

## Section 1: 10-Q (10-Q 06302018)

[Table of Contents](#)

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

### FORM 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2018
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.

Commission file number: 000-32897

## UNITED SECURITY BANCSHARES

(Exact name of registrant as specified in its charter)

CALIFORNIA

(State or other jurisdiction of incorporation or organization)

91-2112732

(I.R.S. Employer Identification No.)

2126 Inyo Street, Fresno, California

(Address of principal executive offices)

93721

(Zip Code)

Registrants telephone number, including area code (559) 248-4943

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a small reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer   
Small reporting company

Accelerated filer

Non-accelerated filer   
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

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

Common Stock, no par value

(Title of Class)

Shares outstanding as of July 31, 2018: 16,901,618

**TABLE OF CONTENTS**

Facing Page

Table of Contents

PART I. Financial Information

Item 1. Financial Statements	
<u>Consolidated Balance Sheets</u>	<u>3</u>
<u>Consolidated Statements of Income</u>	<u>4</u>
<u>Consolidated Statements of Comprehensive Income</u>	<u>5</u>
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	<u>6</u>
<u>Consolidated Statements of Cash Flows</u>	<u>7</u>
<u>Notes to Consolidated Financial Statements</u>	<u>9</u>
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>40</u>
<u>Overview</u>	<u>40</u>
<u>Results of Operations</u>	<u>41</u>
<u>Financial Condition</u>	<u>48</u>
<u>Asset/Liability Management – Liquidity and Cash Flow</u>	<u>60</u>
<u>Regulatory Matters</u>	<u>61</u>
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	<u>63</u>
<u>Item 4. Controls and Procedures</u>	<u>63</u>
PART II. Other Information	
Item 1. <u>Legal Proceedings</u>	<u>65</u>
Item 1A. <u>Risk Factors</u>	<u>65</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>65</u>
Item 3. <u>Defaults Upon Senior Securities</u>	<u>65</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>65</u>
Item 5. <u>Other Information</u>	<u>65</u>
Item 6. <u>Exhibits</u>	<u>65</u>
<u>Signatures</u>	<u>66</u>

**PART I. Financial Information****United Security Bancshares and Subsidiaries  
Consolidated Balance Sheets – (unaudited)  
June 30, 2018 and December 31, 2017***(in thousands except shares)*

	June 30, 2018	December 31, 2017
<b>Assets</b>		
Cash and non-interest bearing deposits in other banks	\$ 29,939	\$ 35,237
Due from Federal Reserve Bank ("FRB")	161,189	72,697
Cash and cash equivalents	191,128	107,934
Investment securities (at fair value)		
Available for sale ("AFS") securities	56,724	41,985
Marketable equity securities	3,659	3,737
Total investment securities	60,383	45,722
Loans	573,996	601,351
Unearned fees and unamortized loan origination costs, net	355	1,039
Allowance for credit losses	(8,425)	(9,267)
Net loans	565,926	593,123
Accrued interest receivable	8,392	6,526
Premises and equipment – net	10,041	10,165
Other real estate owned	5,745	5,745
Goodwill	4,488	4,488
Cash surrender value of life insurance	19,803	19,752
Investment in limited partnerships	1,592	1,601
Deferred tax assets - net	2,616	2,389
Other assets	9,354	8,391
<b>Total assets</b>	<b>\$ 879,468</b>	<b>\$ 805,836</b>
<b>Liabilities &amp; Shareholders' Equity</b>		
<b>Liabilities</b>		
Deposits		
Noninterest bearing	\$ 281,686	\$ 307,299
Interest bearing	475,277	380,394
Total deposits	756,963	687,693
Accrued interest payable	43	44
Accounts payable and other liabilities	7,121	7,017
Junior subordinated debentures (at fair value)	10,125	9,730
<b>Total liabilities</b>	<b>774,252</b>	<b>704,484</b>
<b>Shareholders' Equity</b>		
Common stock, no par value 20,000,000 shares authorized, 16,901,618 issued and outstanding at June 30, 2018, and 16,885,615 at December 31, 2017	58,309	57,880
Retained earnings	46,025	44,182
Accumulated other comprehensive income (loss)	882	(710)
<b>Total shareholders' equity</b>	<b>105,216</b>	<b>101,352</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 879,468</b>	<b>\$ 805,836</b>

[Table of Contents](#)

**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Income**  
**(Unaudited)**

<i>(In thousands except shares and EPS)</i>	Quarter Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
<b>Interest Income:</b>				
Loans, including fees	\$ 7,491	\$ 7,579	\$ 15,717	\$ 14,804
Investment securities – AFS – taxable	265	229	457	453
Interest on deposits in FRB	681	301	1,065	484
Interest on deposits in other banks	—	1	—	2
Total interest income	8,437	8,110	17,239	15,743
<b>Interest Expense:</b>				
Interest on deposits	550	364	937	700
Interest on other borrowings	109	74	199	143
Total interest expense	659	438	1,136	843
<b>Net Interest Income</b>	7,778	7,672	16,103	14,900
<b>Recovery of Provision for Credit Losses</b>	(1,136)	(52)	(1,325)	(31)
<b>Net Interest Income after Recovery of Provision for Credit Losses</b>	8,914	7,724	17,428	14,931
<b>Noninterest Income:</b>				
Customer service fees	1,020	997	1,971	1,938
Increase in cash surrender value of bank-owned life insurance	132	134	257	266
Loss on marketable equity securities	(18)	—	(78)	—
Gain on proceeds from bank-owned life insurance	—	—	171	—
Loss on fair value of financial liability	(192)	(264)	(661)	(601)
Gain on sale of assets	29	—	29	—
Other	198	199	403	372
Total noninterest income	1,169	1,066	2,092	1,975
<b>Noninterest Expense:</b>				
Salaries and employee benefits	3,010	2,586	5,971	5,571
Occupancy expense	1,117	1,043	2,135	2,058
Data processing	38	25	90	52
Professional fees	392	345	727	600
Regulatory assessments	78	133	161	269
Director fees	81	75	162	143
Correspondent bank service charges	17	19	34	37
Loss on California tax credit partnership	5	10	9	119
Net cost (gain) on operation and sale of OREO	49	(309)	100	(277)
Other	531	680	929	1,226
Total noninterest expense	5,318	4,607	10,318	9,798
<b>Income Before Provision for Taxes</b>	4,765	4,183	9,202	7,108
<b>Provision for Taxes on Income</b>	1,373	1,691	2,653	2,845
<b>Net Income</b>	\$ 3,392	\$ 2,492	\$ 6,549	\$ 4,263
<b>Net Income per common share</b>				
Basic	\$ 0.20	\$ 0.15	\$ 0.39	\$ 0.25

Diluted	\$	0.20	\$	0.15	\$	0.39	\$	0.25
<b>Shares on which net income per common shares were based</b>								
Basic		16,899,968		16,875,336		16,895,135		16,792,083
Diluted		16,957,282		16,894,373		16,935,911		16,808,733

[Table of Contents](#)

**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Comprehensive Income**  
**(Unaudited)**

<i>(In thousands)</i>	<b>Three Months Ended June 30, 2018</b>	<b>Three Months Ended June 30, 2017</b>	<b>Six Months Ended June 30, 2018</b>	<b>Six Months Ended June 30, 2017</b>
Net Income	\$ 3,392	\$ 2,492	\$ 6,549	\$ 4,263
Unrealized holdings (loss) gain on securities	(171)	267	(428)	355
Unrealized gains on unrecognized post-retirement costs	18	13	27	26
Unrealized (loss) gain on TRUPs	(272)	—	295	—
Other comprehensive income (loss), before tax	(425)	280	(106)	381
Tax benefit (expense) related to securities	46	(107)	128	(142)
Tax expense related to unrecognized post-retirement costs	(5)	(6)	(8)	(11)
Tax benefit (expense) related to TRUPs	80	—	(88)	—
Total other comprehensive income (loss)	(304)	167	(74)	228
Comprehensive Income	\$ 3,088	\$ 2,659	\$ 6,475	\$ 4,491

[Table of Contents](#)

**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**(unaudited)**

<i>(In thousands except shares)</i>	Common stock		Retained Earnings	Accumulated Other Comprehensive (Loss) Gain	Total
	Number of Shares	Amount			
<b>Balance December 31, 2016 (1)</b>	16,705,594	\$ 56,557	\$ 40,701	\$ (604)	\$ 96,654
(1) Excludes 12,015 unvested restricted shares					
Other comprehensive income				228	228
Common stock dividends	167,082	1,221	(1,221)		—
Dividends on common stock (\$0.05 per share)			(845)		(845)
Dividends payable (\$0.05 per share)			(845)		(845)
Stock options exercised	2,514	6			6
Stock-based compensation expense		60			60
Net income			4,263		4,263
<b>Balance June 30, 2017 (2)</b>	16,875,190	\$ 57,844	\$ 42,053	\$ (376)	\$ 99,521
(2) Excludes 9,011 unvested restricted shares					
Other comprehensive loss				(221)	(221)
Reclassification of income tax effects from accumulated other comprehensive income			113	(113)	—
Dividends on common stock (\$0.07 per share)			(1,180)		(1,180)
Dividends payable (\$0.07 per share)			(1,182)		(1,182)
Restricted stock units released	10,425				—
Stock-based compensation expense		36			36
Net income			4,378		4,378
<b>Balance December 31, 2017 (3)</b>	16,885,615	\$ 57,880	\$ 44,182	\$ (710)	\$ 101,352
(3) Excludes 46,511 unvested restricted shares					
Other comprehensive loss				(74)	(74)
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	—
Dividends on common stock (\$0.09 per share)			(1,520)		(1,520)
Dividends payable (\$0.09 per share)			(1,520)		(1,520)
Restricted stock units released	16,003				—
Stock-based compensation expense		429			429
Net income			6,549		6,549
<b>Balance June 30, 2018 (4)</b>	16,901,618	\$ 58,309	\$ 46,025	\$ 882	\$ 105,216
(4) Excludes 78,508 unvested restricted shares					



[Table of Contents](#)

