a redemption of \$3.0 million junior subordinated debt took place. The current balance of Trust Preferred Securities is \$12 million. As of December 31, 2018, the Company and the Bank meets all capital adequacy requirements to which they are subject.

Dividends – Cash dividends, if any, paid to shareholders are paid by the Company, subject to restrictions set forth in the California Corporations Code and the terms of the Federal Reserve informal supervisory agreement. Dividends paid by the Company during 2018 were in the form of cash dividends. In 2017 dividends were in the form of cash and stock dividends.

The primary source of funds with which cash dividends are paid to shareholders comes from cash dividends

received by the Company from the Bank. The Bank's ability to pay dividends is subject to the restrictions set forth in the California Financial Code. Under the Financial Code, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank's net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the DBO, in an amount not exceeding the greater of: (i) the Bank's retained earnings; (ii) its net income for the last fiscal year; or (iii) its net income for the current fiscal year. During the year ended December 31, 2018 and December 31, 2017, the Bank paid \$6,947,000 and \$4,291,000 in cash dividends to the Company. These dividends funded the Company's operating costs, payments of interest on its junior subordinated debentures, and payments of

cash dividends to shareholders. Approval by the Federal Reserve and the DBO was required for the dividend issued during the first quarter 2017, but subsequently deemed unnecessary alongside the termination of the informal agreements. During the year ended December 31, 2015, a redemption of \$3.0 million junior subordinated debt was approved by both agencies.

Cash Restrictions – The Bank is required to maintain average reserve balances with the Federal Reserve. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program is provided by a third-party vendor, and has been approved by the Federal Reserve Bank.

16. Supplemental Cash Flow Disclosures

(In thousands)	Year Ended December 31,		
	2018	2017	2016
Cash paid during the period for:			
Interest	\$2,690	\$1,792	\$1,362
Income Taxes	7,060	6,863	1,710
Noncash activities:			
OREO financed	—	—	3,766
Unrealized gains on TRUPs	32	—	—
Unrealized gains (losses) on available for sale securities	(362)	16	(648)
Unrealized (losses) gains on unrecognized post retirement costs	5	(6)	(22)
Stock dividends issued	—	1,220	3,949
Cash dividend declared	1,859	1,182	—
Adoption of ASU 2016-01: reclassification of TRUPS to accumulated other comprehensive income	1,482	—	—
Adoption of ASU 2016-01: recognition of previously unrealized losses within CRA Fund	184	—	—

17. Dividends on Common Stock

The Company declared one-percent (1)% common stock dividends for the quarter ended March 31, 2017. All 1% stock dividends were considered “small stock dividends” resulting in a transfer between retained earnings and common stock an amount equal to the number of shares issued in the stock dividend multiplied by the stock’s closing price at the date of declaration. Other than for earnings-per-share calculations and share-based compensation disclosures, shares issued for the stock dividend have been treated prospectively for financial reporting purposes. For purposes of earnings per share calculations, the Company’s weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders for all periods presented.

On March 27, 2018, the Company’s Board of Directors declared a cash dividend of \$0.09 per share on the Company’s common stock. The dividend was payable on April 19, 2018, to shareholders of record as of April 9, 2018. Approximately \$1,521,000 was transferred from retained earnings to cash to allow for distribution of the dividend to shareholders.

On June 26, 2018, the Company’s Board of Directors declared a cash dividend of \$0.09 per share on the Company’s common stock. The dividend was payable on July 19, 2018, to shareholders of record as of July 9, 2018. Approximately \$1,521,000 was transferred from retained earnings to cash to allow for distribution of the dividend to shareholders.

On September 25, 2018, the Company’s Board of Directors declared a cash dividend of \$0.09 per share on the Company’s common stock. The dividend was payable on October 19, 2018, to shareholders of record as of October 9, 2018. Approximately \$1,690,000 was transferred from retained earnings to other liabilities to allow for distribution of the dividend to shareholders.

On December 18, 2018, the Company’s Board of Directors declared a cash dividend of \$0.11 per share on the Company’s common stock. The dividend was payable on January 15, 2019, to shareholders of record as of January 3, 2019. Approximately \$1,859,000 was transferred from retained earnings to other liabilities to allow for distribution of the dividend to shareholders.

During 2017, the Company’s Board of Directors declared cash dividends of \$0.05, \$0.05, \$0.07, and \$0.07, on April 25, 2017, June 27, 2017, September 26, 2017, and December 19, 2017, respectively. On April 25, 2017, The Board of Directors also authorized the repurchase of up to \$3 million of the outstanding common stock of the Company. The timing of the purchases will depend on certain factors, including but not limited to, market conditions and prices, available funds, and alternative uses of capital. The stock repurchase program may be carried out through open-market purchases, block trades, or negotiated private transactions. No shares had been repurchased as of December 31, 2018.

18. Net Income Per Share

The following table provides a reconciliation of the numerator and the denominator of the basic net income per share computation with the numerator and the denominator of the diluted net income per share computation. Prior year amounts have been restated to reflect the impact of stock dividends.

	Year Ended December 31,		
	2018	2017	2016
<i>(In thousands, except earnings per share data)</i>			
Net income available to common shareholders	\$ 14,017	\$ 8,640	\$ 7,385
Weighted average shares outstanding	16,899,960	16,885,587	16,881,379
Add: dilutive effect of stock options	38,812	19,328	7,648
Weighted average shares outstanding adjusted for potential dilution	16,938,772	16,904,915	16,889,027
Basic earnings per share	\$ 0.83	\$ 0.51	\$ 0.44
Diluted earnings per share	\$ 0.83	\$ 0.51	\$ 0.44
Anti-dilutive shares excluded from earnings per share calculation	84,000	98,000	21,000

Dilutive income per share includes the effect of stock options, unvested restricted stock awards, and other potentially dilutive securities using the treasury stock method. There is only one form of outstanding common stock. Holders of unvested restricted stock awards do not receive dividends. Under the two-class method, the difference in EPS is not significant for these participating securities.

19. Common Stock Repurchase Plan

On April 25, 2017, the Company's Board of Directors approved the repurchase of up to \$3 million of the

outstanding common stock of the Company. The timing of the purchases will depend on certain factors, including but not limited to, market conditions and prices, available funds, and alternative uses of capital. The stock repurchase program may be carried out through open-market purchases, block trades, or negotiated private transactions.

The Company did not repurchase any common shares during the years ended December 31, 2018 and 2017.

20. Accumulated Other Comprehensive Income

The components of accumulated other comprehensive income, included in shareholders' equity, are as follows:

	December 31, 2018			December 31, 2017		
(in 000's)	Net unrealized loss on available for sale securities	Unfunded status of the supplemental retirement plans	Net unrealized gain on junior subordinated debentures	Net unrealized loss on available for sale securities	Unfunded status of the supplemental retirement plans	Net unrealized gain on junior subordinated debentures
December 31, 2017	\$(248)	\$(462)	\$ —	\$(221)	\$(383)	\$ —
Reclassifications upon adoption of ASU 2016-01	184	—	1,482	—	—	—
January 1, 2018	(64)	(462)	1,482	(221)	(383)	—
Current period comprehensive (loss) income	(308)	3	23	(27)	(79)	—
December 31, 2018	\$(372)	\$(459)	\$1,505	\$(248)	\$(462)	\$ —
Accumulated other comprehensive income (loss)			\$ 674			\$(710)

21. Parent Company Only Financial Statements

The following are the condensed financial statements of United Security Bancshares and should be read in conjunction with the consolidated financial statements:

United Security Bancshares – (parent only)

Balance Sheets – December 31, 2018 and 2017

(In thousands)

	2018	2017
Assets		
Cash and equivalents	\$ 2,297	\$ 1,656
Investment in bank subsidiary	117,831	109,472
Other assets	1,153	1,136
Total assets	121,281	112,264
Liabilities & Shareholders' Equity		
Liabilities:		
Junior subordinated debt securities (at fair value)	10,155	9,730
Dividends declared	1,859	1,182
Other liabilities	27	—
Total liabilities	12,041	10,912
Shareholders' Equity:		
Common stock, no par value; 20,000,000 shares authorized; issued and outstanding: 16,946,622 at December 31, 2018 and 16,885,615 at December 31, 2017	58,624	57,880
Retained earnings	49,942	44,182
Accumulated other comprehensive income (loss)	674	(710)
Total shareholders' equity	109,240	101,352
Total liabilities and shareholders' equity	\$121,281	\$112,264

United Security Bancshares – (parent only)

Income Statements

(In thousands)

	Year ended December 31,		
	2018	2017	2016
Income			
Loss on fair value of financial liability	\$ (424)	\$ (882)	\$ (518)
Dividends from subsidiary	6,947	4,291	424
Total income	6,523	3,409	(94)
Expense			
Interest expense	422	302	240
Other expense	359	269	241
Total expense	781	571	481
Income (loss) before taxes and equity in undistributed income of subsidiary	5,742	2,838	(575)
Income tax benefit	(356)	(989)	(411)
Undistributed income of subsidiary	7,919	4,813	7,549
Net Income	\$ 14,017	\$ 8,640	\$ 7,385

United Security Bancshares – (parent only)
Statement of Cash Flows
(In thousands)

	Year ended December 31,		
	2018	2017	2016
Cash Flows From Operating Activities			
Net income	\$14,017	\$8,640	\$7,385
Adjustments to reconcile net income to cash provided by operating activities:			
Equity in undistributed income of subsidiary	(9,145)	(4,813)	(7,549)
Provision for deferred income taxes	(111)	(751)	(169)
Loss on fair value option of financial liability	424	882	518
Decrease (increase) in income tax receivable	144	391	(198)
Net change in other assets/liabilities	44	23	15
Net cash provided by operating activities	5,373	4,372	2
Cash Flows From Financing Activities			
Proceeds from exercise of stock options	—	6	6
Dividends paid	(4,732)	(2,870)	—
Net cash (used in) provided by financing activities	(4,732)	(2,864)	6
Net increase (decrease) increase in cash and cash equivalents	641	1,508	8
Cash and cash equivalents at beginning of year	1,656	148	140
Cash and cash equivalents at end of year	\$2,297	\$1,656	\$148

22. Summary of Quarterly Results of Operations (unaudited)

The following table sets forth the results of operations for the four quarters of 2018 and 2017, and is unaudited; however, in the opinion of Management, it reflects all adjustments (which include only normal recurring adjustments) necessary to present fairly the summarized results for such periods.

	2018 Quarters Ended			
<i>(dollars in thousands, except per share data)</i>	December 31,	September 30,	June 30,	March 31,
Interest Income:				
Loans, including fees	\$8,269	\$8,397	\$7,491	\$8,226
Investment securities, interest bearing cash at Banks	1,552	1,157	946	577
Total interest income	9,821	9,554	8,437	8,803
Interest Expense	876	691	659	477
Net Interest Income	8,945	8,863	7,778	8,326
Provision (recovery of provision) for Credit Losses	(65)	(373)	(1,136)	(189)
Net Interest Income after Provision for Credit Losses	9,010	9,236	8,914	8,515
Noninterest Income	1,665	849	1,170	923
Noninterest Expense	5,473	5,143	5,318	5,000
Income Before Provision for Taxes	5,202	4,942	4,766	4,438
Provision for Taxes on Income	1,254	1,424	1,373	1,280
Net Income	\$3,948	\$3,518	\$3,393	\$3,158
Net Income per common share				
Basic	\$ 0.23	\$ 0.21	\$ 0.20	\$ 0.19
Diluted	\$ 0.23	\$ 0.21	\$ 0.20	\$ 0.19

<i>(dollars in thousands, except per share data)</i>	2017 Quarters Ended			
	December 31,	September 30,	June 30,	March 31,
Interest Income:				
Loans, including fees	\$8,035	\$7,978	\$7,579	\$7,225
Investment securities, interest bearing cash at Banks	560	614	531	408
Total interest income	8,595	8,592	8,110	7,633
Interest Expense	451	435	438	405
Net Interest Income	8,144	8,157	7,672	7,228
Provision (recovery of provision) for Credit Losses	48	7	(52)	21
Net Interest Income after Provision for Credit Losses	8,096	8,150	7,724	7,207
Noninterest Income	1,155	1,176	1,066	909
Noninterest Expense	5,260	4,746	4,607	5,190
Income Before Provision for Taxes	3,991	4,580	4,183	2,926
Provision for Taxes on Income	2,354	1,840	1,691	1,155
Net Income	\$1,637	\$2,740	\$2,492	\$1,771
Net Income per common share				
Basic	\$ 0.10	\$ 0.16	\$ 0.15	\$ 0.10
Diluted	\$ 0.10	\$ 0.16	\$ 0.15	\$ 0.10

23. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were issued and no subsequent events occurred requiring accrual or disclosure.

Management's Report on Internal Control Over Financial Reporting

Management of United Security Bancshares, including its consolidated subsidiaries (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, and for performing an assessment of the effectiveness of internal control over financial reporting as of December 31, 2018. The Company's internal control over financial reporting is a process designed under the supervision of the Company's management, including the Chief Executive Officer and Chief Financial Officer, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States.

The Company's system of internal control over financial reporting includes policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Management recognizes that there are inherent limitations in the effectiveness of any system of internal control, and accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation and fair presentation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2018 based upon criteria in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). As a result of this assessment, management has concluded that the Company's internal control over financial reporting is effective as of December 31, 2018.

Moss Adams LLP, the independent registered public accounting firm that audited the Company's consolidated financial statements included in the Report, has issued a report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2018. The report, which expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2018, is included in this Item under the heading "Report of Independent Registered Public Accounting Firm."

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders United Security Bancshares and Subsidiary

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of United Security Bancshares and subsidiaries (the “Company”) as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, changes in shareholders’ equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2018 and 2017, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by COSO.

Basis for Opinions

The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company’s consolidated financial statements and an opinion on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules

and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures

of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



/s/ Moss Adams LLP

Sacramento, California

March 1, 2019

We have served as the Company's auditor since 1999.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The Company

United Security Bancshares, a California corporation, is a bank holding company registered under the BHCA with corporate headquarters located in Fresno, California. The principal business of United Security Bancshares is to serve as the holding company for its wholly-owned subsidiary, United Security Bank. References to the "Bank" refer to United Security Bank together with its wholly-owned subsidiary, USB Investment Trust Inc., a special purpose real estate investment trust organized under Maryland law. References to "we," "us," or the "Company" refer to United Security Bancshares together with its subsidiaries on a consolidated basis. References to the "Holding Company," refer to United Security Bancshares, the parent company, on a stand-alone basis.