**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Cash Flows (unaudited)**

<i>(In thousands)</i>	<b>Six months ended June 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Cash Flows From Operating Activities:</b>		
Net Income	\$ 6,549	\$ 4,263
Adjustments to reconcile net income: to cash provided by operating activities:		
Recovery of provision for credit losses	(1,325)	(31)
Depreciation and amortization	666	654
Amortization of investment securities	261	278
Accretion of investment securities	(3)	(4)
Increase in accrued interest receivable	(1,866)	(1,191)
Decrease in accrued interest payable	(1)	(43)
Decrease in accounts payable and accrued liabilities	(1,401)	(398)
Decrease in unearned fees and unamortized loan origination costs, net	684	152
Increase in income taxes receivable	(1,204)	(1,319)
Unrealized loss on marketable equity securities	78	—
Stock-based compensation expense	429	60
Provision for deferred income taxes	(108)	(247)
Gain on sale of other real estate owned	—	(336)
Gain on bank owned life insurance	(171)	—
Increase in cash surrender value of bank-owned life insurance	(257)	(266)
Loss on fair value option of financial liabilities	661	601
Loss on tax credit limited partnership interest	9	119
Gain on sale of premises and equipment	(29)	—
Net increase in other assets	(28)	(42)
Net cash provided by operating activities	<u>2,944</u>	<u>2,250</u>
<b>Cash Flows From Investing Activities:</b>		
Net increase in interest-bearing deposits with banks	—	(2)
Purchase of correspondent bank stock	(10)	(495)
Purchases of available-for-sale securities	(19,860)	—
Principal payments of available-for-sale securities	4,698	4,112
Net decrease in loans	27,839	2,654
Cash proceeds from sales of other real estate owned	—	1,062
Investment in limited partnership	—	(1,028)
Proceeds from bank owned life insurance	376	—
Capital expenditures of premises and equipment	(542)	(919)
Net cash provided by investing activities	<u>12,501</u>	<u>5,384</u>
<b>Cash Flows From Financing Activities:</b>		
Net increase in demand deposits and savings accounts	67,299	24,885
Net increase (decrease) in time deposits	1,970	(35,203)
Proceeds from exercise of stock options	—	6
Dividends on common stock	(1,520)	(846)
Net cash provided by (used in) financing activities	<u>67,749</u>	<u>(11,158)</u>

Table of Contents

Net increase (decrease) in cash and cash equivalents	83,194	(3,524)
Cash and cash equivalents at beginning of period	107,934	113,032
Cash and cash equivalents at end of period	<u>\$ 191,128</u>	<u>\$ 109,508</u>

**United Security Bancshares and Subsidiaries - Notes to Consolidated Financial Statements - (Unaudited)**

***1. Organization and Summary of Significant Accounting and Reporting Policies***

The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary United Security Bank (the “Bank”) and one bank subsidiary, USB Investment Trust (the “REIT”) (collectively the “Company” or “USB”). Intercompany accounts and transactions have been eliminated in consolidation.

These unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information on a basis consistent with the accounting policies reflected in the audited financial statements of the Company included in its 2017 Annual Report on Form 10-K. These interim financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of a normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

**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. 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.

**Recently Issued 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 11 – 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 10 - 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. Although an estimate of the impact of the new leasing standard has not yet been determined, the Company expects a significant new lease asset and related lease liability on the consolidated balance sheet due to the number of leased branches and standalone ATM sites the Company currently has that are accounted for

[Table of Contents](#)

under current operating lease guidance. The Company has implemented a lease review team and is in the process of determining the best vendor to assist in the calculation and implementation of this standard.

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 established a project team for the implementation of this new standard. The team has started by working with a vendor to put a new Allowance for Loan Loss software in place and is collecting additional historical data to estimate the impact of this standard. An estimate of the impact of this standard has not yet been determined, however, the impact on the Company's consolidated financial statements is expected to be significant.

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.

**2. Investment Securities**

Following is a comparison of the amortized cost and fair value of securities available-for-sale, as of June 30, 2018 and December 31, 2017:

(in 000's)

<b>June 30, 2018</b>				<b>Fair Value (Carrying Amount)</b>
<u>Securities available for sale:</u>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	
U.S. Government agencies	\$ 30,327	\$ 182	\$ (158)	\$ 30,351
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	26,914	37	(578)	26,373
<b>Total securities available for sale</b>	<b>\$ 57,241</b>	<b>\$ 219</b>	<b>\$ (736)</b>	<b>\$ 56,724</b>

(in 000's)

<b>December 31, 2017</b>				<b>Fair Value (Carrying Amount)</b>
<u>Securities available for sale:</u>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	
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
<b>Total securities available for sale</b>	<b>\$ 42,074</b>	<b>\$ 368</b>	<b>\$ (457)</b>	<b>\$ 41,985</b>

The amortized cost and fair value of securities available for sale at June 30, 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.

[Table of Contents](#)

(in 000's)	June 30, 2018	
	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	6,045	6,031
Due after ten years	24,282	24,320
Collateralized mortgage obligations	26,914	26,373
	<u>\$ 57,241</u>	<u>\$ 56,724</u>

There were no realized gains or losses on sales of available-for-sale securities for the three and six month periods ended June 30, 2018 and June 30, 2017. There were no other-than-temporary impairment losses for the three and six month periods ended June 30, 2018 and June 30, 2017.

At June 30, 2018, available-for-sale securities with an amortized cost of approximately \$50,806,841 (fair value of \$50,240,058) were pledged as collateral for FHLB borrowings, securitized deposits, and public funds balances.

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:

(in 000's)	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
<b>June 30, 2018</b>						
<u>Securities available for sale:</u>						
U.S. Government agencies	\$ 12,673	\$ (55)	7,464	(103)	\$ 20,137	\$ (158)
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	7,188	(204)	12,134	(374)	19,322	(578)
Total impaired securities	<u>\$ 19,861</u>	<u>\$ (259)</u>	<u>\$ 19,598</u>	<u>\$ (477)</u>	<u>\$ 39,459</u>	<u>\$ (736)</u>

**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	<u>\$ 9,211</u>	<u>\$ (157)</u>	<u>\$ 20,208</u>	<u>\$ (300)</u>	<u>\$ 29,419</u>	<u>\$ (457)</u>

Temporarily impaired securities at June 30, 2018, were comprised of seven U.S. government agency securities, and twelve U.S. government sponsored entities and agencies collateralized by mortgage obligations securities.

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

## Table of Contents

classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under ASC Topic 320, *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.

Additionally, 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 less any current-period credit loss. If the Company intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, 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 the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period loss, 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 June 30, 2018, the decline in fair value of the seven U.S. government agency securities, and the twelve 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 at June 30, 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 reclassified from accumulated other comprehensive income to retained earnings.

During the six months ended June 30, 2018, the Company recognized \$78,000 of unrealized losses related to equity securities held at June 30, 2018 in the consolidated statements of income. For the quarter ended June 30, 2018, the Company recognized \$18,000 of unrealized losses related to equity securities held at June 30, 2018 in the consolidated statements of income. The resulting impact on basic and diluted earnings per share for the quarter and six months ended June 30, 2018 is immaterial.

The Company had no held-to-maturity or trading securities at June 30, 2018 or December 31, 2017.

### 3. Loans

Loans are comprised of the following:

(in 000's)	June 30, 2018	December 31, 2017
Commercial and Business Loans	\$ 57,047	\$ 46,065
Government Program Loans	908	961
Total Commercial and Industrial	57,955	47,026
Real Estate – Mortgage:		
Commercial Real Estate	212,513	221,032
Residential Mortgages	70,512	84,804
Home Improvement and Home Equity loans	386	457
Total Real Estate Mortgage	283,411	306,293
Real Estate Construction and Development	108,571	122,970
Agricultural	56,662	59,481
Installment and Student Loans	67,397	65,581
Total Loans	\$ 573,996	\$ 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, they are primarily in the state of California.

Commercial and industrial loans represent 10.1% of total loans at June 30, 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 commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 49.4% of total loans at June 30, 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 generally comes from the cash flow of the borrower and or guarantor(s).

- Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and non-income producing 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. 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.
- Home Improvement and Home Equity loans comprise a relatively small portion of total real estate mortgage loans. Home equity loans are generally secured by junior trust deeds, but may be secured by 1<sup>st</sup> trust deeds.

Real estate construction and development loans, representing 18.9% of total loans at June 30, 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 generally comes from long-term mortgages with other lending institutions obtained at completion of the project or from the sale of the constructed homes to individuals.

## Table of Contents

Agricultural loans represent 9.9% of total loans at June 30, 2018 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Installment loans, including student loans, represent 11.7% of total loans at June 30, 2018 and generally consist of student loans, loans to individuals for household, family and other personal expenditures, automobiles or other consumer items. Included in installment loans are \$61,761,000 in unsecured student loans 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 have not entered repayment status totaled \$6,186,000 at June 30, 2018. At June 30, 2018 there were 316 loans within repayment, deferment, and forbearance which represented \$6,129,000, \$1,270,000, and \$3,006,000 in outstanding balances respectively. Prior to June 2018, student loans were insured through a Surety Bond issued by ReliaMax Surety Company and provided the Company reasonable expectation of collection. 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, the Company's student loan portfolio is no longer insured.

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 June 30, 2018 and December 31, 2017, these financial instruments include commitments to extend credit of \$123,711,000 and \$99,958,000, respectively, and standby letters of credit of \$605,000 and \$2,058,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the consolidated 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. A majority 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.

During the second quarter of 2018, the Bank entered into a Small Business Administration (SBA) 504 Loan Forward Purchase Commitment to buy a one hundred percent (100%) interest in up to \$30 million, first mortgage, California SBA 504 loans on a flow basis with servicing released by the Seller.



[Table of Contents](#)

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 June 30, 2018 (in 000's):

June 30, 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	\$ —	\$ —	\$ —	\$ —	\$ 57,047	\$ 57,047	\$ —
Government Program Loans	—	—	—	—	908	908	—
Total Commercial and Industrial	—	—	—	—	57,955	57,955	—
Commercial Real Estate Loans	—	—	—	—	212,513	212,513	—
Residential Mortgages	—	—	—	—	70,512	70,512	—
Home Improvement and Home Equity Loans	—	—	—	—	386	386	—
Total Real Estate Mortgage	—	—	—	—	283,411	283,411	—
Real Estate Construction and Development Loans	—	—	8,825	8,825	99,746	108,571	—
Agricultural Loans	—	—	—	—	56,662	56,662	—
Consumer Loans	231	83	—	314	66,929	67,243	67
Overdraft Protection Lines	—	—	—	—	38	38	—
Overdrafts	—	—	—	—	116	116	—
Total Installment	231	83	—	314	67,083	67,397	67
Total Loans	\$ 231	\$ 83	\$ 8,825	\$ 9,139	\$ 564,857	\$ 573,996	\$ 67

The following is a summary of delinquent loans at December 31, 2017 (in 000's):

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	—
Consumer Loans	—	—	—	—	65,446	65,446	125
Overdraft Protection Lines	—	—	—	—	38	38	—
Overdrafts	—	—	—	—	97	97	—
Total Installment	—	—	—	—	65,581	65,581	125
Total Loans	\$ 779	\$ —	\$ 666	\$ 1,445	\$ 599,906	\$ 601,351	\$ 485



## Table of Contents

### Nonaccrual Loans

Commercial, construction and commercial real estate loans are placed on nonaccrual 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 including 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 nonaccrual 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 other 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.