Current Trends Affecting Results of Operations and Financial Position

Our overall operations are impacted by a number of factors, including not only interest rates and margin spreads, which impact our results of operations, but also the composition of our balance sheet. One of our primary strategic goals is to maintain a mix of assets that will generate a reasonable rate of return without undue risk, and to finance those assets with a low-cost and stable source of funds. Liquidity and capital resources must also be considered in the planning process to mitigate risk and allow for growth.

Since the Bank primarily conducts banking operations in California's Central Valley, our operations and cash flows are subject to changes in the economic condition of the Central Valley. Our business results are dependent in large part upon the business activity, population, income levels, deposits and real estate activity in the Central Valley, and declines in economic conditions can have adverse material effects upon our financial condition and result of operations.

The residential real estate markets in the five county region from Merced to Kern has strengthened since 2013 and that trend has continued into the fourth quarter of 2018. The severe declines in residential construction and home prices that began in 2008 have ended and home prices are now rising on a year-over-year basis. The sustained period of double-digit price declines from 2008–2011 adversely impacted our operations and increased the levels

of nonperforming assets, increased expenses related to foreclosed properties, and decreased profit margins. As we continue our business development and expansion efforts throughout our market areas, we will also maintain our commitment to the reduction of nonperforming assets and provision of options for borrowers experiencing difficulties. Those options include combinations of rate and term concessions, as well as forbearance agreements with borrowers. Median sales prices and housing start numbers improved in the five county region from Merced to Kern beginning in 2013.

We continue to emphasize relationship banking and core deposit growth, and have focused greater attention on the Bank's market area of Fresno, Madera, and Kern Counties, as well as Campbell, in Santa Clara County. The San Joaquin Valley and other California markets are also exhibiting stronger demand for construction lending and commercial lending from small- and medium-size businesses, as commercial and residential real estate markets have shown improvements.

We continually evaluate our strategic business plan as economic and market factors change in our market area. Balance sheet management, enhancing revenue sources, and maintaining market share were of primary importance to us during 2018 and will continue to be beyond 2018. The previous pressure on net margins as interest rates hit historic lows appears to be waning and we anticipate that interest rates will rise slowly. As a result, market rates of interest and asset quality will continue to be important factors in our ongoing strategic planning process.

Application of Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates,

assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently may result in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When third-party information is not available, valuation adjustments are estimated using our own assumptions in regard to the assumptions that market participants would use in pricing the asset or liability.

The most significant accounting policies we follow are presented in Note 1 to our consolidated financial statements included herein. These policies, along with the disclosures presented in the other financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has identified the determination of the allowance for credit losses, other real estate owned through foreclosure, impairment of investment securities, revenue recognition, nonaccrual income recognition, fair value estimates on junior subordinated debt, valuation for deferred income taxes, and goodwill, to be accounting areas that require the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

Allowance for Credit Losses

The allowance for credit losses represents management's estimate of probable incurred credit losses inherent in the loan portfolio. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the

largest asset type on the consolidated balance sheet. Note 1 to the consolidated financial statements describes the methodology used to determine the allowance for credit losses. A discussion of the factors driving changes in the amount of the allowance for credit losses is included in the Asset Quality and Allowance for Credit Losses section of this financial review.

Other Real Estate Owned

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value of the collateral is charged to the allowance for credit losses. The determination of fair value is generally based upon pre-approved, external appraisals. Subsequent declines in the fair value of other real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense. The fair market valuation of such properties is based upon estimates, and as such, is subject to change as circumstances in our market area, or general economic trends, fluctuate.

Impairment of Investment Securities

Investment securities are impaired when the amortized cost exceeds fair value. We evaluate investment securities for other-than-temporary impairment ("OTTI") at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. Our management considers the extent and duration of the unrealized loss and assesses whether it intends to sell, or it is likely that it will be required to sell the security before the anticipated recovery. If the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings.

For investment securities that do not meet the criteria regarding intent or requirement to sell, we compare the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows to determine OTTI related to credit loss. The amount of OTTI related to credit loss is recognized in earnings, with the balance recognized in other comprehensive income.

Revenue Recognition

Our primary sources of revenue are interest income from loans and investment securities. Interest income is generally recorded on an accrual basis, unless the collection of such income is not reasonably assured or cannot be reasonably estimated. Pursuant to accounting standards related

to revenue recognition, nonrefundable fees and costs associated with originating or acquiring loans are recognized as a yield adjustment to the related loans by amortizing them into income over the term of the loan using a method which approximates the interest method. Other credit-related fees, such as standby letter of credit fees, loan placement fees and annual credit card fees are recognized as noninterest income during the period the related service is performed.

For loans placed on nonaccrual status, the accrued and unpaid interest receivable may be reversed at management's discretion based upon management's assessment of collectability, and interest is thereafter credited to principal to the extent necessary to eliminate doubt as to the collectability of the net carrying amount of the loan.

Fair Value

Effective January 1, 2007, we adopted fair value option accounting standards choosing to apply the standards to our junior subordinated debt. We concurrently adopted the accounting standards related to fair value measurements. The accounting standards related to fair value measurements define how applicable assets and liabilities are to be valued, and requires expanded disclosures about financial instruments carried at fair value. The fair value measurement accounting standard establishes a hierarchical disclosure framework associated with the level of pricing observability utilized in measuring financial instruments at fair value. The degree of judgment utilized in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Financial instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment utilized in measuring fair value. Conversely, financial instruments infrequently traded or not quoted in an active market will generally have little or no pricing observability and a higher degree of judgment utilized in measuring fair value. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. Determining fair values under the accounting standards may include judgments related to measurement factors that may vary from actual transactions executed in the marketplace. For the years ended December 31, 2018 and 2017, we recorded fair value adjustments related to our junior subordinated debt totaling losses of \$392,000 and \$882,000, respectively. (See Notes 9 and 14 of the *Notes to Consolidated*

Financial Statements for additional information about financial instruments carried at fair value.)

Income Taxes

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of our assets and liabilities. Deferred taxes are measured using current tax rates applied to such taxable income in the years in which those temporary differences are expected to be recovered. If our future income is not sufficient to apply the deferred tax assets within the tax years to which they may be applied, the deferred tax asset may not be realized and our income will be reduced. We recorded no valuation allowance against our deferred tax assets at December 31, 2018 and 2017.

On January 1, 2007, we adopted accounting standards related to uncertainty in income taxes. The standard prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Under the accounting standards, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term "more likely than not" means a likelihood of more than 50 percent. In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority.

Pursuant to the accounting standards related to uncertainty in income taxes, we will continue to re-evaluate existing tax positions, as well as new positions as they arise. If we determine in the future that our tax positions are not "more likely than not" to be sustained (as defined) by taxing authorities, we may need to recognize additional tax liabilities.

Results of Operations

Net income for the year ended December 31, 2018 was \$14,017,000 or \$0.83 per share (\$0.83 diluted) compared to \$8,640,000 or \$0.51 per share (\$0.51 diluted) for year ended December 31, 2017. The increase of \$5,377,000 between December 31, 2017 and December 31, 2018 is primarily the result of increases in interest-earning assets and the decrease in the tax rate as a result of the Tax Cuts and Jobs Act enacted in 2017 and effective for tax year 2018. Interest income increased by \$3,685,000, or 11.19%, between December 31, 2017 and December 31, 2018. Taxes on income decreased by \$1,707,000, or 24.25%.

Return on average assets was 1.61% for the year ended December 31, 2018 compared to 1.07% for the year ended December 31, 2017. Return on average equity was 13.23% for the year ended December 31, 2018 compared to 8.63% for the year ended December 31, 2017.

As with variances in net income, changes in the return on average assets and average equity experienced by the Company during 2018 and 2017 were effected by increases in average loan balances and net interest income.

The following table sets forth certain selected financial data for each of the years in the five-year periods ended December 31, 2018, and should be read in conjunction with the more detailed information and financial statements contained elsewhere herein:

<i>(In thousands except per share data and ratios)</i>	2018	2017	2016	2015	2014
Selected Financial Ratios:					
Return on average assets	1.61%	1.07%	0.98%	0.98%	0.93%
Return on average shareholders' equity	13.23%	8.63%	7.86%	7.88%	7.80%
Average shareholders' equity to average assets	12.14%	12.46%	12.43%	12.41%	11.88%
Dividend payout ratio	33.76%	33.21%	—%	—%	—%

Net Interest Income

Net interest income, the most significant component of earnings, is the difference between the interest and fees received on earning assets and the interest paid on interest-bearing liabilities. Earning assets consist primarily of loans, and to a lesser extent, investments in securities issued by federal, state and local authorities, and corporations, as well as interest-bearing deposits and overnight investments in federal funds loaned to other financial institutions. These earning assets are funded by a combination of interest-bearing and noninterest-bearing liabilities, primarily customer deposits, and may include short-term and long-term borrowings.

Net interest income before provision (benefit) for credit losses was \$33,912,000 for the year ended December 31, 2018, representing an increase of \$2,712,000, or 8.69%, compared to net interest income before provision for credit losses of \$31,200,000 for the year ended December 31, 2017. Although market rates of interest are at historically low levels, our disciplined deposit pricing efforts have helped maintain adequate margins. Our net interest margin, as shown in Table 1 below, increased to 4.28% for the year ended December 31, 2018, when compared to 4.27% for the year ended December 31, 2017 and 4.11% for the year ended December 31, 2016.

Table 1. – Distribution of Average Assets, Liabilities and Shareholders' Equity:

The following table summarizes the distribution of average assets, liabilities and shareholders' equity, as well as interest income and yields earned on average interestearning assets and interest expense and rates paid on average interestbearing liabilities, presented on a tax equivalent basis for the years indicated:

	2018			2017			2016		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
<i>(Dollars in thousands)</i>									
Assets:									
Interest-earning assets:									
Loans and leases (1)	\$581,221	\$32,383	5.57%	\$569,079	\$30,817	5.42%	\$540,777	\$28,182	5.21%
Investment Securities – taxable	54,838	1,146	2.09%	52,513	901	1.72%	49,612	825	1.66%
Interest-bearing deposits in other banks	—	—	—%	644	5	0.78%	1,517	8	0.53%
Interest-bearing deposits in FRB	157,222	3,086	1.96%	108,218	1,207	1.12%	90,393	458	0.51%
Total interest-earning assets	793,281	\$36,615	4.62%	730,454	\$32,930	4.51%	682,299	\$29,473	4.32%
Allowance for credit losses	(9,118)			(9,067)			(9,311)		
Noninterest-earning assets:									
Cash and due from banks	27,605			22,225			21,886		
Premises and equipment, net	10,040			10,613			10,497		
Accrued interest receivable	7,577			4,594			2,568		
Other real estate owned	5,745			5,998			9,100		
Other assets	37,704			39,313			36,658		
Total average assets	\$872,834			\$804,130			\$753,697		
Liabilities and Shareholders' Equity:									
Interest-bearing liabilities:									
NOW accounts	\$102,130	\$ 145	0.14%	\$ 87,867	\$ 117	0.13%	\$ 85,357	\$ 111	0.13%
Money market accounts	192,344	1,299	0.68%	154,629	703	0.45%	148,911	567	0.38%
Savings accounts	86,086	236	0.27%	79,202	183	0.23%	67,590	145	0.21%
Time deposits	69,452	598	0.86%	76,856	423	0.55%	73,680	344	0.47%
Junior subordinated debentures	9,922	425	4.28%	9,211	304	3.30%	8,058	242	3.00%
Total interest-bearing l	459,934	\$2,703	0.59%	407,765	\$1,730	0.42%	383,596	\$1,409	0.37%
Noninterest-bearing liabilities									
Noninterest-bearing checking	300,698			289,334			268,712		
Accrued interest payable	130			102			81		
Other liabilities	6,123			6,769			7,592		
Total average liabilities	766,885			703,970			659,981		
Total average shareholders' equity	105,949			100,160			93,716		
Total average liabilities and shareholders' equity	\$872,834			\$804,130			\$753,697		
Interest income as a percentage of average earning assets			4.62%			4.51%			4.32%
Interest expense as a percentage of average earning assets			0.34%			0.24%			0.21%
Net interest margin			4.28%			4.27%			4.11%

(1) Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan costs of approximately \$1,046 for the year ended December 31, 2018, loan costs of approximately \$537 for the year ended December 31, 2017, and loan costs of \$163 for the year ended December 31, 2016.

The prime rate rose from 4.50% to 5.50% during 2018 and is expected to see further increases during 2019. These increases will affect rates for both loans and customer deposits, both of which are likely to increase as the prime rate increases.

Both our net interest income and net interest margin are affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as "volume change." Both are also affected by changes in yields on interest-earning assets and rates paid on interest-bearing

liabilities, referred to as "rate change." The following table sets forth the changes in interest income and interest expense for each major category of interest-earning asset and interest-bearing liability, and the amount of change attributable to volume and rate changes for the years indicated. Changes in interest income and expense, which are not attributable specifically to either rate or volume, are allocated proportionately between the two variances based on the absolute dollar amounts of the change in each.