When a loan is placed on nonaccrual 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 are credited to interest income as received.

Loans on non-accrual status are usually not returned to accrual status unless 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). Return to accrual is generally demonstrated through the timely receipt of at least six monthly payments on a loan with monthly amortization.

Nonaccrual loans totaled \$12,202,000 and \$5,296,000 at June 30, 2018 and December 31, 2017, respectively. Two loans were added to nonaccrual during the quarter ended June 30, 2018. Those loans, totaling \$8,825,000, were made to the same borrower and are well-secured by real estate collateral. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at June 30, 2018 or December 31, 2017.

*The following is a summary of nonaccrual loan balances at June 30, 2018 and December 31, 2017 (in 000's).*

Table of Contents

	June 30, 2018	December 31, 2017
Commercial and Business Loans	\$ —	\$ 212
Government Program Loans	—	—
Total Commercial and Industrial	—	212
Commercial Real Estate Loans	438	454
Residential Mortgages	—	288
Home Improvement and Home Equity Loans	—	—
Total Real Estate Mortgage	438	742
Real Estate Construction and Development Loans	11,764	4,342
Agricultural Loans	—	—
Consumer Loans	—	—
Overdraft Protection Lines	—	—
Overdrafts	—	—
Total Installment	—	—
Total Loans	\$ 12,202	\$ 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.

Table of Contents

- 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 June 30, 2018 (in 000's).

June 30, 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	\$ 2,937	\$ 535	\$ 2,414	\$ 2,949	\$ 444	\$ 3,171	\$ 97
Government Program Loans	308	309	—	309	—	226	10
<b>Total Commercial and Industrial</b>	<b>3,245</b>	<b>844</b>	<b>2,414</b>	<b>3,258</b>	<b>444</b>	<b>3,397</b>	<b>107</b>
Commercial Real Estate Loans	1,362	—	1,367	1,367	510	1,409	34
Residential Mortgages	2,219	400	1,828	2,228	80	2,604	60
Home Improvement and Home Equity Loans	—	—	—	—	—	—	—
Total Real Estate Mortgage	3,581	400	3,195	3,595	590	4,013	94
Real Estate Construction and Development Loans	11,764	11,764	—	11,764	—	7,447	205
Agricultural Loans	1,010	1	1,016	1,017	706	1,112	43
Consumer Loans	62	62	—	62	—	49	3
Overdraft Protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	62	62	—	62	—	49	3
<b>Total Impaired Loans</b>	<b>\$ 19,662</b>	<b>\$ 13,071</b>	<b>\$ 6,625</b>	<b>\$ 19,696</b>	<b>\$ 1,740</b>	<b>\$ 16,018</b>	<b>\$ 452</b>

(1) The recorded investment in loans includes accrued interest receivable of \$34.

(2) Information is based on the six month period ended June 30, 2018.

[Table of Contents](#)

The following is a summary of impaired loans at December 31, 2017 (in 000's).

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
Consumer Loans	—	—	—	—	—	241	—
Overdraft Protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	—	—	—	—	—	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 restructurings for which the loan is performing under the current contractual terms for a reasonable period of time, income is recognized under the accrual method.

The average recorded investment in impaired loans for the quarters ended June 30, 2018 and 2017 was \$16,633,000 and \$16,881,000, respectively. Interest income recognized on impaired loans for the quarters ended June 30, 2018 and 2017 was approximately \$282,000 and \$323,000, respectively. For impaired nonaccrual loans, interest income recognized under a cash-basis method of accounting was approximately \$150,000 and \$111,000 for the quarters ended June 30, 2018 and 2017, respectively.

The average recorded investment in impaired loans for the six months ended June 30, 2018 and 2017 was \$16,018,000 and \$16,468,000, respectively. Interest income recognized on impaired loans for the six months ended June 30, 2018 and 2017 was approximately \$452,000 and \$546,000, respectively. For impaired nonaccrual loans, interest income recognized under a cash-basis method of accounting was approximately \$213,000 and \$190,000 for the six months ended June 30, 2018 and 2017, respectively.

Table of Contents

Troubled Debt Restructurings

In certain 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 and continued satisfactory performance is expected. To this end, the Company typically 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 illustrates TDR additions for the periods indicated:

(\$ in 000's)	Three Months Ended June 30, 2018					
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs	
<b>Troubled Debt Restructurings</b>						
Commercial and Business Loans	—	\$ —	\$ —	—	—	\$ —
Government Program Loans	—	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—	—	—
Single Family Residential Loans	—	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—	—
Real Estate Construction and Development Loans	—	—	—	—	—	—
Agricultural Loans	—	—	—	—	—	—
Consumer Loans	—	—	—	—	—	—
Overdraft Protection Lines	—	—	—	—	—	—
<b>Total Loans</b>	<b>—</b>	<b>\$ —</b>	<b>\$ —</b>	<b>—</b>	<b>—</b>	<b>\$ —</b>

Three Months Ended June 30, 2017

(\$ in 000's)	Number of Contracts	Pre-	Post-	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
		Modification Outstanding Recorded Investment	Modification Outstanding Recorded Investment		
<b>Troubled Debt Restructurings</b>					
Commercial and Business Loans	—	\$ —	\$ —	—	\$ —
Government Program Loans	1	178	178	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	1	238	238	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
Real Estate Construction and Development Loans	—	—	—	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft Protection Lines	—	—	—	—	—
<b>Total Loans</b>	<b>2</b>	<b>\$ 416</b>	<b>\$ 416</b>	<b>—</b>	<b>\$ —</b>

Six Months Ended June 30, 2018

(\$ in 000's)	Number of Contracts	Pre-	Post-	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
		Modification Outstanding Recorded Investment	Modification Outstanding Recorded Investment		
<b>Troubled Debt Restructurings</b>					
Commercial and Business Loans	—	\$ —	\$ —	—	\$ —
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
Real Estate Construction and Development Loans	—	—	—	1	310
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft Protection Lines	—	—	—	—	—
<b>Total Loans</b>	<b>—</b>	<b>\$ —</b>	<b>\$ —</b>	<b>1</b>	<b>\$ 310</b>



Six Months Ended June 30, 2017

(\$ in 000's)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
<b>Troubled Debt Restructurings</b>					
Commercial and Business Loans	1	\$ 69	\$ 69	—	\$ —
Government Program Loans	1	178	178	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	1	238	238	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
Real Estate Construction and Development Loans	1	790	790	—	—
Agricultural Loans	1	850	850	—	—
Consumer Loans	—	—	—	—	—
Overdraft Protection Lines	—	—	—	—	—
<b>Total Loans</b>	<b>5</b>	<b>\$ 2,125</b>	<b>\$ 2,125</b>	<b>—</b>	<b>\$ —</b>

The Company makes various types of concessions when structuring TDRs including rate discounts, payment extensions, and forbearance. At June 30, 2018, the Company had 17 restructured loans totaling \$7,641,000 as compared to 25 restructured loans totaling \$11,362,000 at December 31, 2017.

The following tables summarize TDR activity by loan category for the quarters ended June 30, 2018 and June 30, 2017 (in 000's).

Three Months Ended June 30, 2018	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Other	Total
Beginning balance	\$ 147	\$ 1,314	\$ 2,525	\$ —	\$ 4,606	\$ 1,110	\$ —	\$ 9,702
Defaults	—	—	—	—	—	—	—	—
Additions	—	—	—	—	—	—	—	—
Principal (reductions) additions	(37)	48	(305)	—	(1,667)	(100)	—	(2,061)
Charge-offs	—	—	—	—	—	—	—	—
<b>Ending balance</b>	<b>\$ 110</b>	<b>\$ 1,362</b>	<b>\$ 2,220</b>	<b>\$ —</b>	<b>\$ 2,939</b>	<b>\$ 1,010</b>	<b>\$ —</b>	<b>\$ 7,641</b>
<b>Allowance for loan loss</b>	<b>\$ —</b>	<b>\$ 511</b>	<b>\$ 80</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 706</b>	<b>\$ —</b>	<b>\$ 1,297</b>

Table of Contents

Three Months Ended June 30, 2017	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Other	Total
Beginning balance	\$ 1,212	\$ 1,091	\$ 2,351	\$ —	\$ 6,960	\$ 850	\$ 965	\$ 13,429
Defaults	—	—	—	—	—	—	—	—
Additions	178	—	238	—	—	—	—	416
Principal reductions	(332)	(29)	(16)	—	(92)	(450)	(965)	(1,884)
Charge-offs	(3)	—	—	—	—	—	—	—
Ending balance	\$ 1,055	\$ 1,062	\$ 2,573	\$ —	\$ 6,868	\$ 400	\$ —	\$ 11,958
Allowance for loan loss	\$ 36	\$ 216	\$ 207	\$ —	\$ —	\$ 203	\$ —	\$ 662

The following tables summarize TDR activity by loan category for the six months ended June 30, 2018 and June 30, 2017 (in 000's).

Six Months Ended June 30, 2018	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Other	Total
Beginning balance	\$ 436	\$ 1,233	\$ 2,542	\$ —	\$ 5,951	\$ 1,200	\$ —	\$ 11,362
Defaults	—	—	—	—	(310)	—	—	(310)
Additions	—	—	—	—	—	—	—	—
Principal reductions	(263)	129	(322)	—	(2,702)	(190)	—	(3,348)
Charge-offs	(63)	—	—	—	—	—	—	(63)
Ending balance	\$ 110	\$ 1,362	\$ 2,220	\$ —	\$ 2,939	\$ 1,010	\$ —	\$ 7,641
Allowance for loan loss	\$ —	\$ 511	\$ 80	\$ —	\$ —	\$ 706	\$ —	\$ 1,297

Six Months Ended June 30, 2017	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Other	Total
Beginning balance	\$ 1,356	\$ 1,454	\$ 2,368	\$ —	\$ 6,267	\$ —	\$ 965	\$ 12,410
Defaults	—	—	—	—	—	—	—	—
Additions	247	—	238	—	790	850	—	2,125
Principal additions (reductions)	(538)	(392)	(33)	—	(189)	(450)	(965)	(2,567)

Charge-offs	(10)	—	—	—	—	—	—	(10)
Ending balance	\$ 1,055	\$ 1,062	\$ 2,573	\$ —	\$ 6,868	\$ 400	\$ —	\$ 11,958
Allowance for loan loss	\$ 36	\$ 216	\$ 207	\$ —	\$ —	\$ 203	\$ —	\$ 662

Credit Quality Indicators

## Table of Contents

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 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-

## Table of Contents

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 Company did not carry any loans graded as loss at June 30, 2018 or December 31, 2017.

[Table of Contents](#)

The following tables summarize the credit risk ratings for commercial, construction, and other non-consumer related loans for June 30, 2018 and December 31, 2017:

<b>June 30, 2018</b> (in 000's)	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Real Estate Construction and Development</b>	<b>Agricultural</b>	<b>Total</b>
Grades 1 and 2	\$ 325	\$ 2,924	\$ —	\$ —	\$ 3,249
Grade 3	217	1,067	—	—	1,284
Grades 4 and 5 – pass	54,230	199,707	85,057	55,652	394,646
Grade 6 – special mention	10	8,376	—	—	8,386
Grade 7 – substandard	3,173	439	23,514	1,010	28,136
Grade 8 – doubtful	—	—	—	—	—
<b>Total</b>	<b>\$ 57,955</b>	<b>\$ 212,513</b>	<b>\$ 108,571</b>	<b>\$ 56,662</b>	<b>\$ 435,701</b>

<b>December 31, 2017</b> (in 000's)	<b>Commercial and Industrial</b>	<b>Commercial Real Estate</b>	<b>Real Estate Construction and Development</b>	<b>Agricultural</b>	<b>Total</b>
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	—	—	—	—	—
<b>Total</b>	<b>\$ 47,026</b>	<b>\$ 221,032</b>	<b>\$ 122,970</b>	<b>\$ 59,481</b>	<b>\$ 450,509</b>

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 June 30, 2018 and December 31, 2017:

(in 000's)	<b>June 30, 2018</b>				<b>December 31, 2017</b>			
	<b>Residential Mortgages</b>	<b>Home Improvement and Home Equity</b>	<b>Installment and Other</b>	<b>Total</b>	<b>Residential Mortgages</b>	<b>Home Improvement and Home Equity</b>	<b>Installment and Other</b>	<b>Total</b>
Not graded	\$ 60,242	\$ 364	\$ 65,178	\$ 125,784	\$ 69,249	\$ 433	\$ 63,565	\$ 133,247
Pass	9,415	22	2,156	11,593	13,899	24	2,011	15,934
Special Mention	636	—	—	636	643	—	—	643
Substandard	219	—	63	282	1,013	—	5	1,018
Doubtful	—	—	—	—	—	—	—	—
<b>Total</b>	<b>\$ 70,512</b>	<b>\$ 386</b>	<b>\$ 67,397</b>	<b>\$ 138,295</b>	<b>\$ 84,804</b>	<b>\$ 457</b>	<b>\$ 65,581</b>	<b>\$ 150,842</b>

## Table of Contents

The following tables summarize the credit quality indicators for outstanding student loans as of June 30, 2018 and December 31, 2017 (in 000's, except for number of borrowers):

	June 30, 2018		December 31, 2017	
	Number of Loans	Amount (in 000's)	Number of Loans	Amount (in 000's)
School	992	\$ 37,565	1,216	\$ 48,825
Grace	294	13,724	55	1,446
Repayment	184	6,129	201	6,473
Deferment	40	1,270	32	1,128
Forbearance	92	3,006	50	1,981
Claim	1	67	—	—
Total	1,603	\$ 61,761	1,554	\$ 59,853

**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.

**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.

### 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 ten 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

[Table of Contents](#)

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 seven 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.

Installment and other 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 quarters ended June 30, 2018 and 2017 (in 000's).

Three Months Ended June 30, 2018	Commercial and Industrial	Real Estate Mortgage	Real Estate Construction Development	Agricultural	Installment & Other	Unallocated	Total
Beginning balance	\$ 1,985	\$ 1,204	\$ 2,862	\$ 1,342	\$ 821	\$ 902	\$ 9,116
Provision (recovery of provision) for credit losses	(793)	(7)	(175)	(41)	(55)	(65)	(1,136)
Charge-offs	—	—	—	—	(7)	—	(7)
Recoveries	355	16	—	—	81	—	452
Net charge-offs	355	16	—	—	74	—	445
Ending balance	\$ 1,547	\$ 1,213	\$ 2,687	\$ 1,301	\$ 840	\$ 837	\$ 8,425
Period-end amount allocated to:							
Loans individually evaluated for impairment	444	590	—	706	—	—	1,740
Loans collectively evaluated for impairment	1,103	623	2,687	595	840	837	6,685
Ending balance	\$ 1,547	\$ 1,213	\$ 2,687	\$ 1,301	\$ 840	\$ 837	\$ 8,425



Table of Contents

<b>Three Months Ended June 30, 2017</b>	<b>Commercial and Industrial</b>	<b>Real Estate Mortgage</b>	<b>Real Estate Construction Development</b>	<b>Agricultural</b>	<b>Installment &amp; Other</b>	<b>Unallocated</b>	<b>Total</b>
Beginning balance	\$ 1,781	\$ 1,285	\$ 3,096	\$ 1,097	\$ 848	\$ 841	\$ 8,948
Provision (recovery of provision) for credit losses	(72)	(118)	(209)	492	(92)	(53)	(52)
Charge-offs	(98)	—	—	—	(5)	—	(103)
Recoveries	154	7	—	—	53	—	214
Net charge-offs	56	7	—	—	48	—	111
Ending balance	\$ 1,765	\$ 1,174	\$ 2,887	\$ 1,589	\$ 804	\$ 788	\$ 9,007
Period-end amount allocated to:							
Loans individually evaluated for impairment	711	441	—	793	—	—	1,945
Loans collectively evaluated for impairment	1,054	733	2,887	796	804	788	7,062
Ending balance	\$ 1,765	\$ 1,174	\$ 2,887	\$ 1,589	\$ 804	\$ 788	\$ 9,007

The following summarizes the activity in the allowance for credit losses by loan category for the six months ended June 30, 2018 and 2017 (in 000's).

<b>Six Months Ended June 30, 2018</b>	<b>Commercial and Industrial</b>	<b>Real Estate Mortgage</b>	<b>Real Estate Construction Development</b>	<b>Agricultural</b>	<b>Installment &amp; Other</b>	<b>Unallocated</b>	<b>Total</b>
Beginning balance	\$ 1,408	\$ 1,182	\$ 2,903	\$ 1,631	\$ 887	\$ 1,256	\$ 9,267
Provision (recovery of provision) for credit losses	(181)	11	(216)	(330)	(190)	(419)	(1,325)
Charge-offs	(88)	—	—	—	(11)	—	(99)
Recoveries	408	20	—	—	154	—	582
Net recoveries	320	20	—	—	143	—	483
Ending balance	\$ 1,547	\$ 1,213	\$ 2,687	\$ 1,301	\$ 840	\$ 837	\$ 8,425
Period-end amount allocated to:							
Loans individually evaluated for impairment	444	590	—	706	—	—	1,740
Loans collectively evaluated for impairment	1,103	623	2,687	595	840	837	6,685
Ending balance	\$ 1,547	\$ 1,213	\$ 2,687	\$ 1,301	\$ 840	\$ 837	\$ 8,425

<b>Six Months Ended June 30, 2017</b>	<b>Commercial and Industrial</b>	<b>Real Estate Mortgage</b>	<b>Real Estate Construction Development</b>	<b>Agricultural</b>	<b>Installment &amp; Other</b>	<b>Unallocated</b>	<b>Total</b>
Beginning balance	\$ 1,843	\$ 1,430	\$ 3,378	\$ 666	\$ 888	\$ 697	\$ 8,902
Provision (recovery of provision) for credit losses	(137)	(268)	(491)	902	(128)	91	(31)
Charge-offs	(105)	(2)	—	—	(10)	—	(117)
Recoveries	164	14	—	21	54	—	253

Net charge-offs	59	12	—	21	44	—	136
Ending balance	\$ 1,765	\$ 1,174	\$ 2,887	\$ 1,589	\$ 804	\$ 788	\$ 9,007
Period-end amount allocated to:							
Loans individually evaluated for impairment	711	441	—	793	—	—	1,945
Loans collectively evaluated for impairment	1,054	733	2,887	796	804	788	7,062
Ending balance	\$ 1,765	\$ 1,174	\$ 2,887	\$ 1,589	\$ 804	\$ 788	\$ 9,007

[Table of Contents](#)

The following summarizes information with respect to the loan balances at June 30, 2018 and 2017.

(in 000's)	June 30, 2018			June 30, 2017		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans
Commercial and Business Loans	\$ 2,949	\$ 54,098	\$ 57,047	\$ 3,950	\$ 47,128	\$ 51,078
Government Program Loans	309	599	908	396	997	1,393
<b>Total Commercial and Industrial</b>	<b>3,258</b>	<b>54,697</b>	<b>57,955</b>	<b>4,346</b>	<b>48,125</b>	<b>52,471</b>
Commercial Real Estate Loans	1,367	211,146	212,513	1,066	201,298	202,364
Residential Mortgage Loans	2,228	68,284	70,512	2,678	76,641	79,319
Home Improvement and Home Equity Loans	—	386	386	—	572	572
<b>Total Real Estate Mortgage</b>	<b>3,595</b>	<b>279,816</b>	<b>283,411</b>	<b>3,744</b>	<b>278,511</b>	<b>282,255</b>
Real Estate Construction and Development Loans	11,764	96,807	108,571	6,878	117,871	124,749
Agricultural Loans	1,017	55,645	56,662	1,056	57,376	58,432
Installment and Other Loans	62	67,335	67,397	—	49,333	49,333
<b>Total Loans</b>	<b>\$ 19,696</b>	<b>\$ 554,300</b>	<b>\$ 573,996</b>	<b>\$ 16,024</b>	<b>\$ 551,216</b>	<b>\$ 567,240</b>

**4. Deposits**

Deposits include the following:

(in 000's)	June 30, 2018	December 31, 2017
Noninterest-bearing deposits	\$ 281,686	\$ 307,299
Interest-bearing deposits:		
NOW and money market accounts	322,995	234,154
Savings accounts	85,480	81,408
Time deposits:		
Under \$250,000	51,925	51,687
\$250,000 and over	14,877	13,145
<b>Total interest-bearing deposits</b>	<b>475,277</b>	<b>380,394</b>
<b>Total deposits</b>	<b>\$ 756,963</b>	<b>\$ 687,693</b>
<b>Total brokered deposits included in time deposits above *</b>	<b>\$ —</b>	<b>\$ —</b>

\* CDARs reciprocal deposits are no longer considered brokered deposits for the Company.