Table 2. Rate and Volume Analysis

(In thousands)	2018 compared to 2017			2017 compared to 2016		
	Total	Rate	Volume	Total	Rate	Volume
Increase (decrease) in interest income:						
Loans	\$1,566	\$ 936	\$ 630	\$2,635	\$1,216	\$1,419
Investment securities	245	204	41	76	30	46
Interest-bearing deposits in other banks	(5)	(8)	3	(3)	5	(8)
Interest-bearing deposits in FRB	1,879	762	1,117	749	535	214
Total interest income	3,685	1,894	1,791	3,457	1,786	1,671
Increase (decrease) in interest expense:						
Interest-bearing demand accounts	624	424	200	142	118	24
Savings accounts	53	36	17	38	12	26
Time deposits	175	219	(44)	79	64	15
Subordinated debentures	121	96	25	62	26	36
Total interest expense	973	775	198	321	220	101
Increase (decrease) in net interest income	\$2,712	\$1,119	\$1,593	\$3,136	\$1,566	\$1,570

The net interest margin rose slightly in 2018 due to increase in loan portfolio yields, yields of overnight investments with the Federal Reserve Bank, and investment securities yields. We seek to mitigate the low interest rate environment with loan floors included in new and renewed loans when practical. Loans yielded 5.57% during the year ended December 31, 2018, as compared to 5.42% and 5.21% for the years ended December 31, 2017 and 2016, respectively. For the year ended December 31, 2018, total interest income increased approximately \$3,685,000, or 11.19%, as compared to the year ended December 31, 2017, reflective of an increase of \$1,566,000 in loan interest income. Average interest-earning assets increased approximately \$62,827,000 between 2018 and 2017 and the rate on interest-earning assets increased 11 basis points during the two periods. The increase in average earning assets between 2018 and 2017 consisted of

increases of \$49,004,000 in interest-bearing deposits held at the Federal Reserve Bank, increases of \$12,142,000 in loans, and increases of \$2,325,000 in investment securities. Average interest-earning assets increased approximately \$48,155,000 between 2017 and 2016 and the rate on interest-earning assets increased 19 basis points during the two periods. The average rates on loans increased 21 basis points between the two periods, and the average rate on investment securities increased approximately 6 basis points during the year ended December 31, 2017, as compared to the same period of 2016. The rate on interest-earning assets increased during the year ended December 31, 2017 due to increases in loans, overnight deposit yields, and investment securities.

For the year ended December 31, 2018, total interest expense increased approximately \$973,000, or 56.24%, as compared to the year ended December 31, 2017. Between those two

periods, average interest-bearing liabilities increased by \$52,169,000, and the average rates paid on these liabilities increased by 17 basis points. CDARs reciprocal deposits,

which are preferred by some depositors, have increased from \$12.1 million to \$19.5 million.

The following table summarizes the year-to-date averages of the components of interest-earning assets as a percentage of total interest-earning assets, and the components of interest-bearing liabilities as a percentage of total interest-bearing liabilities:

	YTD Average 12/31/18	YTD Average 12/31/17	YTD Average 12/31/16
Loans	73.27%	77.91%	79.26%
Investment securities available for sale	6.91%	7.18%	7.27%
Interest-bearing deposits in other banks	—%	0.09%	0.22%
Interest-bearing deposits in FRB	19.82%	14.82%	13.25%
Total earning assets	100.00%	100.00%	100.00%
NOW accounts	22.21%	21.55%	22.25%
Money market accounts	41.82%	37.92%	38.82%
Savings accounts	18.72%	19.42%	17.62%
Time deposits	15.10%	18.85%	19.21%
Subordinated debentures	2.15%	2.26%	2.10%
Total interest-bearing liabilities	100.00%	100.00%	100.00%

Provision for Credit Losses

Provisions for credit losses are determined on the basis of management's periodic credit review of the loan portfolio, consideration of past loan loss experience, current and future economic conditions, and other pertinent factors. Such factors consider the allowance for credit losses to be adequate when it covers estimated losses inherent in the loan portfolio. Based on the condition of the loan portfolio, management believes the allowance is appropriate to cover risk elements in the loan portfolio.

For the year ended December 31, 2018, the recovery of provision to the allowance for credit losses totaled \$1,764,000. The provision for the year ended December 31, 2017 totaled \$24,000. The recovery of provision for the year ended December 31, 2016 totaled \$21,000.

The allowance for credit losses decreased to 1.43% of total loans during the year ended December 31, 2018, as compared to 1.54% at December 31, 2017, and 1.56% at December 31, 2016. The recovery of provision recorded during 2016, the modest provision recorded in 2017, and the recovery of provision of \$1,764,000 recorded during 2018, are a result of continuing improvements in the overall credit quality of the loan portfolio, net recoveries, overall improvements in economic conditions over the recent years, and improvements in loan collateral property values. For further discussion, refer to Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations – Asset Quality and Allowance for Credit Losses.

Noninterest Income

The following table summarizes significant components of noninterest income for the years indicated and the net changes between those years:

<i>(In thousands)</i>	2018	% of Total	2017	% of Total	2016	% of Total
Customer service fees	\$3,544	76.96%	\$3,851	89.43%	\$3,792	84.01%
Increase in cash surrender value of bank-owned life insurance	520	11.29%	534	12.40%	\$ 530	11.74%
Loss on fair value of marketable equity securities	(78)	(1.69)%	—	0.00%	\$ —	—%
Gain on proceeds from bank-owned life insurance	171	3.71%	—	—%	\$ —	—%
Loss on fair value of junior subordinated debentures	(424)	(9.21)%	(882)	(20.48)%	\$ (518)	(11.48)%
Other	872	18.94%	803	18.65%	\$710	15.73%
Total	\$4,605	100.00%	\$4,306	100.00%	\$4,514	100.00%

Noninterest income consists primarily of fees and commissions earned on services that are provided to our banking customers and, to a lesser extent, gains on sales of Company assets and other miscellaneous income.

Noninterest income for the year ended December 31, 2018 increased \$299,000, or 6.94%, when compared to the same period of 2017. Customer service fees, the primary component of noninterest income, decreased \$307,000, or 7.97%, between the two periods presented. The decrease was due primarily to the closing of the Financial Services department. The increase in noninterest income of \$299,000 between the two periods is the result of a decrease in the loss on the fair value of junior subordinated debentures of \$424,000 during 2018 as compared to a loss of \$882,000 during 2017. The change in the fair value

of junior subordinated debentures was primarily caused by fluctuations in the LIBOR yield curve. The cost of our subordinated debentures issued by USB Capital Trust II has increased in concert with market rates over the last three or four years. With pricing at 3-month-LIBOR plus 129 basis points, the effective cost of the subordinated debt was 3.73% and 3.20% at December 31, 2018 and 2017, respectively.

Noninterest income for the year ended December 31, 2017, decreased \$208,000 or 4.61% when compared to the same period of 2016. Customer service fees increased \$59,000 or 1.56% between the two periods. The decrease in noninterest income of \$208,000 is the result of a loss on the fair value of junior subordinated debentures of \$882,000 during 2017 as compared to a loss of \$518,000 during 2016, partially offset by increases in customer service fees.

Noninterest Expense

The following table sets forth the components of total noninterest expense in dollars and as a percentage of average earning assets for the years ended December 31, 2018, 2017, and 2016:

	2018		2017		2016	
	Amount	% of Average Earning Assets	Amount	% of Average Earning Assets	Amount	% of Average Earning Assets
<i>(Dollars in thousands)</i>						
Salaries and employee benefits	\$11,721	1.48%	\$10,821	1.48%	\$10,628	1.56%
Occupancy expense	4,372	0.55%	4,254	0.58%	4,222	0.62%
Data processing	171	0.02%	119	0.02%	148	0.02%
Professional fees	1,617	0.20%	1,433	0.20%	1,493	0.22%
Regulatory assessments	330	0.04%	391	0.05%	767	0.11%
Director fees	321	0.04%	289	0.04%	284	0.04%
Correspondent bank service charges	63	0.01%	71	0.01%	—	—%
Loss on California tax credit partnership	25	—%	109	0.01%	158	0.02%
Net cost (gain) on operation and sale of OREO	145	0.02%	(150)	(0.02)%	263	0.04%
Other	2,167	0.27%	2,466	0.34%	2,382	0.35%
Total	\$20,932	2.64%	\$19,803	2.71%	\$20,345	2.98%

Noninterest expense increased \$1,129,000, or 5.70%, between the years ended December 31, 2018 and 2017. The net increase in noninterest expense between the comparative periods is primarily the result of increases in salaries and employee benefits, professional fees, and net OREO costs, partially offset by a decrease in the loss recorded on a tax credit partnership. Noninterest expense decreased \$542,000 between the years ended December 31, 2017 and 2016, due to decreases in net OREO costs and regulatory assessments, partially offset by increases in salaries and employee benefits.

Included in net costs on operations of OREO for the years ended December 31, 2018 and 2017 are OREO operating expenses totaling \$145,000 and \$186,000, respectively, and a gain on OREO of \$336,000 recorded in 2017. There were no impairment losses on OREO recorded during the years ended 2018 and 2017.

During the years ended December 31, 2018 and 2017, the Company recognized stock-based compensation expense of \$744,000 (\$0.04 per share basic and diluted) and \$97,000 (less than \$0.01 per share basic and diluted), respectively. This expense is included in noninterest expense under salaries and employee benefits. If new stock options or units are issued, or existing options fail to vest due, for example, to forfeiture, actual stock-based compensation expense in future periods will change.

Income Taxes

Our income tax expense is impacted to some degree by permanent taxable differences between income reported for book purposes and income reported for tax purposes, as well as certain tax credits which are not reflected in our pretax income or loss shown in the statements of operations and comprehensive income. As pretax income or loss amounts become smaller, the impact of these differences become more significant and are reflected as variances in our effective tax rate for the periods presented. In general, the permanent differences and tax credits affecting tax expense have a positive impact and tend to reduce the effective tax rates shown in our statements of operations and comprehensive income. Our effective tax rate for the year ended December 31, 2018 was 27.56% compared to 44.89% for the year ended December 31, 2017. With the enactment of the Tax Cuts and Jobs Act, which was signed into law on December 22, 2017, the Company's federal income tax rate changed from 34% to 21%. At December 31, 2017, the effective tax rate rose to 45%, from 40% as a result of the revaluation of our net deferred tax asset in light of the reduction in tax for 2018. This resulted in a write-down of \$986,000 on our net deferred tax asset at year end 2017. The impact to earnings for fourth quarter 2017 was \$0.06 per share.

We review our current tax positions at least quarterly based upon accounting standards related to uncertainty in income taxes which includes the criteria that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the income tax guidelines, an entity should recognize the financial statement benefit of a tax position if it determines that it is *more likely than not* that the position will be sustained on examination. The term "more likely than not" means a likelihood of "more than 50 percent." In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority.

We have reviewed all of our tax positions as of December 31, 2018, and have determined that there are no material amounts that should be recorded under the current income tax accounting guidelines.

Financial Condition

Total assets increased by \$127,222,000, or 15.79%, from \$805,836,000 at December 31, 2017 to \$933,058,000 at December 31, 2018. During the year ended December 31, 2018, net loans decreased by \$13,704,000. Overnight interest-bearing deposits in the Federal Reserve Bank and federal funds sold increased a net \$118,691,000, and investment securities increased by \$24,363,000 during the year ended December 31, 2018. Total deposits of \$805,643,000 at December 31, 2018, increased \$117,950,000, or 17.15%, from \$687,693,000 at December 31, 2017.

During the year ended December 31, 2017, net loans increased \$31,191,000. Overnight interest-bearing deposits in the Federal Reserve Bank and federal funds sold decreased by \$14,554,000, while investment securities decreased by \$11,769,000 during the year ended December 31, 2017. Total deposits of \$687,693,000 at December 31, 2017 increased \$11,064,000, or 1.64%, from the balance at December 31, 2016 of \$676,629,000.

Earning assets averaged approximately \$793,281,000 during the year ended December 31, 2018, as compared to \$730,454,000 for the year ended December 31, 2017. Average interest-bearing liabilities increased to \$459,934,000 for the year ended December 31, 2018, as compared to \$407,765,000 for the year ended December 31, 2017.

Loans

Our primary business is that of acquiring deposits and making loans, with the loan portfolio representing the largest and most important component of our earning assets. Loans totaled \$587,933,000 at December 31, 2018, a decrease of \$13,418,000, or 2.23%, from total loans of \$601,351,000 at December 31, 2017. During 2018, average loans increased 2.13% when compared to the year ended December 31, 2017. Average loans totaled \$581,221,000 and \$569,079,000 for the years ended December 31, 2018 and 2017, respectively.

The following table sets forth the amounts of loans outstanding by category and the category percentages as of the year-end dates indicated:

	2018		2017		2016		2015		2014	
<i>(Dollars in thousands)</i>	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans
Commercial and industrial	\$ 56,978	9.7%	\$ 47,026	7.8%	\$ 49,005	8.6%	\$ 55,826	10.8%	\$ 62,369	13.6%
Real estate mortgage	289,200	49.2%	306,293	50.9%	288,200	50.6%	252,232	48.9%	214,877	46.9%
RE construction & development	108,795	18.5%	122,970	20.4%	130,687	22.9%	130,596	25.3%	137,158	30.0%
Agricultural	61,149	10.4%	59,481	9.9%	56,918	10.0%	52,137	10.1%	31,713	6.9%
Installment and student loans	71,811	12.2%	65,581	11.0%	44,949	7.9%	24,527	4.9%	11,802	2.6%
Total loans	\$587,933	100.0%	\$601,351	100.0%	\$569,759	100.0%	\$515,318	100.0%	\$457,919	100.0%

Loan volume continues to be highest in what has historically been our primary lending emphasis: commercial, real estate mortgage, and construction lending. Total loans decreased \$13,418,000 during 2018. There were decreases of \$17,093,000, or 5.58%, in real estate mortgage loans and \$14,175,000, or 11.53%, in real estate construction and development loans. There were increases of \$9,952,000, or 21.16%, in commercial and industrial loans, \$6,230,000, or 9.5%, in installment loans, and \$1,668,000, or 2.8%, in agriculture loans.

Commercial real estate loans (a component of real estate mortgage loans) have remained as a significant percentage of total loans over the past year, amounting to 39.03% and 36.76%, of the total loan portfolio at December 31, 2018 and December 31, 2017, respectively. Commercial real estate loans increased \$8,416,000 during 2018. Residential mortgage loans are not generally a large part of our loan portfolio, but some residential mortgage loans have been made over the past several years to facilitate take-out loans for construction borrowers who were unable to obtain permanent financing elsewhere. Additionally, we purchase residential mortgage pools. Residential mortgage loans are generally 30-year amortizing loans with maturities of between three and five years. These loans totaled \$59,431,000 or 10.11% of the portfolio at December 31, 2018, and \$84,804,000, or 14.10% of the portfolio at December 31, 2017. We held no purchased loan participations at December 31, 2018 or December 31, 2017. Loan participations sold decreased from \$7,535,000 or 1.25% of the portfolio at December 31, 2017, to \$7,140,000, or 1.21%, at December 31, 2018.