**5. Short-term Borrowings/Other Borrowings**

At June 30, 2018, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling \$279,450,000, as well as Federal Home Loan Bank (FHLB) lines of credit totaling \$4,687,000. At June 30, 2018, the Company had an uncollateralized line of credit with Pacific Coast Bankers Bank ("PCBB") totaling \$10,000,000, a Fed Funds line of \$10,000,000 with Union Bank, and a Fed Funds line of \$20,000,000 with Zions First National Bank. 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 June 30, 2018, \$7,130,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, \$415,304,000 in

[Table of Contents](#)

secured and unsecured loans were pledged at June 30, 2018, as collateral for borrowing lines with the Federal Reserve Bank. At June 30, 2018, the Company had no outstanding borrowings.

At December 31, 2017, 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, the Company had an uncollateralized line of credit with Pacific Coast Bankers Bank ("PCBB") totaling \$10,000,000 and a Fed Funds line of \$20,000,000 with Zions First National Bank. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time. 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. At December 31, 2017, the Company had no outstanding borrowings.

**6. Supplemental Cash Flow Disclosures**

(in 000's)	Six months ended June 30,			
	2018		2017	
Cash paid during the period for:				
Interest	\$	1,137	\$	886
Income taxes	\$	4,800	\$	4,410
Noncash investing activities:				
Unrealized gains on unrecognized post retirement costs	\$	27	\$	26
Unrealized loss on available for sale securities	\$	(428)	\$	355
Unrealized gains on TRUPs	\$	295	\$	—
Stock dividends issued	\$	—	\$	1,220
Cash dividend declared	\$	1,520	\$	845
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	\$	—

**7. Dividends on Common Stock**

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 \$1,520,000 was transferred from retained earnings to dividends payable to allow for distribution of the dividend to shareholders.

On June 26, 2018, the Company's Board of Directors declared a regular quarterly cash dividend \$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 \$1,520,000 was transferred from retained earnings to dividends payable to allow for distribution of the dividend to shareholders.

During 2017, the Board of Directors 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. At this time, no shares have been repurchased.

**8. Net Income per Common Share**

The following table provides a reconciliation of the numerator and the denominator of the basic EPS computation with the numerator and the denominator of the diluted EPS computation:

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Net income (000's, except per share amounts)	\$ 3,392	\$ 2,492	\$ 6,549	\$ 4,263
Weighted average shares issued	16,899,968	16,875,336	16,895,135	16,792,083
Add: dilutive effect of stock options	57,314	19,037	40,776	16,650
Weighted average shares outstanding adjusted for potential dilution	16,957,282	16,894,373	16,935,911	16,808,733
Basic earnings per share	\$ 0.20	\$ 0.15	\$ 0.39	\$ 0.25
Diluted earnings per share	\$ 0.20	\$ 0.15	\$ 0.39	\$ 0.25
Anti-dilutive stock options excluded from earnings per share calculation	60,000	30,000	103,000	30,000

## **9. Taxes on Income**

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 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. At June 30, 2018 and December 31, 2017, the Company had no recorded valuation allowance.

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 2013. As of June 30, 2018, the Company is unaware of any change in tax positions as a result of the IRS examination.

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 June 30, 2018 and 2017 were insignificant.

The Company reported a provision for income taxes of \$2,653,000 for the six months ended June 30, 2018 as compared to the \$2,845,000 provision reported in the comparable period of 2017. The effective tax rate was 28.83% for the six months ended June 30, 2018 as compared to 40.03% for the comparable period of 2017. The disparity between the effective tax rates for 2018 as compared to 2017 is primarily due to a decrease in the federal corporate tax rate from 34% in 2017 to 21% in 2018 related to the Tax Cuts and Jobs Act of 2017.

## **10. Junior Subordinated Debt/Trust Preferred Securities**

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. The Company may redeem the junior subordinated debentures at any time at par.

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 as of June 30, 2018.

The fair value guidance generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. Effective January 1, 2008, the Company elected the fair value option for its junior subordinated debt issued under USB Capital Trust II. The Company believes the election of fair value accounting for the junior subordinated debentures better reflects the true economic value of the debt instrument on the balance sheet. The rate paid on the junior subordinated debt issued under USB Capital Trust II is 3-month LIBOR plus 129 basis points, and is adjusted quarterly.

At June 30, 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 6.05% discount rate used represents what a

## Table of Contents

market participant would consider under the circumstances based on current market assumptions. At June 30, 2018, the total cumulative gain recorded on the debt is \$2,447,000.

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 separately present in other comprehensive income the portion of the total change in the fair value resulting from a change in the instrument-specific credit risk. As of January 1, 2018 a cumulative effect adjustment of \$1,482,000 was made to accumulated other comprehensive income.

The net fair value calculation performed as of June 30, 2018 resulted in a pretax loss adjustment of \$367,000 for the six months ended June 30, 2018, compared to a pretax loss adjustment of \$601,000 (\$354,000, net of tax) for the six months ended June 30, 2017. As part of the adoption of ASU 2016-01, for the six months ended June 30, 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 six months ended June 30, 2018, the net \$367,000 fair value loss adjustment was separately presented as a \$661,000 loss (\$464,000, net of tax) recognized on the consolidated statements of income, and a \$295,000 gain (\$207,000, 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 \$0.01.

The net fair value calculation performed at June 30, 2018 resulted in a pretax loss adjustment of \$464,000 for the three months ended June 30, 2018, compared to a pretax loss adjustment of \$264,000 (\$126,000, net of tax) for the three months ended June 30, 2017. As part of the adoption of ASU 2016-01, for the three months ended June 30, 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 three months ended June 30, 2018, the net \$464,000 fair value loss adjustment was separately presented as a \$192,000 loss (\$135,000, net of tax) recognized on the consolidated statements of income, and a \$272,000 loss (\$192,000, 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 \$0.01.

### **11. 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).

In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of June 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

*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:*

[Table of Contents](#)

June 30, 2018						
(in 000's)	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	
<b>Financial Assets:</b>						
Cash and cash equivalents	\$ 191,128	\$ 191,128	\$ 191,128	\$ —	\$ —	\$ —
AFS Investment securities	56,724	56,724	—	56,724	—	—
Marketable equity securities	3,659	3,659	3,659	—	—	—
Loans	565,926	555,193	—	—	—	555,193
Accrued interest receivable	8,392	8,392	—	8,392	—	—
<b>Financial Liabilities:</b>						
<b>Deposits:</b>						
Noninterest-bearing	281,686	281,686	281,686	—	—	—
NOW and money market	322,995	322,995	322,995	—	—	—
Savings	85,480	85,480	85,480	—	—	—
Time deposits	66,802	66,159	—	—	—	66,159
Total deposits	756,963	756,320	690,161	—	—	66,159
Junior subordinated debt	10,125	10,125	—	—	—	10,125
Accrued interest payable	43	43	—	43	—	—

December 31, 2017						
(in 000's)	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	
<b>Financial Assets:</b>						
Cash and cash equivalents	\$ 107,934	\$ 107,934	\$ 107,934	\$ —	\$ —	\$ —
Investment securities	41,985	45,722	3,737	41,985	—	—
Loans	593,123	588,938	—	—	—	588,938
Accrued interest receivable	6,526	6,526	—	6,526	—	—
<b>Financial Liabilities:</b>						
<b>Deposits:</b>						
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 investment securities and junior subordinated debt are performed on a recurring basis, while others, such as impairment of 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,



## Table of Contents

be actively traded. The Company's Level 3 financial assets include certain instruments 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 three month period ended June 30, 2018.

The following methods and assumptions were used in estimating the fair values of financial instruments measured at fair value on a recurring and non-recurring basis:

**Investment Securities** – Available for sale and marketable equity 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.

**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.

**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. Cash flows are 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.

*The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring basis at June 30, 2018 and December 31, 2017:*

June 30, 2018				December 31, 2017			
Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average	Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average
Junior Subordinated Debt	Discounted cash flow	Discount Rate	6.05%	Junior 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). The increase in discount rate between the periods ended June 30, 2018 and December 31, 2017 is primarily due to increases in rates for similar debt instruments.

[Table of Contents](#)

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 June 30, 2018 (in 000's):

Description of Assets	June 30, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>AFS Securities (2):</b>				
U.S. Government agencies	\$ 30,351	\$ —	\$ 30,351	\$ —
U.S. Government collateralized mortgage obligations	26,373	—	26,373	—
Marketable equity securities (2)	3,659	3,659	—	—
<b>Total investment securities</b>	<b>\$ 60,383</b>	<b>\$ 3,659</b>	<b>\$ 56,724</b>	<b>\$ —</b>
<b>Total</b>	<b>\$ 60,383</b>	<b>\$ 3,659</b>	<b>\$ 56,724</b>	<b>\$ —</b>

Description of Liabilities	June 30, 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)	\$ 10,125	—	—	\$ 10,125
<b>Total</b>	<b>\$ 10,125</b>	<b>—</b>	<b>—</b>	<b>\$ 10,125</b>

- (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)
<b>AFS Securities (2):</b>				
U.S. Government agencies	\$ 19,954	\$ —	\$ 19,954	\$ —
U.S. Government collateralized mortgage obligations	22,031	—	22,031	—
Marketable equity securities (2)	3,737	3,737	—	—
<b>Total investment securities</b>	<b>45,722</b>	<b>3,737</b>	<b>41,985</b>	<b>\$ —</b>
<b>Total</b>	<b>\$ 45,722</b>	<b>\$ 3,737</b>	<b>\$ 41,985</b>	<b>\$ —</b>

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
<b>Total</b>	<b>\$ 9,730</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 9,730</b>

- (1) Nonrecurring  
(2) Recurring



[Table of Contents](#)

The Company did not record a write-down on other real estate owned during the six months ended June 30, 2018 or the year ended December 31, 2017.

There were no assets measured at fair value on a non-recurring basis as of the six months ended June 30, 2018 or the year ended December 31, 2017.