During 2017, we experienced an increase of \$18,093,000, or 6.28%, in real estate mortgage loans, an increase of \$20,632,000, or 45.90%, in installment loans, an increase of \$2,563,000, or 4.50%, in agricultural loans, and decreases of \$1,979,000, or 4.04%, in commercial and industrial loans and \$7,717,000, or 5.90%, in construction loans.

At December 31, 2018, approximately 55.3% of commercial and industrial loans have floating rates and, although some may be secured by real estate, many are secured by accounts receivable, inventory, and other business assets. Real estate mortgage loans decreased \$17,093,000 during 2018 due to paydowns on purchased residential mortgage loans. Real estate construction loans decreased \$14,175,000, or 11.5%, during 2018, and \$7,717,000, or 5.9%, during 2017. Construction loans are generally short-term, floating-rate obligations, which consist of both residential and commercial projects. Agricultural loans, which primarily consist of short-term, floating rate loans for crop financing, increased

\$1,668,000, or 2.8%, between December 31, 2017 and December 31, 2018. Commercial loans, consisting primarily of loans for non real estate business operations, increased \$9,952,000, or 21.16%.

The real estate mortgage loan portfolio totaling \$289,200,000 at December 31, 2018, consists of commercial real estate, residential mortgages, and home equity loans. Commercial real estate is the predominate segment of the portfolio, with balances of \$229,448,000, and \$221,032,000 at December 31, 2018 and 2017, respectively. Commercial real estate loans are generally a mix of short to medium-term, fixed and floating rate instruments and are mainly secured by commercial income and multi-family residential properties. The Company does not currently offer traditional residential mortgage loans, but does purchase mortgage portfolios. The residential real estate mortgage portfolio balances totaled \$59,431,000 and \$84,804,000 at December 31, 2018 and 2017, respectively. Our home equity loan portfolio totaled \$321,000 at December 31, 2018, and \$457,000 at December 31, 2017.

Included within the installment loan portfolio are \$68,221,000 in student loans as of December 31, 2018, as compared to \$59,853,000 at December 31, 2017, an increase of \$8,368,000. The student loan portfolio consists of unsecured loans to medical and pharmacy students currently enrolled in medical and pharmacy schools in the US and the Caribbean. The medical student loans are made to US citizens attending medical schools in the US and Antigua, while the pharmacy student loans are made to pharmacy students attending pharmacy school in the US. Upon graduation the loan is automatically placed on deferment for 6 months. This may be extended up to 48 months for graduates enrolling in Internship, Medical Residency or Fellowship. As approved the student may receive additional deferment for hardship or administrative reasons in the form of forbearance for a maximum of 24 months throughout the life of the loan. The outstanding balance of student loans that have not entered repayment status totaled \$52,695,000 at December 31, 2018. Accrued interest on loans that have not entered repayment status totaled \$5,612,000 at December 31, 2018. At December 31, 2018, there were 595 loans within repayment, deferment, and forbearance which represented \$15,526,000, \$1,945,000, and \$7,336,000 in outstanding balances respectively. Repayment of the unsecured student loans is premised on the medical and pharmacy students graduating and becoming high wage earners. Underwriting is premised on qualifying credit scores. The weighted average credit score for the portfolio is in the mid-700s. In addition, there are non-student co-borrowers for roughly one-third of the portfolio that provide additional repayment capacity. Graduation and

employment placement rates are high for both medical and pharmacy students. The average student loan balance per borrower as of December 31, 2018 was approximately \$90,000. Loan interest rates range from 4.875% to 9.875%. At December 31, 2018, \$15,526,000 in loans were in repayment compared to \$6,473,000 as of December 31, 2017. Accrued interest on student loans was \$5,984,000 and \$4,261,000 as of December 31, 2018 and 2017, respectively. As of December 31, 2017 the student loan portfolio was insured through a surety bond issued by ReliaMax Surety Company which provided us a reasonable expectation of collection. As such the allowance calculated for the portfolio was included within the calculation of our general reserves. In June 2018, ReliaMax Surety Company was declared insolvent by the South Dakota Division of Insurance and is now in liquidation. As a result of the insolvency, we assessed the risks within the student loan portfolio and determined that along with the calculation of the general reserve of \$880,000 an additional allowance of \$640,000 was appropriate for a total reserve against the

student loan portfolio of \$1,520,000 as of December 31, 2018. At December 31, 2017 the reserve against the student loan portfolio was \$772,000. Additionally, as of December 31, 2018, \$26,000 in accrued interest receivable was reversed, due to charge-offs of \$388,000. There were no TDR's within the portfolio as of December 31, 2018 or 2017.

We utilize Reunion Student Loan Finance Corporation ("RSLFC") as our third-party servicer for the student loan portfolio. RSLFC provides servicing for the student loan portfolio, including application administration, processing, approval, documenting, funding, and collection. They also provide file custodial responsibilities. Except in cases where applicants/loans do not meet program requirements, or extreme delinquency, we are reliant on RSLFC for complete program management. We pay RSLFC a monthly servicing fee based on the principal balance outstanding. Interest income on the student loan portfolio offsets this expense, and is presented net of expense within loan interest income.

The following table summarizes the credit quality indicators for outstanding student loans as of December 31, 2018 and December 31, 2017 (in 000's, except for number of borrowers):

	December 31, 2018			December 31, 2017		
	Number of Loans	Amount	Accrued Interest	Number of Loans	Amount	Accrued Interest
School	1,056	\$42,852	\$5,494	1,216	\$48,825	\$3,973
Grace	23	562	81	55	1,446	166
Repayment	366	15,526	118	201	6,473	40
Deferment	48	1,945	79	32	1,128	45
Forbearance	181	7,336	212	50	1,981	37
Claim	—	—	—	—	—	—
Total	1,674	\$68,221	\$5,984	1,554	\$59,853	\$4,261

School – The time in which the borrower is still actively in school at least half time. No payments are expected during this stage, though the borrower may begin immediate payments.

Grace – A six month period of time granted to the borrower immediately upon graduation, or if deemed no longer an active student. Interest continues to accrue. Upon completion of the six month grace period the loan is transferred to repayment status. Additionally, if applicable, this status may represent a borrower activated to military duty while in their in-school period, they will be allowed to return to that status once their active duty has expired. The

borrower must return to an at least half time status within six months of the active duty end date in order to return to an in-school status.

Repayment – The time in which the borrower is no longer actively in school at least half time, and has not received an approved grace, deferment, or forbearance. Regular payment is expected from these borrowers under an allotted payment plan.

Deferment – May be granted up to 48 months for borrowers who have begun the repayment period on their loans but are (1) actively enrolled in an eligible school at least half time, or

(2) are actively enrolled in an approved and verifiable medical residency, internship, or fellowship program.

Forbearance – The period of time during which the borrower may postpone making principal and interest payments, which may be granted for either hardship or administrative reasons. Interest will continue to accrue on loans during periods of authorized forbearance. If the borrower is delinquent at the time the forbearance is granted, the delinquency will be covered by the forbearance and all accrued and unpaid interest from the date of delinquency or if none, from the date of beginning of the forbearance period, will be capitalized at the end of each forbearance period. The term of the loan will not change and payments may be increased to allow the loan to pay off in the required time

frame. A forbearance that results in only a delay in payment considered insignificant, is not a concessionary change in terms provided the borrower affirms the obligation. Forbearance is not an uncommon status designation, this designation is standard industry practice, and is consistent with the succession of students migrating to employed medical professionals.

Claim – Occurs after a loan has been delinquent for a period of time in which the servicer believes payment may not be received. A claim can be filed at any point in the delinquency, but typically not until 180 – 210 days. ReliaMax Surety Company was declared insolvent by the South Dakota Division of Insurance and is now in liquidation. No future claims will be filed with ReliaMax.

The following table sets forth the maturities of the Bank's loan portfolio at December 31, 2018. Amounts presented are shown by maturity dates rather than repricing periods:

<i>(In thousands)</i>	Due in one year or less	Due after one year through five years	Due after five years	Total
Commercial and agricultural	\$ 49,269	\$ 37,290	\$ 31,568	\$118,127
Real estate construction & development	76,439	30,202	2,154	108,795
Real estate – mortgage	28,679	132,891	127,630	289,200
All other loans	1,659	1,546	68,606	71,811
Total loans	<u>\$156,046</u>	<u>\$201,929</u>	<u>\$229,958</u>	<u>\$587,933</u>

For the year ended December 31, 2018 and 2017, the average yield on loans was 5.57% and 5.42%, respectively. We utilize rate floors intended to mitigate interest rate risk if interest rates fall, as well as to compensate us for additional credit risk under current market conditions. Our loan portfolio is generally comprised of short-term or floating rate loans and is therefore susceptible to fluctuations in market rates of interest.

At December 31, 2018 and 2017, approximately 55.3% and 52.0%, respectively, of our loan portfolio consisted of floating rate instruments, with the majority of those tied to the prime rate.

The following table sets forth the contractual maturities of the Bank's fixed and floating rate loans at December 31, 2018. Amounts presented are shown by maturity dates rather than repricing periods, and do not consider renewals or prepayments of loans:

(In thousands)	Due in one year or less	Due after one year through five years	Due after five years	Total
Accruing loans:				
Fixed rate loans	\$ 56,949	\$156,722	\$ 32,220	\$245,891
Floating rate loans	91,018	41,234	197,738	329,990
Total accruing loans	147,967	197,956	229,958	575,881
Nonaccrual loans:				
Fixed rate loans	8,079	3,973	—	12,052
Floating rate loans	—	—	—	—
Total nonaccrual loans	8,079	3,973	—	12,052
Total Loans	\$156,046	\$201,929	\$229,958	\$587,933

Securities

The following is a comparison of the amortized cost and approximate fair value of available-for-sale securities for the years indicated:

(In thousands)	December 31, 2018		December 31, 2017	
	Amortized Cost	Fair Value (Carrying Amount)	Amortized Cost	Fair Value (Carrying Amount)
Available-for-sale:				
U.S. Government agencies	\$36,665	\$36,527	\$19,683	\$19,954
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	30,289	29,899	22,391	22,031
Total available-for-sale	\$66,954	\$66,426	\$42,074	\$41,985

The contractual maturities of investment securities as well as yields based on amortized cost of those securities at December 31, 2018 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	One year or less		After one year to five years		After five years to ten years		After ten years		Total	
	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)
Available-for-sale:										
U.S. Government agencies	\$—	—%	\$ —	—%	\$4,721	3.06%	\$31,944	3.01%	\$36,665	3.02%
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	7	(3.8)%	8,170	2.71%	1,015	2.71%	21,097	3.26%	30,289	3.09%
Total amortized cost	\$ 7	(3.80)%	\$8,170	2.71%	\$5,736	3.00%	\$53,041	3.11%	\$66,954	3.05%

(1) Weighted average yields are not computed on a tax equivalent basis

At December 31, 2018 and 2017, available-for-sale securities with an amortized cost of approximately \$58,790,000 and \$34,781,000, respectively (fair value of \$58,263,000 and \$34,543,000, respectively) were pledged as collateral for public funds and FHLB borrowings.

As of December 31, 2017, marketable equity securities with a fair value of \$3,737,000 were recorded within investment securities available for sale with unrealized losses recorded through comprehensive income and accumulated other comprehensive income. As of January 1, 2018, the Company adopted Accounting Standard Update ("ASU") 2016-01 and reclassified its marketable equity securities from investments available for sale into a separate component of investment securities. The ASU requires marketable equity securities to be reported at fair value with changes recorded through earnings. As of January 1, 2018, unrealized losses of \$184,000 were reversed from accumulated other comprehensive income to retained earnings.

During the year ended December 31, 2018, the Company recognized \$78,000 of unrealized losses related to marketable equity securities held at December 31, 2018 in the consolidated statements of income.

Deposits

Our Bank attracts commercial deposits primarily from local businesses and professionals, as well as retail checking accounts, savings accounts and time deposits. Core deposits, consisting of all deposits other than time deposits of \$250,000 or more and brokered deposits, continue to provide the foundation for the Bank's principal sources of funding and liquidity. These core deposits amounted to 97.3% and 98.1% of the total deposit portfolio at December 31, 2018 and 2017, respectively. The Bank currently holds no brokered deposits as part of its continuing effort to maintain sufficient liquidity without a reliance on brokered deposits.

The following table sets forth the year-end amounts of deposits by category for the years indicated, and the dollar change in each category during the year:

<i>(In thousands)</i>	December 31,				
	2018	2017	2016	2015	2014
Noninterest-bearing deposits	\$292,720	\$307,299	\$262,697	\$262,168	\$215,439
Interest-bearing deposits:					
NOW and money market accounts	340,445	234,154	235,873	226,886	211,290
Savings accounts	90,046	81,408	75,068	63,592	60,499
Time deposits:					
Under \$250,000	60,875	51,687	87,419	58,122	65,844
\$250,000 and over	21,557	13,145	15,572	11,037	12,301
Total interest-bearing deposits	512,923	380,394	413,932	359,637	349,934
Total deposits	\$805,643	\$687,693	\$676,629	\$621,805	\$565,373

The following table sets forth the year-end percentages of total deposits by category for the years indicated:

<i>(In thousands)</i>	December 31,				
	2018	2017	2016	2015	2014
Noninterest-bearing deposits	36.33%	44.69%	38.82%	42.16%	38.11%
Interest-bearing deposits:					
NOW and money market accounts	42.26%	34.05%	34.86%	36.49%	37.37%
Savings accounts	11.18%	11.84%	11.09%	10.23%	10.70%
Time deposits:					
Under \$250,000	7.56%	7.52%	12.92%	9.35%	11.65%
\$250,000 and over	2.68%	1.91%	2.30%	1.77%	2.18%
Total interest-bearing deposits	63.67%	55.31%	61.18%	57.84%	61.89%
Total deposits	100.00%	100.00%	100.00%	100.00%	100.00%

Our deposit base consists of two major components represented by noninterest-bearing (demand) deposits and interest-bearing deposits. Interest-bearing deposits consist of time certificates, NOW and money market accounts and savings deposits. Increases in total deposits have been realized during each of the last five years. During the year ended December 31, 2018, noninterest-bearing deposits decreased \$14,579,000, or 4.74%. Total time deposits increased \$17,600,000, or 27.15%, during the year ended December 31, 2018. NOW and money market deposits increased \$106,291,000, or 45.39%, during the year ended December 31, 2018. Savings accounts increased \$8,638,000, or 10.61%.

During the year ended December 31, 2017 noninterest-bearing deposits increased \$44,602,000, or 16.98%. Total time deposits decreased \$38,159,000, or 37.05%. Savings accounts increased \$6,340,000, or 8.45%, and NOW and money market decreased \$1,719,000, or 0.73%.

On a year-to-date average basis, total deposits increased \$62,822,000, or 9.1%, between the years ended December 31, 2017 and December 31, 2018. Interest-bearing deposits increased by \$51,458,000, or 12.91%, and noninterest-bearing deposits increased \$11,364,000, or 3.93%, during 2018. On average, we experienced increases in all deposit account categories between the years ended December 31, 2017 and December 31, 2018, except for time deposits. On a year-to-date average basis, total deposits increased by \$43,638,000, or 6.8%, between the years ended December 31, 2016 and December 31, 2017. Of that total, interest-bearing deposits increased by \$23,016,000, or 6.13%, and noninterest-bearing deposits increased \$20,622,000, or 7.67%, during 2017. On average, we experienced increases in all deposit categories between the years ended December 31, 2016 and December 31, 2017.

The following table sets forth the average deposits and average rates paid on those deposits for the years ended December 31, 2018 and 2017:

(Dollars in thousands)	2018		2017	
	Average Balance	Rate %	Average Balance	Rate %
Interest-bearing deposits:				
Checking accounts	\$294,474	0.49%	\$242,496	0.34%
Savings	86,086	0.27%	79,202	0.23%
Time deposits (1)	69,452	0.86%	76,856	0.55%
Noninterest-bearing deposits	300,698		289,334	

(1) Included at December 31, 2018, are \$21,557,000 in time certificates of deposit of \$250,000 or more, of which \$4,842,000 mature in three months or less, \$11,111,000 mature between three to twelve months, \$4,549,000 mature in one to three years, and \$1,055,000 mature in over three years.

Short-term Borrowings

We have the ability to obtain borrowed funds consisting of federal funds purchased, discount window borrowings, securities sold under agreements to repurchase ("repurchase agreements") and Federal Home Loan Bank ("FHLB") advances as alternatives to retail deposit funds. We have established collateralized and uncollateralized lines of credit with several correspondent banks, the FRB discount window, as well as a securities dealer, for the purpose of obtaining borrowed funds as needed. We may continue to borrow funds in the future as part of our asset/liability strategy, and may use these funds to acquire certain other assets as deemed appropriate by our management for investment purposes and to better utilize the capital resources of the Bank. Federal

funds purchased represent temporary overnight borrowings from correspondent banks and are generally unsecured. Repurchase agreements are collateralized by mortgage backed securities and securities of U.S. Government agencies, and generally have maturities of one to six months, but may have longer maturities if deemed appropriate as part of our asset/liability management strategy. FHLB advances are collateralized by our investment in FHLB stock, securities, and certain qualifying mortgage loans. In addition, we have the ability to obtain borrowings from the Federal Reserve Bank of San Francisco ("FRB"), collateralized by certain pledged loans in our loan portfolio. The lines of credit are subject to periodic review of the Company's financial statements by the grantors of the credit lines. Lines of credit may be modified or revoked

at any time if the grantors feel there are adverse trends in our financial position.

We had collateralized lines of credit with the FRB of \$287,446,000 and \$305,236,000, as well as FHLB lines of credit totaling \$4,119,000 and \$13,363,000 at December 31, 2018 and 2017, respectively. In addition, the Company obtained a \$10,000,000 uncollateralized line of credit during 2013 from Pacific Coast Bankers Bank, a \$20,000,000 uncollateralized line of credit during 2014 from Zion's Bank, and a \$10,000,000 uncollateralized line of credit during 2017 from Union Bank. At December 31, 2018, we had no outstanding balances drawn against any of its lines of credit. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR.

Asset Quality and Allowance for Credit Losses

Lending money is our principal business activity, and ensuring appropriate evaluation, diversification, and control of credit risks is a primary management responsibility. Losses are implicit in lending activities and the amount of such losses will vary, depending on the risk characteristics of the loan portfolio as affected by local economic conditions and the financial experience of borrowers.

The allowance for credit losses is maintained at a level deemed appropriate by our management to provide for known and inherent risks in existing loans and commitments to extend credit. The adequacy of the allowance for credit losses is based upon management's continuing assessment of various factors affecting the collectability of loans and commitments to extend credit; including current economic conditions, past credit experience, collateral, and concentrations of credit. There is no precise method of predicting specific losses or amounts which may ultimately be charged off on particular segments of the loan portfolio. The conclusion that a loan may become uncollectible, either

in part or in whole is judgmental and subject to economic, environmental, and other conditions which cannot be predicted with certainty. When determining the adequacy of the allowance for credit losses, we follow in accordance with GAAP, the guidelines set forth in the Revised Interagency Policy Statement on the Allowance for Loan and Lease Losses ("Statement") issued by banking regulators in December 2006. The Statement is a revision of the previous guidance released in July 2001, and outlines characteristics that should be used in segmentation of the loan portfolio for purposes of the analysis including risk classification, past due status, type of loan, industry or collateral. It also outlines factors to consider when adjusting the loss factors for various segments of the loan portfolio, and updates previous guidance that describes the responsibilities of the board of directors, management, and bank examiners regarding the allowance for credit losses. Securities and Exchange Commission Staff Accounting Bulletin No. 102 was released during July 2001, and represents the SEC staff's view relating to methodologies and supporting documentation for the Allowance for Loan and Lease Losses that should be observed by all public companies in complying with the federal securities laws and the Commission's interpretations. It is also generally consistent with the guidance published by the banking regulators.

The allowance for loan losses includes an asset-specific component, as well as a general or formula-based component. We segment the loan and lease portfolio into eleven (11) segments, primarily by loan class and type, that have homogeneity and commonality of purpose and terms for analysis under the formula-based component of the allowance. Those loans which are determined to be impaired under current accounting guidelines are not subject to the formula-based reserve analysis, and are instead evaluated individually for specific impairment under the asset-specific component of the allowance.

The eight segments of our loan portfolio are as follows (subtotals are provided as needed to allow the reader to reconcile the amounts to our loan classification reported elsewhere in this report):

Loan Segments for Loan Loss Reserve Analysis (Dollars in thousands)	Loan Balances at December 31,				
	2018	2017	2016	2015	2014
Commercial and business loans	\$ 55,929	\$ 46,065	\$ 47,464	\$ 54,503	\$ 60,422
Government program loans	1,049	961	1,541	1,323	1,947
Total commercial and industrial	56,978	47,026	49,005	55,826	62,369
Real estate – mortgage:					
Commercial real estate	229,448	221,032	200,213	182,554	154,672
Residential mortgages	59,431	84,804	87,388	68,811	59,095
Home improvement and home equity loans	321	457	599	867	1,110
Total real estate mortgage	289,200	306,293	288,200	252,232	214,877
Real estate construction and development	108,795	122,970	130,687	130,596	137,158
Agricultural	61,149	59,481	56,918	52,137	31,713
Installment and student loans	71,811	65,581	44,949	24,527	11,802
Total loans	\$587,933	\$601,351	\$569,759	\$515,318	\$457,919

(1) Consumer Loans

Our methodology for assessing the adequacy of the allowance for credit losses consists of several key elements, which include:

- the formula allowance;
- specific allowances for problem graded loans identified as impaired; and
- and the unallocated allowance.

The formula allowance is calculated by applying loss factors to outstanding loans and certain unfunded loan commitments. Loss factors are based on our historical loss experience and on the internal risk grade of those loans and, may be adjusted for significant factors that, in management's judgment, affect the collectability of the portfolio as of the evaluation date. Factors that may affect collectability of the loan portfolio include:

- Levels of, and trends in delinquencies and nonaccrual loans;
- Trends in volumes and term of loans;
- Effects of any changes in lending policies and procedures including those for underwriting, collection, charge-off, and recovery;
- Experience, ability, and depth of lending management and staff;
- National and local economic trends and conditions; and

- Concentrations of credit that might affect loss experience across one or more components of the portfolio, including high-balance loan concentrations and participations.

Management determines the loss factors for problem graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates loan losses over the previous quarters as determined by management (time horizons adjusted as business cycles or environment changes) and loss factors are adjusted to recognize and quantify the loss exposure from changes in market conditions and trends in our loan portfolio. For purposes of this analysis, loans are grouped by internal risk classifications and categorized as pass, special mention, substandard, doubtful, or loss. Certain loans are homogeneous in nature and are therefore pooled by risk grade. These homogeneous loans include consumer installment and home equity loans. Special mention loans are currently performing but are potentially weak, as the borrower has begun to exhibit deteriorating trends which, if not corrected, could jeopardize repayment of the loan and result in further downgrades. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as doubtful has critical weaknesses that make full collection of the obligation improbable. Classified loans include impaired loans and loans categorized as substandard, doubtful, and loss, which are not considered impaired. At December 31,

2018, impaired and classified loans totaled \$18,717,000, or 3.18%, of gross loans as compared to \$27,311,000, or 4.54%, of gross loans at December 31, 2017.

Loan participations are reviewed for allowance adequacy under the same guidelines as other loans in our portfolio, with an additional participation factor added, if required, for specific risks associated with participations. In general, participations are subject to certain thresholds set by us, and are reviewed for geographic location as well as the well-being of the underlying agent bank.

The formula allowance includes reserves for certain off-balance sheet risks including letters of credit, unfunded loan commitments, and lines of credit. Reserves for undisbursed commitments are generally formula allocations based on our historical loss experience and other loss factors, rather than specific loss contingencies. At December 31, 2018 and 2017, the formula reserve allocated to undisbursed commitments totaled \$494,000 and \$329,000, respectively. The reserve for unfunded commitments is considered a reserve for contingent liabilities and is therefore carried as a liability on the balance sheet for all periods presented.

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in impaired

loans. For impaired loans, specific allowances are determined based on the net realizable value of the underlying collateral, the net present value of the anticipated cash flows, or the market value of the underlying assets. Formula allowances for classified loans, excluding impaired loans, are determined on the basis of additional risks involved with individual loans that may be in excess of risk factors associated with the loan portfolio as a whole. The specific allowance is different from the formula allowance in that the specific allowance is determined on a loan-by-loan basis based on risk factors directly related to a particular loan, as opposed to the formula allowance which is determined for a pool of loans with similar risk characteristics, based on past historical trends and other risk factors which may be relevant on an ongoing basis.

The unallocated portion of the allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting our key lending areas, credit quality trends, collateral values, loan volumes and concentrations, and other business conditions.

The following table summarizes the specific allowance, formula allowance, and unallocated allowance at December 31, 2018 and 2017.

(In thousands)

	December 31, 2018	December 31, 2017
Specific allowance – impaired loans	\$ 1,776	\$ 1,888
Formula allowance – classified loans not impaired	4	1,136
Formula allowance – special mention loans	17	181
Total allowance for special mention and classified loans	1,797	3,205
Formula allowance for pass loans	6,005	4,806
Unallocated allowance	593	1,256
Total allowance	8,395	9,267
Impaired loans	18,683	14,790
Classified loans not considered impaired	34	12,521
Total classified and impaired loans	18,717	27,311
Special mention loans not considered impaired	2,228	10,201

The following table summarizes allowance for loan losses, nonperforming loans, and classified loans for the periods shown:

(Dollars in thousands)

	December 31, 2018	December 31, 2017
Allowance for loan losses – beginning of period	\$ 9,267	\$ 8,902
Net loans recovered during period	(892)	(341)
(Recovery of provision) provision for credit loss	(1,764)	24
Allowance for loan losses – end of period	8,395	9,267
Loans outstanding at period-end	587,933	601,351
ALLL as % of loans at period-end	1.43%	1.54%
Nonaccrual loans	12,052	5,296
Accruing restructured loans	3,832	6,084
Loans, past due 90 days or more, still accruing	—	485
Total non-performing loans	15,884	11,865
ALLL as % of nonperforming loans	52.85%	78.10%
Impaired loans	18,683	14,790
Classified loans not considered impaired	34	12,521
Total classified and impaired loans	\$ 18,717	\$ 27,311
ALLL as % of classified loans	44.85%	33.93%

Impaired loans increased \$3,893,000 between December 31, 2017 and December 31, 2018 while the specific allowance related to those impaired loans decreased \$112,000 between December 31, 2017 and December 31, 2018. This was the result of certain payoffs with higher reserves throughout the year, and the addition of newly identified collateral dependent impaired loans. The formula allowance related to criticized loans that are not impaired (including special mention and substandard) decreased by \$1,296,000 between December 31, 2017 and December 31, 2018 through a risk upgrade of one significant-balance loan. The level of “pass” loans increased approximately \$2,789,000 between December 31, 2017 and December 31, 2018, while the related formula allowance increased \$1,199,000 during the same period as a result in part due to the increased allowance for student loans. The formula allowance for “pass loans” is derived from loss factors using migration analysis and management’s consideration of qualitative factors. The unallocated reserve totaled \$593,000, or 7.1% of total ALLL at December 31, 2018, and \$1,256,000, or 13.6%, of total ALLL at December 31, 2017. The decrease in the unallocated reserve was primarily due to management’s decision to reverse \$1,615,000 in provision throughout the period, offset by provisions for overdrafts and undisbursed commitments. In evaluating the level of the unallocated reserve, management considered our loan relationships, our construction and land development concentrations, and our loss history relative to peers.

Our methodology attempts to accurately estimate losses. The specific allowance portion of the analysis is designed to be self-correcting by taking into account the current loan loss experience based on that portion of the portfolio. By analyzing the estimated losses inherent in the loan portfolio on a quarterly basis, management is able to adjust specific and inherent loss estimates using the most recent information available. In performing the periodic migration analysis, management believes that historical loss factors used in the computation of the formula allowance need to be adjusted to reflect current changes in market conditions and trends in our loan portfolio. There are a number of other factors which are reviewed when determining adjustments in the historical loss factors. Those factors include 1) trends in delinquent and nonaccrual loans, 2) trends in loan volume and terms, 3) effects of changes in lending policies, 4) concentrations of credit, 5) competition, 6) national and local economic trends and conditions, 7) experience of lending staff, 8) loan review and Board of Directors oversight, 9) high balance loan concentrations, and 10) other business conditions.