The following tables provide a reconciliation of assets and liabilities at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and six months ended June 30, 2018 and 2017 (in 000's):

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
	Junior Subordinated Debt	Junior Subordinated Debt	Junior Subordinated Debt	Junior Subordinated Debt
Reconciliation of Liabilities:				
Beginning balance	\$ 9,641	\$ 9,171	\$ 9,730	\$ 8,832
Gross loss included in earnings	192	264	661	601
Gross loss (gain) related to changes in instrument specific credit risk	272	—	(295)	—
Change in accrued interest	20	6	29	8
Ending balance	<u>\$ 10,125</u>	<u>\$ 9,441</u>	<u>\$ 10,125</u>	<u>\$ 9,441</u>
The amount of total (gain) loss for the period included in earnings attributable to the change in unrealized gains or losses relating to liabilities still held at the reporting date	<u>\$ 192</u>	<u>\$ 264</u>	<u>\$ 661</u>	<u>\$ 601</u>

**12. Goodwill and Intangible Assets**

At June 30, 2018, the Company had goodwill in the amount of \$4,488,000 in connection with various business combinations and purchases. This amount was unchanged from the balance of \$4,488,000 at December 31, 2017. While goodwill is not amortized, the Company does conduct periodic impairment analysis on goodwill at least annually or more often as conditions require. The Company performed its analysis of goodwill impairment and concluded goodwill was not impaired at June 30, 2018.

**13. Accumulated Other Comprehensive Income**

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

(in 000's)	June 30, 2018			December 31, 2017		
	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
Beginning balance	\$ (248)	\$ (462)	\$ —	\$ (221)	\$ (383)	\$ —
Reclassifications upon adoption of ASU 2016-01	184	—	1,482	—	—	—
Current period comprehensive (loss) income	(300)	19	207	(27)	(79)	—
Ending balance	<u>\$ (364)</u>	<u>\$ (443)</u>	<u>\$ 1,689</u>	<u>\$ (248)</u>	<u>\$ (462)</u>	<u>\$ —</u>
Accumulated other comprehensive income (loss)			<u>\$ 882</u>			<u>\$ (710)</u>

**14. 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 consolidated financial statements were issued and have identified no subsequent events requiring disclosure.

## Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

### Overview

*Certain matters discussed or incorporated by reference in this Quarterly Report of Form 10-Q are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, but are not limited to, those described in Management's Discussion and Analysis of Financial Condition and Results of Operations. Such risks and uncertainties include, but are not limited to, the following factors: i) competitive pressures in the banking industry and changes in the regulatory environment; ii) exposure to changes in the interest rate environment and the resulting impact on the Company's interest rate sensitive assets and liabilities; iii) decline in the health of the economy nationally or regionally which could reduce the demand for loans or reduce the value of real estate collateral securing most of the Company's loans; iv) credit quality deterioration that could cause an increase in the provision for loan losses; v) Asset/Liability matching risks and liquidity risks; vi) volatility and devaluation in the securities markets, vi) expected cost savings from recent acquisitions are not realized, vii) potential impairment of goodwill and other intangible assets, and viii) technology implementation problems and information security breaches. Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company. For additional information concerning risks and uncertainties related to the Company and its operations, please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2017.*

United Security Bancshares (the "Company" or "Holding Company") is a California corporation incorporated during March of 2001 and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended. United Security Bank (the "Bank") is a wholly-owned bank subsidiary of the Company and was formed in 1987. References to the Company are references to United Security Bancshares (including the Bank). References to the Bank are to United Security Bank, while references to the Holding Company are to the parent only, United Security Bancshares. The Company currently has eleven banking branches, which provide financial services in Fresno, Madera, Kern, and Santa Clara counties in the state of California.

### ***Trends Affecting Results of Operations and Financial Position***

The Company's overall operations are impacted by a number of factors, including not only interest rates and margin spreads, which impact the results of operations, but also the composition of the Company's balance sheet. One of the primary strategic goals of the Company 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, its 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 the Bank. In addition, the Central Valley remains largely dependent on agriculture. A downturn in agriculture and agricultural related business could indirectly and adversely affect the Company as many borrowers and customers are involved in, or are impacted to some extent, by the agricultural industry. While a great number of our borrowers are not directly involved in agriculture, they would likely be impacted by difficulties in the agricultural industry since many jobs in our market areas are ancillary to the regular production, processing, marketing and sale of agricultural commodities. While the prolonged drought has been alleviated during the past year due to significant amounts of precipitation, the state of California recently experienced the worst drought in recorded history. It is not possible to quantify the drought's impact on businesses and consumers located in the Company's market areas or to predict adverse economic impacts related to future droughts.

The residential real estate markets in the five county region from Merced to Kern has strengthened since 2013 and that trend has continued through 2018. The severe declines in residential construction and home prices that began in 2008 have ended and home prices continue to rise on a year-over-year basis. As the Company continues its business development and expansion efforts throughout its market areas, it maintains its 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.

The Company continues to emphasize relationship banking and core deposit growth, and has focused greater attention on its 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 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.

## Table of Contents

The Company continually evaluates its strategic business plan as economic and market factors change in its market area. Balance sheet management, enhancing revenue sources, and maintaining market share will continue to be of primary importance during 2018 and beyond. The previous pressure on net margins as interest rates hit historical lows may now be ending as interest rates are anticipated to rise. As a result, market rates of interest and asset quality will continue to be important factors in the Company's ongoing strategic planning process.

### **Results of Operations**

On a year-to-date basis, the Company reported net income of \$6,549,000 or \$0.39 per share (\$0.39 diluted), for the six months ended June 30, 2018, as compared to \$4,263,000, or \$0.25 per share (\$0.25 diluted), for the same period in 2017. The Company's return on average assets was 1.57% for the six months ended June 30, 2018, as compared to 1.09% for the six months ended June 30, 2017. The Company's return on average equity was 12.69% for the six months ended June 30, 2018, as compared to 8.72% for the six months ended June 30, 2017.

### ***Net Interest Income***

The following tables present condensed average balance sheet information, together with interest income and yields earned on average interest earning assets, and interest expense and rates paid on average interest-bearing liabilities for the three and six month periods ended June 30, 2018 and 2017.

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

Interest rates and Interest Differentials

Three Months Ended June 30, 2018 and 2017

[Table of Contents](#)

(dollars in thousands)	2018			2017		
	Average Balance	Interest	Yield/Rate (2)	Average Balance	Interest	Yield/Rate (2)
<b>Assets:</b>						
Interest-earning assets:						
Loans and leases (1)	\$ 576,670	\$ 7,491	5.21%	\$ 554,553	\$ 7,579	5.48%
Investment Securities – taxable (3)	49,752	265	2.14%	54,505	229	1.69%
Interest-bearing deposits in other banks	—	—	—%	651	1	0.62%
Interest-bearing deposits in FRB	148,441	681	1.84%	113,981	301	1.06%
Total interest-earning assets	774,863	\$ 8,437	4.37%	723,690	\$ 8,110	4.49%
Allowance for credit losses	(9,291)			(9,021)		
Noninterest-earning assets:						
Cash and due from banks	27,067			20,872		
Premises and equipment, net	10,048			10,846		
Accrued interest receivable	7,221			4,269		
Other real estate owned	5,683			6,041		
Other assets	36,675			36,810		
Total average assets	\$ 852,266			\$ 793,507		
<b>Liabilities and Shareholders' Equity:</b>						
Interest-bearing liabilities:						
NOW accounts	\$ 103,767	\$ 37	0.14%	\$ 88,015	\$ 29	0.13%
Money market accounts	190,724	328	0.69%	152,552	181	0.48%
Savings accounts	82,623	47	0.23%	78,448	46	0.24%
Time deposits	65,683	138	0.84%	81,230	108	0.53%
Junior subordinated debentures	9,493	109	4.61%	9,139	74	3.25%
Total interest-bearing liabilities	452,290	\$ 659	0.58%	409,384	\$ 438	0.43%
Noninterest-bearing liabilities:						
Noninterest-bearing checking	290,490			278,457		
Accrued interest payable	119			102		
Other liabilities	5,366			6,215		
Total Liabilities	748,265			694,158		
Total shareholders' equity	104,001			99,349		
Total average liabilities and shareholders' equity	\$ 852,266			\$ 793,507		
Interest income as a percentage of average earning assets			4.37%			4.49%
Interest expense as a percentage of average earning assets			0.34%			0.24%
Net interest margin			4.03%			4.25%

(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 \$719 for the quarter ended June 30, 2018 and loan costs of \$44 for the quarter ended June 30, 2017.

(2) Interest income/expense is divided by actual number of days in the period times 365 days in the yield calculation

(3) Yields on investments securities are calculated based on average amortized cost balances rather than fair value, as changes in fair value are reflected as a component of shareholders' equity.



Table of Contents

For the three months ended June 30, 2018, total interest income increased \$327,000, or 4.03%, as compared to the quarter ended June 30, 2017. Comparing those two periods, average interest earning assets increased \$51,173,000, with a \$22,117,000 increase in loans and leases and a \$34,460,000 increase in balances held at the Federal Reserve Bank, partially offset by a \$4,753,000 decrease in investment securities. The average yield on total interest-earning assets decreased 12 basis points while loan yields decreased 27 basis points. These decreases were primarily the result of \$550,000 in writedowns of unamortized insurance premiums on the student loan portfolio, \$175,000 in reversal of accrued interest on nonaccrual loan activity, and discontinued accretion of previous nonaccrual interest.

Yields on interest bearing deposits at the Federal Reserve Bank increased for the three months ended June 30, 2018 as a result of three 0.25% interest rate increases during 2017 and two during 2018. For the three months ended June 30, 2018, total interest expense increased \$221,000, or 50.46%, as compared to the three months ended June 30, 2017, as a result of a \$42,906,000 increase in interest-bearing liabilities. The average rate paid on interest-bearing liabilities was 0.58% for the three months ended June 30, 2018 and 0.43% for the three months ended June 30, 2017.