The general reserve requirements (ASC 450-70) decreased with the continued strengthening of local, state, and national economies and their impact on our local lending base, which has resulted in a lower qualitative component for the general reserve calculation. Our stake-in-the-ground methodology requires the Company to use December 31, 2005 as the starting point of the look back period to capture loss history

and better capture an entire economic cycle. Time horizons are subject to Management's assessment of the current period, taking into consideration changes in business cycles and environment changes.

Management and the Company's lending officers evaluate the loss exposure of classified and impaired loans on a weekly/monthly basis and through discussions and officer meetings as conditions change. The Company's Loan Committee meets weekly and also serves as a forum to discuss specific problem assets that pose significant concerns to the Company, and to keep the Board of Directors informed through committee minutes. All special mention and classified loans are reported quarterly on Problem Asset Reports and Impaired Loan Reports and are reviewed by senior management. Migration analysis and impaired loan analysis are performed on a quarterly basis and adjustments are made to the allowance as deemed necessary. The Board of Directors is kept abreast of any changes or trends in problem assets on a monthly basis, or more often if required.

The specific allowance for impaired loans is measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. The amount of impaired loans is not directly comparable to the amount of nonperforming loans disclosed later in this section. The primary differences between impaired loans and nonperforming loans are: i) all loan categories are considered in determining nonperforming loans while impaired loan recognition is limited to commercial and industrial loans, commercial and residential real estate loans, construction loans, and agricultural loans, and ii) impaired loan recognition considers not only loans 90 days or more past due, restructured loans and nonaccrual loans but may also include problem loans other than delinquent loans.

We consider a loan to be impaired when, based upon current information and events, we believe it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include nonaccrual loans, troubled debt restructures, and performing loans in which full payment of principal or interest is not expected. Management bases the measurement of these impaired loans either on the fair value of the loan's collateral or the expected cash flows on the loans discounted at the loan's stated interest rates. Cash receipts on impaired loans not performing to contractual terms and that are on nonaccrual status are used to reduce principal balances. Impairment losses are included in the allowance for credit losses through a charge to the provision, if applicable.

At December 31, 2018 and 2017, our recorded investment in loans for which impairment has been recognized totaled \$18,683,000 and \$14,790,000, respectively. Included in total impaired loans at December 31, 2018, are \$5,437,000 of impaired loans for which the related specific allowance is \$1,776,000, as well as \$13,246,000 of impaired loans that, as a result of excess collateral or excess in the calculation of net present value of future cash flows, did not need a specific allowance. Total impaired loans at December 31, 2017 included \$7,187,000 of impaired loans for which the related specific allowance was \$1,888,000, as well as \$7,603,000 of impaired loans that as a result of write-downs on the fair value of the collateral, did not have a specific allowance. The average recorded investment in impaired loans was \$17,197,000 and \$15,973,000 during the years ended December 31, 2018 and 2017, respectively. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms, income is recognized under the accrual method.

The largest category of impaired loans at December 31, 2018 was real estate construction and development loans, comprising of 62.43% of total impaired loans. Impaired construction loans increased \$5,691,000, impaired commercial and industrial loans decreased \$502,000, impaired real estate mortgage loans decreased \$951,000, and impaired agricultural loans decreased \$386,000 during the year ended December 31, 2018. Specific collateral related to impaired loans is reviewed for current appraisal information, economic trends within geographic markets, loan-to-value ratios, and other factors that may impact the value of the loan collateral. Adjustments are made to collateral values as needed for these factors. Of total impaired loans, approximately \$15,736,000, or 84.2%, at December 31, 2018, as compared to \$10,491,000, or 70.93%, of total impaired loans at December 31, 2017 were secured by real estate.

The following table summarizes the components of impaired loans and their related specific allowance at December 31, 2018 and 2017.

(In thousands)	Balance	Allowance	Balance	Allowance
	December 31, 2018	December 31, 2018	December 31, 2017	December 31, 2017
Commercial and industrial	\$ 2,816	\$ 787	\$ 3,318	\$ 534
Real estate – mortgage	3,345	469	4,296	488
Real estate construction and development	11,663	—	5,972	—
Agricultural	818	520	1,204	866
Installment and student loans	41	—	—	—
Total impaired loans	\$18,683	\$1,776	\$14,790	\$1,888

Included in impaired loans are loans modified in troubled debt restructurings (TDRs), where concessions have been granted to borrowers experiencing financial difficulties in an attempt to enhance collection. The Company makes various types of concessions when structuring TDRs including rate reductions, payment extensions, and forbearance.

At December 31, 2018, total TDRs of \$7,059,000 included \$2,838,000 in real estate construction balances, \$2,029,000 in residential mortgage balances, and \$1,305,000 in commercial real estate balances. At December 31, 2017, total TDRs of \$11,362,000 included \$5,951,000 in real estate construction balances, \$2,542,000 in residential mortgage balances, and \$1,233,000 in commercial real estate balances.

Total TDRs decreased by 37.87% at December 31, 2018, as compared to December 31, 2017. Nonaccrual TDRs decreased by 38.86% and accruing TDRs decreased by 37.02% over the same period. While commercial real estate balances increased slightly, all other TDR categories decreased when compared on a year-over-year basis. Concessions granted include lengthened maturities and/or rate reductions that enabled the borrower to finish the projects and may be entirely successful. In large part, current successes are related to a recovering real estate market.

The following tables summarize TDRs by type, classified separately as nonaccrual or accrual, which are included in impaired loans at December 31, 2018 and December 31, 2017.

(In thousands)	Total TDRs	Nonaccrual TDRs	Accruing TDRs
	December 31, 2018	December 31, 2018	December 31, 2018
Commercial and industrial	\$ 75	\$ —	\$ 75
Real estate – mortgage:			
Commercial real estate	1,305	389	916
Residential mortgages	2,028	—	2,028
Total real estate mortgage	3,333	389	2,944
Real estate construction and development	2,838	2,838	—
Agricultural	813	—	813
Installment and student loans	—	—	—
Total Troubled Debt Restructurings	\$7,059	\$3,227	\$3,832

<i>(In thousands)</i>	Total TDRs December 31, 2017	Nonaccrual TDRs December 31, 2017	Accruing TDRs December 31, 2017
Commercial and industrial	\$ 436	\$ 194	\$ 242
Real estate – mortgage:			
Commercial real estate	1,233	454	779
Residential mortgages	2,542	288	2,254
Total real estate mortgage	3,775	742	3,033
Real estate construction and development	5,951	4,342	1,609
Agricultural	1,200	—	1,200
Installment and student loans	—	—	—
Total Troubled Debt Restructurings	\$11,362	\$5,278	\$6,084

Of the \$7,059,000 in total TDRs at December 31, 2018, \$3,227,000 were on nonaccrual status at period-end. Of the \$11,362,000 in total TDRs at December 31, 2017, \$5,278,000 were on nonaccrual status at period-end. As of December 31, 2018, the Company has no commercial real estate (CRE) workouts whereby an existing loan was restructured into multiple new loans.

For a restructured loan to return to accrual status there needs to be at least 6 months successful payment history.

In addition, the Company's Credit Administration performs a financial analysis of the credit to determine whether the borrower has the ability to continue to perform successfully over the remaining life of the loan. This includes, but is not limited to, a review of financial statements and a cash flow analysis of the borrower. Only after determining that the borrower has the ability to perform under the terms of the loans will the restructured credit be considered for accrual status.

The following table summarizes special mention loans by type for the years ended December 31, 2018 and December 31, 2017.

<i>(In thousands)</i>	December 31, 2018	December 31, 2017
Commercial and industrial	\$ 48	\$ —
Real estate – mortgage:		
Commercial real estate	2,180	8,487
Residential mortgages	470	643
Home equity loans	—	—
Total real estate mortgage	2,650	9,130
RE construction & development	—	720
Agricultural	—	994
Installment and student loans	—	—
Total Special Mention Loans	\$2,698	\$10,844

The Company focuses on competition and other economic conditions within its market area and other geographical areas in which it does business, which may ultimately affect the risk assessment of the portfolio. The Company continues to experience increased competition from major banks, local independents and non-bank institutions which creates pressure on loan pricing. The Company continues

to place increased emphasis on reducing both the level of nonperforming assets and the level of losses on the disposition of these assets. It is in the best interest of both the Company and the borrowers to seek alternative options to foreclosure in an effort to reduce the impacts on the real estate market. As part of this strategy, the Company has increased its level of troubled debt restructurings, when it

improves collection prospects. While business and consumer spending show improvement, it is difficult to forecast what impact Federal Reserve rate increases will have on the economy. Local unemployment rates in the San Joaquin Valley have improved, but remain elevated compared with other regions and historically are higher as a result of the area's agricultural dynamics. The Company believes that the

Central San Joaquin Valley will continue to grow and diversify as property and housing costs remain low relative to other areas of the state. Management recognizes increased risk of loss due to the Company's exposure to local and worldwide economic conditions, as well as potentially volatile real estate markets, and takes these factors into consideration when analyzing the adequacy of the allowance for credit losses.

The following table provides a summary of the Company's allowance for credit losses, provisions made to that allowance, and charge-off and recovery activity affecting the allowance for the years indicated.

(Dollars in thousands)	December 31,				
	2018	2017	2016	2015	2014
Total loans outstanding at end of period before deducting allowances for credit losses	\$587,814	\$602,390	\$570,834	\$515,376	\$459,575
Average net loans outstanding during period	581,221	569,079	540,777	493,375	422,760
Balance of allowance at beginning of period	9,267	8,902	9,713	10,771	10,988
Loans charged off:					
Real estate	(47)	(23)	(29)	—	(200)
Commercial, industrial & agricultural	(98)	(122)	(870)	(1,397)	(318)
Installment and student loans	(409)	(18)	(24)	(489)	(16)
Total loans charged off	(554)	(163)	(923)	(1,886)	(534)
Recoveries of loans previously charged off:					
Real estate	29	95	55	225	728
Commercial, industrial & agricultural	1,102	201	60	630	330
Installment and student loans	315	208	18	14	104
Total loan recoveries	1,446	504	133	869	1,162
Net loans recovered (charged off)	892	341	(790)	(1,017)	628
(Recovery of provision) provision charged to operating expense	(1,764)	24	(21)	(41)	(845)
Balance of allowance for credit losses at end of period	\$8,395	\$9,267	\$8,902	\$9,713	\$10,771
Net loan recoveries (charge-offs) to total average loans	0.15%	0.06%	(0.15)%	(0.21)%	0.15%
Net loan recoveries (charge-offs) to loans at end of period	0.15%	0.06%	(0.14)%	(0.20)%	0.14%
Allowance for credit losses to total loans at end of period	1.43%	1.54%	1.56%	1.88%	2.34%
Net loan recoveries (charge-offs) to allowance for credit losses	10.63%	3.68%	(8.87)%	(10.47)%	5.83%
Net loan recoveries (charge-offs) to (recovery of provision) provision for credit losses	(50.57)%	1,420.83%	3,761.90%	2,480.49%	(74.32)%

Loan charge-offs increased \$391,000 during the year ended December 31, 2018, when compared to the year ended December 31, 2017. Loan recoveries increased \$942,000

during the same period. There were student loan charge-offs totaling \$388,000 during the fourth quarter and an addition to the overdraft reserve of \$1,000.

The following is a summary of the quarterly activity in the allowance for loan losses for the year ended December 31, 2018 (in thousands).

Description	Loss	Recoveries	Provision	Balance
Balance Forward				\$9,267
1st quarter – 2018	\$ 95	\$ 133	\$ (189)	9,116
2nd quarter- 2018	5	450	(1,136)	8,425
3rd quarter – 2018	52	798	(373)	8,798
4th quarter – 2018	402	65	(66)	8,395
Total YTD – 2018	\$554	\$1,446	\$(1,764)	\$8,395

At December 31, 2018 and 2017, \$494,000 and \$329,000, respectively, of the formula allowance is allocated to unfunded loan commitments and is, therefore, carried separately in Other Liabilities on the consolidated balance sheets.

Management believes that the 1.43% credit loss allowance to total loans at December 31, 2018 is adequate to absorb known and inherent risks in the loan portfolio. No assurance can be given, however, that economic conditions may materialize which differ and more adversely affect the Company's service areas or other circumstances will not be reflected in increased losses in the loan portfolio. Management is not currently aware of any conditions that

may adversely affect the levels of losses incurred in the Company's loan portfolio.

The allocations to specific loan categories are estimates based on the same factors as considered by management in determining the amount of additional provisions to the credit loss allowance and the overall adequacy of the allowance for credit losses. The portion not allocated provides for coverage of credit losses inherent in the loan portfolio but not captured in the loss factors that are utilized in the risk rating-based component, or in the specific impairment reserve component of the allowance for credit losses, and acknowledges the inherent imprecision of all loss prediction models.

	2018		2017		2016		2015		2014	
	Allowance for Credit Losses	% of Loans	Allowance for Credit Losses	% of Loans	Allowance For Credit Losses	% of Loans	Allowance for Credit Losses	% of Loans	Allowance for Credit Losses	% of Loans
<i>(Dollars in thousands)</i>										
Commercial and industrial	\$1,673	0.28%	\$1,408	0.23%	\$1,843	0.32%	\$1,652	0.32%	\$ 1,218	0.27%
Real estate – mortgage	1,015	0.17%	1,182	0.20%	1,430	0.25%	1,449	0.28%	1,653	0.36%
RE construction and development	2,424	0.41%	2,903	0.48%	3,378	0.59%	4,629	0.90%	6,278	1.37%
Agricultural	1,131	0.19%	1,631	0.27%	666	0.12%	655	0.13%	482	0.11%
Installment and student loans	1,559	0.27%	887	0.15%	888	0.16%	1,258	0.24%	293	0.06%
Not allocated	593	0.11%	1,256	0.21%	697	0.12%	70	0.01%	847	0.18%
	\$8,395	1.43%	\$9,267	1.54%	\$8,902	1.56%	\$9,713	1.88%	\$10,771	2.35%

During 2018, reserve allocations as a percentage of loans decreased for real estate mortgage, real estate construction and development, and agricultural loans. These decreases are a result of a combination of factors including decreases in charge-offs, classified and past due loans, and credit quality improvements. Increases in reserve allocations for commercial and industrial loans were primarily due to the growth of the loan segment, adjusted by the change in the qualitative factors related to the nature and volume of the portfolio. Increases in reserve allocation for installment loans were a result of increases in the overall portfolio balances, and the addition of reserves related to student loans.

During 2017, reserve allocations as a percentage of loans decreased for commercial and industrial, real estate

mortgage, real estate construction and development, and installment loans. These decreases are a result of a combination of factors including decreases in charge-offs, classified and past due loans, and credit quality improvements. Increases in reserve allocation for agricultural loans was primarily due to the growth of the loan segment, adjusted by the change in the qualitative factors related to the nature and volume of the portfolio.

During 2016, reserve allocations as a percentage of loans decreased for real estate mortgage, real estate construction and development, agriculture and installment loans. These decreases are a result of a combination of factors including decreases in charge-offs, classified and past due loans, and credit quality improvements.

The following summarizes our allowance for credit losses related to the specific, formula, and unallocated reserves for the year-ends shown:

<i>(In thousands)</i>	December 31,				
	2018	2017	2016	2015	2014
Formula allowance	\$6,026	\$6,123	\$6,845	\$6,546	\$ 9,209
Specific allowance	1,776	1,888	1,360	3,097	715
Unallocated allowance	593	1,256	697	70	847
Total allowance	<u>\$8,395</u>	<u>\$9,267</u>	<u>\$8,902</u>	<u>\$9,713</u>	<u>\$10,771</u>

The total formula allowance has decreased steadily over the past five years. This downward trend is the result of reduced net charge offs coupled with continued improving economic conditions.

No loans were classified as doubtful at December 31, 2018 or December 31, 2017.

The evaluation of our inherent losses involve a high degree of uncertainty because they are not identified with specific problem credits, and therefore we do not allocate the unallocated allowance among segments of the portfolio. At December 31, 2018 and December 31, 2017, we had unallocated allowances of \$593,000 and \$1,256,000. Our estimate of the unallocated allowance is based upon a number of underlying factors including 1) current loan concentrations 2) historical loss history relative to peers during the economic crises 3) the effect of soft real estate markets, and 4) the effects of having a larger number of borrowing relationships which are close to our lending limit, which, if any one were not to perform to contractual terms, would have a material impact on the allowance.

While our loan portfolio has elevated concentrations in commercial real estate, commercial, and construction loans, the portfolio percentages fall within our loan policy guidelines.

It is our policy to discontinue the accrual of interest income on loans for which reasonable doubt exists with respect to the timely collectability of interest or principal due to the inability of the borrower to comply with the terms of the loan agreement. Such loans are placed on nonaccrual status whenever the payment of principal or interest is 90 days past due or earlier when the conditions warrant, and interest collected is thereafter credited to principal to the extent necessary to eliminate doubt as to the collectability of the net carrying amount of the loan. We may grant exceptions to this policy if the loans are well secured and in the process of collection.

The following table sets forth our nonperforming assets as of the dates indicated:

(Dollars in thousands)	December 31,				
	2018	2017	2016	2015	2014
Nonaccrual loans (1)	\$12,052	\$ 5,296	\$ 7,264	\$ 8,193	\$ 9,935
Accruing restructured loans	3,832	6,084	5,146	11,028	5,641
Loans, past due 90 days or more, still accruing	—	485	1,250	—	—
Total non-performing loans	15,884	11,865	13,660	19,221	15,576
Other real estate owned	5,745	5,745	6,471	12,873	14,010
Total non-performing assets	\$21,629	\$17,610	\$20,131	\$32,094	\$29,586
Non-performing loans to total gross loans	2.70%	1.97%	2.40%	3.73%	3.40%
Non-performing assets to total gross loans	3.68%	2.92%	3.53%	6.23%	6.47%
Allowance for loan losses to nonperforming loans	52.85%	78.10%	65.17%	50.53%	69.15%

(1) Included in nonaccrual loans at December 31, 2018 and 2017 are restructured loans totaling \$3,227 and \$5,278, respectively.

Non-performing assets at December 31, 2018 increased \$4,019,000 between December 31, 2017 and December 31, 2018, due to a increase in nonaccrual loans of \$6,756,000, offset by a decrease of \$2,252,000 in accruing restructured loans.

Non-performing assets decreased \$2,646,000 between December 31, 2017 and December 31, 2016, due to decreases of \$1,968,000 in nonaccrual loans and \$726,000 in

other real estate owned, offset by an increase of \$938,000 in accruing restructured loans.

Non-performing assets decreased \$11,963,000 between December 31, 2016 and December 31, 2015, due to a decrease of \$929,000 in nonaccrual loans, a decrease of \$5,881,000 in accruing restructured loans, and a decrease of \$6,402,000 in other real estate owned, offset by \$1,250,000 in loans past due 90 days or more but still accruing.

The following table summarizes various nonperforming components of the loan portfolio as compared to total loans for the periods shown.

(In thousands)	December 31, 2018	December 31, 2017
(Recovery of provision) provision for credit losses during period	\$(1,764)	\$24
Allowance as % of nonperforming loans	52.85%	78.10%
Nonperforming loans as % total loans	2.70%	1.97%
Restructured loans as % total loans	1.20%	1.89%

Nonperforming assets, which are primarily related to the real estate loans and other real estate owned portfolio, increased \$4,019,000 from a balance of \$17,610,000 at December 31, 2017 to a balance of \$21,629,000 at December 31, 2018. Nonaccrual loans totaling \$12,052,000 at December 31, 2018, increased \$6,756,000 from the balance of \$5,296,000 reported at December 31, 2017. In determining the adequacy of the underlying collateral related to these loans, management monitors trends within specific geographical areas, loan-to-value ratios, appraisals, and other credit issues related to the specific loans. Impaired loans increased \$3,893,000 during the

year ended December 31, 2018 to a balance of \$18,683,000 at December 31, 2018 due primarily to the addition of two large-balance loans secured by real estate, offset by decreases in impaired TDRs. Other real estate owned remained at the same balance at December 31, 2017 and December 31, 2018. As a result of these events, nonperforming assets as a percentage of total assets increased from 2.19% at December 31, 2017 to 2.32% at December 31, 2018.

While real estate markets have strengthened over the last few years, management continues to monitor economic

conditions in the real estate market for signs of either deterioration or improvement which may impact the level of the allowance for loan losses required to cover identified losses in the loan portfolio. Management continues to monitor and reduce the level of problem assets by working with borrowers to identify options, including loan restructures, in order to work through difficulties a borrower might face. Restructured loans numbers have been greatly reduced over the last four years. Net loan recoveries during the year ended December 31, 2018 totaled \$892,000, as compared to net loan recoveries of \$341,000 for the year ended December 31, 2017. We charged-off approximately 9 loans during the year ended December 31, 2018, compared to 6 loans during the year ended December 31, 2017. Net loan recoveries totaling \$892,000 during the year ended December 31, 2018, included \$38,000 in net recoveries during the quarter ended March 31, 2018, \$445,000 in net

recoveries during the quarter ended June 30, 2018, \$746,000 in net recoveries during the quarter ended September 30, 2018, and \$337,000 in net charge-offs during the fourth quarter of 2018. The percentage of net recoveries to average loans was 0.15%, for the year ended December 31, 2018.

The loan portfolio increased from \$515,318,000 at December 31, 2016, to \$601,351,000 at December 31, 2017, and decreased to \$587,933,000 at December 31, 2018. Nonperforming loans increased to \$15,884,000 at December 31, 2018, from \$11,865,000 at December 31, 2017, and \$13,660,000 at December 31, 2016. Nonaccrual loans and accruing restructured loans are included in nonperforming loans. During the same period, total impaired and classified loans decreased from \$27,311,000 at December 31, 2017, to \$18,717,000 at December 31, 2018.

The following table summarizes the nonaccrual totals by loan category for the periods shown:

(In thousands)	Balance		Change
	December 31, 2018	December 31, 2017	December 31, 2017
Commercial and industrial	\$ —	\$ 212	\$ (212)
Real estate – mortgage	389	742	(353)
Real estate – construction	11,663	4,342	7,321
Agricultural	—	—	—
Installment and student loans	—	—	—
Total Nonaccrual Loans	\$12,052	\$5,296	\$6,756

Loans past due more than 30 days are receiving increased management attention and are monitored for increased risk. As of December 31, 2018 and 2017 past due loans more than 30 days totaled \$9,515,000 and \$1,445,000, respectively. We continue to move past due loans to nonaccrual status in its ongoing effort to recognize loan problems at an earlier point in time when they may be dealt with more effectively. As impaired loans, nonaccrual and restructured loans are reviewed for specific reserve allocations and the allowance for credit losses is adjusted accordingly.

Except for the loans included in the above tables, there were no loans at December 31, 2018, where the known credit problems of a borrower caused us to have serious doubts as to the ability of such borrower to comply with the present loan repayment terms and which would result in such loan being included as a nonaccrual, past due or restructured loan at some future date.

Liquidity and Asset/Liability Management

The primary function of asset/liability management is to provide adequate liquidity and maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities.

Liquidity

Liquidity management may be described as the ability to maintain sufficient cash flows to fulfill both on- and off-balance sheet financial obligations, including loan funding commitments and customer deposit withdrawals, without straining the Company's equity structure. To maintain an adequate liquidity position, the Company relies on, in addition to cash and cash equivalents, cash inflows from deposits and short-term borrowings, repayments of principal on loans and investments, and interest income received. The

Company's principal cash outflows are for loan origination, purchases of investment securities, depositor withdrawals and payment of operating expenses. Other sources of liquidity not on the balance sheet at December 31, 2018, include unused collateralized and uncollateralized lines of credit from other banks, the Federal Home Loan Bank, Pacific Coast Banker's Bank, Zion's Bank, Union Bank, and from the Federal Reserve Bank totaling \$331,565,000.

Cash and cash equivalents have fluctuated during the three years ended December 31, 2018, 2017, and 2016, with period-end balances as follows (from Consolidated Statements of Cash Flows – in 000's):

	Balance
December 31, 2018	\$220,337
December 31, 2017	\$107,934
December 31, 2016	\$113,032

Cash and cash equivalents increased \$112,403,000 during the year ended December 31, 2018, and decreased \$5,098,000 during the year ended December 31, 2017.

The Company had a net cash inflow from operations of \$11,124,000 for the year ended December 31, 2018, and a net cash inflow from operations totaling \$7,555,000 for the period ended December 31, 2017. The Company experienced net cash outflows from investing activities totaling \$11,939,000 and net cash outflows of \$20,856,000 during the years ended December 31, 2018 and December 31, 2017, respectively. For the year ended December 31, 2018, increases in deposits outweighed purchases of available for sale securities. For the year ended December 31, 2017, increases in loans outweighed principal payments on available for sale securities.

During the year ended December 31, 2018, the Company experienced net cash inflows from financing activities totaling \$113,218,000, primarily as the result of increases in demand deposit and savings accounts and time deposits. For the year ended December 31, 2017, the Company experienced net cash inflows from financing activities totaling \$8,203,000 primarily as the result of increases in demand deposits and savings accounts offset by decreases in time deposits.

Liquidity risk arises from the possibility the Company may not be able to satisfy current or future financial commitments, or the Company may become unduly reliant on alternative funding sources. The Company maintains a liquidity risk

management policy to address and manage this risk. The policy identifies the primary sources of liquidity, sets wholesale funding limits, establishes procedures for monitoring and measuring liquidity, and establishes minimum liquidity requirements, which comply with regulatory guidance. The liquidity position is continually monitored and reported on a monthly basis to the Board of Directors.

The policy also includes a contingency funding plan to address liquidity needs in the event of an institution-specific or a systemic financial market crisis. In addition to unused lines of credit from other banks totaling \$331,565,000, the contingency plan includes identified funding sources, and steps that may be taken in the event the total liquidity ratio falls or is projected to fall below policy limits for any extended period of time. One of the primary directives of the contingency funding plan is to limit the Company's overall level of wholesale funding to no more than 25% of deposits. The current funding program uses both asset-based and liability-based principles, and identifies core deposits as the favored funding source when attainable at a reasonable cost. The policy identifies a number of funding sources or methods the Bank ALCO committee may utilize to fulfill the Company's liquidity funding requirements:

- 1) Local core deposits are the Company's primary funding source. The Company works to attract these deposits through service-related and competitive pricing tactics. Other liquidity funding sources are considered if local core deposits are not attractive because of maturity or pricing.
- 2) Unsecured Federal Funds lines with correspondent banks may be used to fund short-term peaks in loan demand or deposit run-off. Currently, unsecured borrowing lines with correspondents are limited and may not be reliable for long periods of time or in times of economic stress.
- 3) Other funding sources such as secured credit lines with the Federal Home Loan Bank or the Federal Reserve may be used for longer periods. The Company collateralized these available lines with a combination of investment securities and pledged loans. The Company has utilized specific loan pledging with both the FHLB and the Federal Reserve to better ensure the continued availability of those lines of credit.
- 4) The Company presently has a Discount Window facility available from the Federal Reserve Bank of San Francisco collateralized with loans as discussed above.

At December 31, 2018, the Company had available credit of \$287,446,000 from the Federal Reserve based upon the loans pledged at that date. The Federal Reserve will monitor use of the Discount Window closely given the current status of the Company and the economy as a whole. This credit facility may not be competitively priced under certain economic conditions. As such, the Company does not expect to use this facility except for short periods, but does consider this to be a key contingency funding source.

- 5) As long as the Bank remains "Well Capitalized," the Company may rely on brokered deposits when core deposit rates are higher in the marketplace or maturity structures are not desirable. The Company's current policy limit for brokered deposits is 25% of total deposits. The Company may also utilize other wholesale deposit sources such as memberships that advertise the Bank's time deposit rates to other subscribers, typically banks and credit unions. The Company's current policy limit on other wholesale deposits is 10% of total deposits.
- 6) The Bank may sell whole loans or participations in loans to provide additional liquidity. During economic downturns or other crises events, these funding sources may be difficult to achieve in a short period of time or at a reasonable price. As such, this strategy is better used as a long-term asset/liability management tool to effectively balance assets and liabilities to reduce liquidity risk.
- 7) The Company currently has Bank-Owned Life Insurance (BOLI) and Corporate-Owned Life Insurance (COLI) policies issued by highly rated insurance companies which may be sold to increase liquidity.
- 8) The Company owns certain real estate including its administration building and several of its branches. These may be sold and vacated or leased back from the purchaser after sale to provide additional liquidity if needed. The sales process may require substantial time to complete, and may have an adverse impact on earnings depending on market rates and other factors at the time of sale.
- 9) Investments near maturity may be sold to meet temporary funding needs but may need to be replaced to maintain liquidity ratios within acceptable limits. At the current time approximately half of the investment portfolio is pledged to secure public deposits and borrowing lines. The Company seeks

to maintain an investment-grade securities portfolio to ensure quality collateral for pledging against borrowing lines of credit as well as to provide liquidity in times of needs.