Interest rates and Interest Differentials  
Six months ended June 30, 2018 and 2017

(dollars in 000's)	2018			2017		
	Average Balance	Interest	Yield/Rate (2)	Average Balance	Interest	Yield/Rate (2)
<b>Assets:</b>						
Interest-earning assets:						
Loans and leases (1)	\$ 590,905	\$ 15,717	5.36%	\$ 560,282	\$ 14,804	5.33%
Investment Securities – taxable (3)	47,381	457	1.95%	55,541	453	1.64%
Interest-bearing deposits in other banks	—	—	—%	651	2	0.62%
Interest-bearing deposits in FRB	124,215	1,065	1.73%	102,898	484	0.95%
<b>Total interest-earning assets</b>	<b>762,501</b>	<b>\$ 17,239</b>	<b>4.56%</b>	<b>719,372</b>	<b>\$ 15,743</b>	<b>4.41%</b>
Allowance for credit losses	(9,364)			(8,973)		
Noninterest-earning assets:						
Cash and due from banks	26,906			20,894		
Premises and equipment, net	10,157			10,751		
Accrued interest receivable	6,768			3,928		
Other real estate owned	5,745			6,255		
Other assets	36,930			36,414		
<b>Total average assets</b>	<b>\$ 839,643</b>			<b>\$ 788,641</b>		
<b>Liabilities and Shareholders' Equity:</b>						
Interest-bearing liabilities:						
NOW accounts	\$ 97,124	\$ 66	0.14%	\$ 87,681	\$ 57	0.13%
Money market accounts	174,985	525	0.61%	150,329	319	0.43%
Savings accounts	83,352	94	0.23%	76,834	89	0.23%
Time deposits	66,547	252	0.76%	87,987	235	0.54%
Junior subordinated debentures	9,641	199	4.16%	8,969	143	3.22%
<b>Total interest-bearing liabilities</b>	<b>431,649</b>	<b>\$ 1,136</b>	<b>0.53%</b>	<b>411,800</b>	<b>\$ 843</b>	<b>0.41%</b>
Noninterest-bearing liabilities:						
Noninterest-bearing checking	297,712			271,230		
Accrued interest payable	110			110		
Other liabilities	6,089			6,925		
<b>Total Liabilities</b>	<b>735,560</b>			<b>690,065</b>		
<b>Total shareholders' equity</b>	<b>104,083</b>			<b>98,576</b>		
<b>Total average liabilities and shareholders' equity</b>	<b>\$ 839,643</b>			<b>\$ 788,641</b>		
Interest income as a percentage of average earning assets			4.56%			4.41%
Interest expense as a percentage of average earning assets			0.30%			0.24%
Net interest margin			4.26%			4.17%

(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 \$835 and \$268 for the six months ended June 30, 2018 and 2017, respectively.

(2) Interest income/expense is divided by actual number of days in the period times 365 days in the yield calculation

(3) Yields on investments securities are calculated based on average amortized cost balances rather than fair value, as changes in fair value are reflected as a component of shareholders' equity.

[Table of Contents](#)

The prime rate was raised three times during 2017 and twice during 2018 to reach its present rate of 5.00%. These increases affect rates for loans and customer deposits, both of which have increased and are likely to increase further as the prime rate continues to rise.

Both the Company's 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 periods indicated.

Table 2. Rate and Volume Analysis

(in 000's)	Increase (decrease) in the six months ended June 30, 2018 compared to June 30, 2017		
	Total	Rate	Volume
Increase (decrease) in interest income:			
Loans and leases	\$ 913	\$ 134	\$ 779
Investment securities available for sale	4	77	(73)
Interest-bearing deposits in other banks	(2)	(3)	1
Interest-bearing deposits in FRB	581	382	199
Total interest income	1,496	590	906
Increase (decrease) in interest expense:			
Interest-bearing demand accounts	215	156	59
Savings and money market accounts	5	(2)	7
Time deposits	17	83	(66)
Subordinated debentures	56	45	11
Total interest expense	293	282	11
Increase in net interest income	\$ 1,203	\$ 308	\$ 895

For the six months ended June 30, 2018, total interest income increased approximately \$1,496,000, or 9.50%, as compared to the six months ended June 30, 2017. Average earning asset volumes for loans and leases increased \$30,623,000. Overnight investments with the FRB increased \$21,317,000, while available for sale investment securities decreased \$8,160,000 between the two periods. The average yield on loans increased 3 basis points between the two periods, and the average yield on investment securities increased approximately 31 basis points during the six months ended June 30, 2018 as compared to the same period in 2017.

The overall average yield on the loan portfolio increased to 5.36% for the six months ended June 30, 2018, as compared to 5.33% for the six months ended June 30, 2017. The yield on loans for the six months ended June 30, 2018 includes \$550,000 in writedowns of unamortized insurance premiums on the student loan portfolio and \$175,000 in reversal of accrued interest on nonaccrual loan activity. The Company has successfully sought to mitigate the low-interest rate environment with loan floors included in new and renewed loans when practical. At June 30, 2018, 57.7% of the Company's loan portfolio consisted of floating rate instruments, as compared to 52.0% of the portfolio at December 31, 2017, with the majority of those tied to the prime rate. Approximately 19.6%, or \$64,748,000, of the floating rate loans had rate floors at June 30, 2018, making them effectively fixed-rate loans for certain increases in interest rates, and fixed-rate loans for all decreases in interest rates. None of the loans with floors have floor spreads of 100 basis points or more.

Although market rates of interest are at historically low levels, the Company's disciplined deposit pricing efforts have helped keep the Company's cost of funds low. The Company's net interest margin increased to 4.26% for the six months ended June 30, 2018, when compared to 4.17% for the six months ended June 30, 2017. The net interest margin increased due to increases in the loan portfolio yield, increases in the yield on investment securities, and increases in the yield on overnight investments held at correspondent banks. As interest rates paid on deposits have also increased, the Company's average cost of funds rose to 0.53% for the six months ended June 30, 2018, as compared to 0.41% for the six months ended June 30, 2017. For the six months ended June 30, 2018, total interest expense increased approximately \$293,000, or 34.76%, as compared to the six months ended June 30, 2017. Between those two periods, average interest-bearing liabilities increased by \$19,849,000 due to increases in NOW, money

[Table of Contents](#)

market, and savings accounts, partially offset by decreases in time deposits. The Company may utilize brokered deposits as an additional source of funding, however, the Company held no brokered deposits at June 30, 2018.

Net interest income has increased between the six months ended June 30, 2018 and 2017, totaling \$16,103,000 for the six months ended June 30, 2018 as compared to \$14,900,000 for the six months ended June 30, 2017. The increase in net interest income between 2017 and 2018 was primarily the result of reinvestment of lower yielding overnight investments into the loan and investment portfolios and growth in total interest-earning assets.

The increase in net interest margin between 2017 and 2018 can be primarily attributed to the relative increase in average loans, the highest yielding asset, as a percentage of total average assets, and the decrease in average time deposits, the most costly interest bearing liability, as a percentage of total interest bearing liabilities.

**Table 3. Interest-Earning Assets and Liabilities**

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 6/30/2018	YTD Average 12/31/17	YTD Average 6/30/2017
Loans	77.50%	77.91%	77.89%
Investment securities available for sale	6.21%	7.18%	7.72%
Interest-bearing deposits in other banks	—%	0.09%	0.09%
Interest-bearing deposits in FRB	16.29%	14.82%	14.30%
Total interest-earning assets	100.00%	100.00%	100.00%
NOW accounts	22.50%	21.55%	21.29%
Money market accounts	40.54%	37.92%	36.50%
Savings accounts	19.31%	19.42%	18.66%
Time deposits	15.42%	18.85%	21.37%
Subordinated debentures	2.23%	2.26%	2.18%
Total interest-bearing liabilities	100.00%	100.00%	100.00%

**Noninterest Income**

**Table 4. Changes in Noninterest Income**

The following tables sets forth the amount and percentage changes in the categories presented for the three and six month periods ended June 30, 2018 and 2017:

(in 000's)	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Amount of Change	Percent Change
Customer service fees	\$ 1,020	\$ 997	\$ 23	2.31 %
Increase in cash surrender value of BOLI/COLI	132	134	(2)	(1.49)%
Loss on marketable equity securities	(18)	—	(18)	(100.00)%
Loss on fair value of financial liability	(192)	(264)	72	(27.27)%
Gain on sale of assets	29	—	29	100.00 %
Other	198	199	(1)	(0.50)%
Total noninterest income	\$ 1,169	\$ 1,066	\$ 103	9.66 %

Noninterest income for the quarter ended June 30, 2018 increased \$103,000 to \$1,169,000, compared to the quarter ended June 30, 2017. The increase is mostly attributed to the decrease in the recorded loss on the fair value of financial liability of \$72,000 for the quarter ended June 30, 2018. The fluctuation in fair value of financial liability was caused by changes in the LIBOR yield curve.

[Table of Contents](#)

(in 000's)	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017	Amount of Change	Percent Change
Customer service fees	\$ 1,971	\$ 1,938	\$ 33	1.70 %
Increase in cash surrender value of BOLI/COLI	257	266	(9)	(3.38)%
Loss on marketable equity securities	(78)	—	(78)	(100.00)%
Gain on proceeds from bank-owned life insurance	171	—	171	(100.00)%
Loss on fair value of financial liability	(661)	(601)	(60)	9.98 %
Gain on sale fixed assets	29	—	29	100.00 %
Other	403	372	31	8.33 %
<b>Total noninterest income</b>	<b>\$ 2,092</b>	<b>\$ 1,975</b>	<b>\$ 117</b>	<b>5.92 %</b>

Noninterest income for the six months ended June 30, 2018 increased \$117,000 to \$2,092,000, compared to the six months ended June 30, 2017. The increase is mostly attributed to the gain on death benefit proceeds from bank owned life insurance of \$171,000, partially offset by the increase in the recorded loss on the fair value of financial liability of \$60,000 for the six months ended June 30, 2018. The fluctuation in fair value of financial liability was caused by changes in the LIBOR yield curve.

**Noninterest Expense**

**Table 5. Changes in Noninterest Expense**

The following table sets forth the amount and percentage changes in the categories presented for the three and six month periods ended June 30, 2018 and 2017:

(in 000's)	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Amount of Change	Percent Change
Salaries and employee benefits	\$ 3,010	\$ 2,586	\$ 424	16.40 %
Occupancy expense	1,117	1,043	74	7.09 %
Data processing	38	25	13	52.00 %
Professional fees	392	345	47	13.62 %
FDIC/DFI insurance assessments	78	133	(55)	(41.35)%
Director fees	81	75	6	8.00 %
Loss on California tax credit partnership	5	10	(5)	(50.00)%
Correspondent bank service charges	17	19	(2)	(10.53)%
Net cost on operation of OREO	49	(309)	358	(115.86)%
Other	531	680	(149)	(21.91)%
<b>Total expense</b>	<b>\$ 5,318</b>	<b>\$ 4,607</b>	<b>\$ 711</b>	<b>15.43 %</b>

Noninterest expense for the quarter ended June 30, 2018 increased \$711,000 to \$5,318,000, compared to the quarter ended June 30, 2017. The increase was attributed to increases in OREO expenses and salaries and employee benefits. OREO expense for quarter ended June 30, 2017 includes \$336,000 in gains on sale of OREO. The increase in salary and employee benefits was primarily due to the increased employee salary expense and compensation expense related to equity awards.