The Company's liquid asset base which generally consists of cash and due from banks, federal funds sold, securities purchased under agreements to resell ("reverse repos") and investment securities, are maintained at levels deemed sufficient to provide the cash necessary to fund loan growth as well as projected deposit runoff. Within this framework is the objective of maximizing the yield on earning assets. This is generally achieved by maintaining a high percentage of earning assets in loans, which historically have represented the Company's highest yielding asset. At December 31, 2018, the Bank had 63.00% of total assets in the loan portfolio and a loan to deposit ratio of 71.92%, as compared to 74.75% of total assets in the loan portfolio and a loan to deposit ratio of 86.25% at December 31, 2017. Liquid assets at December 31, 2018 include cash and cash equivalents totaling \$220,337,000, as compared to \$107,934,000 at December 31, 2017.

Liabilities used to fund liquidity sources include core and non-core deposits as well as short-term borrowings capability. Core deposits, which comprise approximately 97.32% of total deposits at December 31, 2018, provide a significant and stable funding source for the Company. At December 31, 2018, unused lines of credit with the Federal Home Loan Bank, Pacific Coast Banker's Bank, Zion's Bank, Union Bank and the Federal Reserve Bank totaling \$331,565,000 are collateralized in part by certain qualifying loans in the Company's loan portfolio. The carrying value of loans pledged on these used and unused borrowing lines totaled \$421,393,000 at December 31, 2018. For further discussion of the Company's borrowing lines, see "Short Term Borrowings" included previously in the financial condition section of this financial review.

The liquidity of the parent company, United Security Bancshares, is separate from the bank and is primarily dependent on the payment of cash dividends by its subsidiary, United Security Bank, subject to limitations imposed by the Financial Code of the State of California and federal and state banking regulations. During the years ended December 31, 2018 and December 31, 2017, the Bank paid \$6,947,000 and \$4,291,000 in cash dividends to the parent company, respectively.

Regulatory Matters

Capital Adequacy

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements adopted by the Board of Governors of the Federal Reserve System (the "Board of Governors"). Failure to meet minimum capital requirements can initiate certain mandates and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements and results of operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the consolidated Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by the capital adequacy guidelines require insured institutions to maintain a

minimum leverage ratio of Tier 1 capital (the sum of common shareholders' equity, noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries, minus intangible assets, identified losses and investments in certain subsidiaries, plus unrealized losses or minus unrealized gains on available for sale securities) to total assets. Institutions which have received the highest composite regulatory rating and which are not experiencing or anticipating significant growth are required to maintain a minimum leverage capital ratio of 3% of Tier 1 capital to total assets. All other institutions are required to maintain a minimum leverage capital ratio of at least 100 to 200 basis points above the 3% minimum requirement.

We have adopted a capital plan that includes guidelines and trigger points to ensure sufficient capital is maintained at the Bank and the Company, and that capital ratios are maintained at a level deemed appropriate under regulatory guidelines given the level of classified assets, concentrations of credit, ALLL, current and projected growth, and projected retained earnings. The capital plan also contains contingency strategies to obtain additional capital as required to fulfill future capital requirements for both the Bank, as a separate legal entity, and the Company on a consolidated basis.

The following table sets forth the Company's and the Bank's actual capital positions at December 31, 2018 and 2017, as well as the minimum capital requirements and requirements to be well capitalized under prompt corrective action provisions (Bank required only) under the regulatory guidelines discussed above:

	Ratio at December 31, 2018	Ratio at December 31, 2017	Minimum for Capital Adequacy	Minimum requirement to be "Well Capitalized"
Total capital to risk weighted assets				
Company	17.80%	17.54%	8.00%	N/A
Bank	17.70%	17.31%	8.00%	10.00%
Tier 1 capital to risk-weighted assets				
Company	16.55%	16.29%	6.00%	N/A
Bank	16.45%	16.06%	6.00%	8.00%
Common equity tier 1 capital to risk-weighted assets				
Company	15.15%	14.81%	4.50%	N/A
Bank	16.45%	16.06%	4.50%	6.50%
Tier 1 capital to adjusted average assets (leverage)				
Company	12.15%	13.01%	4.00%	N/A
Bank	12.16%	12.90%	4.00%	5.00%

Federal regulations require FDIC-insured depository institutions, including the Bank, to meet several minimum capital standards: a common equity Tier 1 capital to risk-based assets ratio; a Tier 1 capital to risk-based assets ratio; a total capital to risk-based assets; and a Tier 1 capital to total assets leverage ratio. The existing capital requirements were effective January 1, 2015 and are the result of a final rule implementing regulatory amendments based on recommendations of the Basel Committee on Banking Supervision and certain requirements of the Dodd-Frank Act.

The capital standards require the maintenance of common equity Tier 1 capital, Tier 1 capital and Total capital to risk-weighted assets of at least 4.5%, 6% and 8%, respectively. The regulations also establish a minimum required leverage ratio of at least 4% Tier 1 capital. In addition to establishing the minimum regulatory capital requirements, the regulations limit capital distributions and certain discretionary bonus payments to management if the institution does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets above the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirement was fully implemented at 2.5% on December 31, 2018. Institutions that do not maintain the required capital buffer will become subject to progressively most stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to executive management.

As of December 31, 2018, the Company and the Bank meet all capital adequacy requirements to which they are subject.

Dividends

Dividends paid to our shareholders are subject to restrictions set forth in the California General Corporation Law. The California General Corporation Law provides that we may make a distribution to its shareholders if retained earnings immediately prior to the dividend payment are at least equal to the amount of the proposed distribution or if immediately after the distribution, the value of our assets would equal or exceed the sum of our total liabilities. The primary source of funds with which dividends will be paid to shareholders will come from cash dividends received by the Holding Company from the Bank.

During the year ended December 31, 2018, the Holding Company paid \$4,732,000 in cash dividends to our shareholders and the Bank paid cash dividends of \$6,947,000 to the Holding Company in order to fund the Holding Company's operating costs, payments of interest on our

junior subordinated debentures, estimated tax payments, redemption of junior subordinated debentures, and cash dividends paid to shareholders. During 2015, \$3.0 million of the Company's \$15.0 million in junior subordinated debt was retired. The balance of junior subordinated debentures remained at \$12.0 million for the years ended December 31, 2018 and December 31, 2017.

The Bank, as a state-chartered bank, is subject to dividend restrictions set forth in California state banking law and administered by the Commissioner of the California Department of Business Oversight ("Commissioner"). Under such restrictions, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank's net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the Commissioner, in an amount not exceeding the Bank's net income for its last fiscal year or the amount of its net income for the current fiscal year. Such restrictions do not apply to stock dividends, which generally require neither the satisfaction of any tests nor the approval of the Commissioner. Notwithstanding the foregoing, if the Commissioner finds that the shareholders' equity is not adequate or that the declarations of a dividend would be unsafe or unsound, the Commissioner may order the state bank not to pay any dividend. The FRB may also limit dividends paid by the Bank.

Reserve Balances

The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, we implemented a deposit reclassification program, which allows us to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At December 31, 2018, the Bank was not subject to a reserve requirement.



BANKING SERVICES

Checking Accounts

- Business
- Personal
- Interest Bearing

Certificates of Deposit

- Regular/Jumbo CD (various terms)
- Rate Increase CD™
- Variable Rate CD
- Individual Retirement Accounts (IRA) CD
- Certificates of Deposit Registry Service (CDARS)

Loan Services

- Agricultural Development & Production
- Commercial Business
- Commercial Construction & Development
- Consumer

Savings Accounts

- Business
- Personal
- Individual Retirement Accounts (IRA)

Cash Management Services

- ACH
- Merchant Card Service
- Positive Pay
- Remote Deposit Capture
- Stop Payments
- Wire Transfers

Online Services

- Bill Payment
- eStatements
- Mobile Banking
- Online Banking

Safe Deposit Boxes

- Various sizes available at each branch location





CORPORATE DATA

BOARD OF DIRECTORS

Dennis R. Woods

Chairman of the Board

Robert M. Mochizuki, MD

Lead Director

Susan Quigley, CPA

Secretary of the Board

Stanley J. Cavalla

Director

Tom Ellithorpe

Director

Benjamin Mackovak

Director

Nabeel Mahmood

Director

Kenneth Newby, CPA

Director

Brian Tkacz

Director

Michael T. Woolf, DDS

Director

MANAGEMENT

Dennis R. Woods

*President and
Chief Executive Officer*

David L. Eytcheson

*Senior Vice President
and Chief Operating Officer*

Bhavneet Gill

*Senior Vice President
and Chief Financial Officer*

Robert Oberg

*Senior Vice President
and Chief Risk Officer*

William M. Yarbenet

*Senior Vice President
and Chief Credit Officer*

Evette Bertsche

*Vice President and Operations
Assistant and Training Officer*

Kim Bledsoe

*Vice President
and Risk Manager*

Joseph Carnevali, CISSP

*Vice President
and IT Manager*

John Elliott

*Vice President and
Credit Administrator*

Denise Flynn

*Vice President and R/E
Construction Loan Officer*

Bart Hill

*Vice President and
Area Manager, Bakersfield*

Tanya Iacono

*Vice President and
Commercial Loan Officer*

Shyam Iyer

*Vice President and
Credit Administrator*

Michael Ossanna

*Vice President and
Commercial Loan Officer*

Dana C. Paull, CRCM

*Vice President and
Compliance Manager*

Karyn D. Reynolds

*Vice President and
Loan Service Center Manager*

Susan J. Robertson

*Vice President and
Data Processing Manager*

Ellie M. Rosenberg

*Vice President and
Human Resources Director*

Porsche A. Saunders

*First Vice President and R/E
Construction Loan Manager*

Phillip Smith

*Vice President and R/E
Construction Loan Officer*

Jeremy Snow, CPA

Vice President and Controller

Paul N. Thaxter

*First Vice President and
Commercial Banking Center
Manager*

DIRECTORS EMERITI

William J. Asbury, DDS, MS

W. Gerald Flanagan

Robert Bitter, PHARM. D.

Jerry Greer

R. Kent Kunz

Gerald Mcintyre

Ronnie Miller

Joseph Petkewish

Walter Reinhard

Martha Sanford

O'Neal Sutton, III

John Terzian

Bobbi Thomason

Les Workman

Samson Zarnegar

William H. Ziering, MD

TRANSFER AGENT AND REGISTRAR OF COMMON STOCK

EQ by Equiniti

1110 Centre Point Curve, Suite 101
MAC N9173-010
Mendota Heights, MN 55120
(800) 468-9716

STOCK INFORMATION

Crowell, Weedon & Co.

42605 Moonridge Rd.
Big Bear Lake, CA 92315
(800) 288-2811

Hill Thompson Magid & Co.

15 Exchange Place
P. O. Box 1688 – NOL Center
Jersey City, NJ 07302
(800) 631-3083

**Howe Barnes Hoeffler &
Arnett, Inc.**

555 Market Street, 18th Floor
San Francisco, CA 94105
(415) 362-7111

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BRANCHES

FRESNO

West & Shaw

2151 W. Shaw Avenue
Fresno, CA 93711
(559) 225-0101

First & Herndon

7088 N. First Street
Fresno, CA 93720
(559) 248-4949

Convention Center

855 M Street, Suite 130
Fresno, CA 93721
(559) 233-7968

BAKERSFIELD

3404 Coffee Road
Bakersfield, CA 93308
(661) 588-2265

CAMPBELL

1875 S. Bascom, Suite 119
Campbell, CA 95008
(408) 341-1000

CARUTHERS

13356 S. Henderson Road
Caruthers, CA 93609
(559) 864-3287

COALINGA

145 E. Durian Street
Coalinga, CA 93210
(559) 935-0862

FIREBAUGH

1067 O Street
Firebaugh, CA 93622
(559) 659-2077

OAKHURST

40074 Highway 49
Oakhurst, CA 93644
(559) 683-2200

SAN JOAQUIN

21574 W. Manning Avenue
San Joaquin, CA 93660
(559) 693-4332

TAFT

523 Cascade Place
Taft, CA 93268
(661) 763-5151

ATM ONLY

BAKERSFIELD

Bakersfield, CA 93301
S/W corner of
24th & G Street

CLOVIS

Clovis Crossing
Shopping Center
Clovis, CA 93612
N/E corner of
Herndon Ave. & Clovis Ave.

COARSEGOLD

Hillside Supermarket
28420 Yosemite Springs Pkwy.
Coarsegold, CA 93614

FRESNO

Ventura Market Center
3232 E. Ventura Avenue
Fresno, CA 93702

FRESNO

5720 N. Blackstone Avenue
Fresno, CA 93710
S/E corner of
Blackstone Ave. & Bullard Ave.

FRESNO

The Market Place at El Paseo
6709 N. Riverside Dr.
Fresno, CA 93722

KERMAN

15146 W. Whitesbridge Ave.
Kerman, CA 93630

McFARLAND

698 Frontage Road
McFarland, CA 93250

MENDOTA

697 Derrick Avenue
Mendota, CA 93640

INTERACTIVE TELLER MACHINE (ITM)

BAKERSFIELD

3504 Coffee Rd.
Bakersfield, CA 93308

FIREBAUGH

1067 O Street
Firebaugh, CA 93622

OFFICES

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2151 W. Shaw Avenue
Fresno, CA 93711
(559) 225-0101

CONSUMER LENDING

7088 N. First Street
Fresno, CA 93720
(559) 243-2345

CORPORATE OFFICE

2126 Inyo Street
Fresno, CA 93721
(888) 683-6030

REAL ESTATE CONSTRUCTION LENDING

7088 N. First Street
Fresno, CA 93720
(559) 248-4940

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