## Table of Contents

(in 000's)	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017	Amount of Change	Percent Change
Salaries and employee benefits	\$ 5,971	\$ 5,571	\$ 400	7.18 %
Occupancy expense	2,135	2,058	77	3.74 %
Data processing	90	52	38	73.08 %
Professional fees	727	600	127	21.17 %
FDIC/DFI insurance assessments	161	269	(108)	(40.15)%
Director fees	162	143	19	13.29 %
Correspondent bank service charges	34	37	(3)	(8.11)%
Loss on California tax credit partnership	9	119	(110)	(92.44)%
Net cost on operation of OREO	100	(277)	377	(136.10)%
Other	929	1,226	(297)	(24.23)%
Total expense	\$ 10,318	\$ 9,798	\$ 520	5.31 %

Noninterest expense increased approximately \$520,000 or 5.31% between the six months ended June 30, 2017 and June 30, 2018. The increase experienced during the six months ended June 30, 2018, was primarily the result of \$377,000 in increased costs on OREO and \$400,000 in additional salaries and employee benefits. OREO expense for six months ended June 30, 2017 includes \$336,000 in gains on sale of OREO. The increase in salaries and employee benefits expense for the six months ended June 30, 2018 is primarily attributed to higher stock compensation expense as a result from the issuance of equity awards. The increases in the period were offset by a decrease of \$110,000 in loss on a tax credit partnership and a decrease of \$108,000 in regulatory assessments.

### ***Income Taxes***

The Company's 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 the Company's 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 the Company's 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 the Company's statements of income and comprehensive income.

The Company reviews its current tax positions at least quarterly based on the 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.

The Company has reviewed all of its tax positions as of June 30, 2018, and has determined that, there are no material amounts to be recorded under the current income tax accounting guidelines.

The Company's effective tax rate for the six months ended June 30, 2018 was 28.83% compared to 40.03% for the six months ended June 30, 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%.

### **Financial Condition**

Total assets increased \$73,632,000, or 9.14%, to a balance of \$879,468,000 at June 30, 2018, from the balance of \$805,836,000 at December 31, 2017, and increased \$97,902,000, or 12.53%, from the balance of \$781,566,000 at June 30, 2017. Total deposits of \$756,963,000 at June 30, 2018, increased \$69,270,000, or 10.07%, from the balance reported at December 31, 2017, and increased \$90,652,000, or 13.61%, from the balance of \$666,311,000 reported at June 30, 2017. Cash and cash equivalents increased \$83,194,000, or 77.08%, between December 31, 2017 and June 30, 2018; net loans decreased \$27,197,000, or 4.59%, to a balance of \$565,926,000; and investment securities increased \$14,661,000, or 32.07%, during the first six months of 2018.

## Table of Contents

Earning assets averaged approximately \$762,501,000 during the six months ended June 30, 2018, as compared to \$719,372,000 for the same period in 2017. Average interest-bearing liabilities increased to \$431,649,000 for the six months ended June 30, 2018, from \$411,800,000 reported for the comparative period of 2017.

### **Loans and Leases**

The Company's primary business is that of acquiring deposits and making loans, with the loan portfolio representing the largest and most important component of earning assets. Loans totaled \$573,996,000 at June 30, 2018, a decrease of \$27,355,000, or 4.55%, when compared to the balance of \$601,351,000 at December 31, 2017, and an increase of \$6,756,000, or 1.19%, when compared to the balance of \$567,240,000 reported at June 30, 2017. Loans on average increased \$30,623,000, or 5.47%, between the six months ended June 30, 2017 and June 30, 2018, with loans averaging \$590,905,000 for the six months ended June 30, 2018, as compared to \$560,282,000 for the same period of 2017.

Total loans decreased \$27,355,000 between December 31, 2017 and June 30, 2018, and increased \$6,756,000 between June 30, 2017 and June 30, 2018. During the six months ended June 30, 2018, the Company experienced increases in commercial and industrial loans, commercial real estate, and consumer loans compared to the same period ended June 30, 2017. Commercial and industrial loans increased \$10,929,000 between December 31, 2017 and June 30, 2018 and increased \$5,484,000 between June 30, 2017 and June 30, 2018. Agricultural loans decreased \$2,819,000, or 4.74%, between December 31, 2017 and June 30, 2018 and decreased \$1,770,000 between June 30, 2017 and June 30, 2018.

Installment and other loans increased \$18,064,000 during the six months ended June 30, 2018 as compared to the same period ended June 30, 2017, due to growth in the student loan portfolio. Included in installment loans are \$61,761,000 in student loans made to medical and pharmacy school students. The outstanding balance of student loans that have not entered repayment status totaled \$55,632,000 at June 30, 2018. 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 have not entered repayment status totaled \$6,186,000 at June 30, 2018. At June 30, 2018 there were 316 loans within repayment, deferment, and forbearance which represented \$6,129,000, \$1,270,000, and \$3,006,000 in outstanding balances respectively. Prior to June 2018, student loans were insured through a Surety Bond issued by ReliaMax Surety Company and provided the Company reasonable expectation of collection. 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, the Company's student loan portfolio is no longer insured. 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 borrower balance as of June 30, 2018 is approximately \$90,000.

Commercial real estate loans (a component of real estate mortgage loans) continue to represent a significant portion of the total loan portfolio. Commercial real estate loans amounted to 37.02%, 36.76%, and 35.68%, of the total loan portfolio at June 30, 2018, December 31, 2017, and June 30, 2017, respectively. Real estate mortgage loans decreased \$22,882,000, or 7.47%, between December 31, 2017 and June 30, 2018, and increased \$1,156,000 between June 30, 2017 and June 30, 2018. Residential mortgage loans are not generally originated by the Company, but some residential mortgage loans have been made over the past several years to facilitate take-out loans for construction borrowers when they were not able to obtain permanent financing elsewhere. These loans are generally 30-year amortizing loans with maturities of between three and five years. Residential mortgages totaled \$70,512,000, or 12.28%, of the portfolio at June 30, 2018, \$84,804,000, or 14.10% of the portfolio at December 31, 2017, and \$79,319,000 or 13.98% of the portfolio at June 30, 2017. The Company held no loan participation purchases at June 30, 2017, December 31, 2017 or June 30, 2018. Loan participations sold increased from \$9,712,000, or 1.71%, of the portfolio at June 30, 2017, to \$15,067,000, or 2.5%, of the portfolio, at December 31, 2017, and decreased to \$14,559,000, or 2.5%, of the portfolio, at June 30, 2018.

### Table 6. Loans

*The following table sets forth the amounts of loans outstanding by category at June 30, 2018 and December 31, 2017, the category percentages as of those dates, and the net change between the two periods presented.*

(in 000's)	June 30, 2018		December 31, 2017		Net Change	% Change
	Dollar Amount	% of Loans	Dollar Amount	% of Loans		
Commercial and industrial	\$ 57,955	10.1%	\$ 47,026	7.9%	\$ 10,929	23.24 %
Real estate – mortgage	283,411	49.4%	306,293	50.9%	(22,882)	(7.47)%
RE construction & development	108,571	18.9%	122,970	20.4%	(14,399)	(11.71)%
Agricultural	56,662	9.9%	59,481	9.9%	(2,819)	(4.74)%
Installment/other	67,397	11.7%	65,581	10.9%	1,816	2.77 %
Total Gross Loans	\$ 573,996	100.0%	\$ 601,351	100.0%	\$ (27,355)	(4.55)%

### Deposits

Total deposits totaled \$756,963,000 at June 30, 2018, representing an increase of \$69,270,000, or 10.07%, from the balance of \$687,693,000 reported at December 31, 2017, and an increase of \$90,652,000, or 13.61%, from the balance of \$666,311,000 reported at June 30, 2017.

Table 7. Deposits

The following table sets forth the amounts of deposits outstanding by category at June 30, 2018 and December 31, 2017, and the net change between the two periods presented.

(in 000's)	June 30, 2018	December 31, 2017	Net Change	Percentage Change
Noninterest bearing deposits	\$ 281,686	\$ 307,299	\$ (25,613)	-8.33 %
Interest bearing deposits:				
NOW and money market accounts	322,995	234,154	88,841	37.94 %
Savings accounts	85,480	81,408	4,072	5.00 %
Time deposits:				
Under \$250,000	51,925	51,687	238	0.46 %
\$250,000 and over	14,877	13,145	1,732	13.18 %
Total interest bearing deposits	475,277	380,394	94,883	24.94 %
Total deposits	\$ 756,963	\$ 687,693	\$ 69,270	10.07 %

The Company's deposit base consists of two major components represented by noninterest bearing (demand) deposits and interest bearing deposits, totaling \$281,686,000 and \$475,277,000 at June 30, 2018, respectively. Interest bearing deposits consist of time certificates, NOW and money market accounts, and savings deposits. Total interest bearing deposits increased \$94,883,000, or 24.94%, between December 31, 2017 and June 30, 2018, and noninterest bearing deposits decreased \$25,613,000, or 8.33%, between the same two periods presented. Noninterest bearing deposits decreased as the deposits migrated to other interest bearing categories. Included in the increase of \$94,883,000 in interest bearing deposits during the six months ended June 30, 2018, are increases of \$88,841,000 in NOW and money market accounts, increases of \$1,970,000 in time deposits, and increases of \$4,072,000 in savings accounts. The increase in time deposits is attributed to an increase in activity driven by the increase in the prime rate, which is the index for the Company's variable CD rate.

Core deposits, as defined by the Company as consisting of all deposits other than time deposits of more than \$250,000 and brokered deposits, continue to provide the foundation for the Company's principal sources of funding and liquidity. These core deposits amounted to 98.03% and 98.09% of the total deposit portfolio at June 30, 2018 and December 31, 2017, respectively. The Company held no brokered deposits at June 30, 2018 and December 31, 2017

On a year-to-date average, the Company experienced an increase of \$45,659,000, or 6.77%, in total deposits between the six months ended June 30, 2018 and June 30, 2017. Between these two periods, average interest bearing deposits increased \$19,177,000, or 4.76%, and total noninterest-bearing deposits increased \$26,482,000, or 9.76%, on a year-to-date average basis.



### ***Short-Term Borrowings***

At June 30, 2018, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling \$279,450,000, as well as Federal Home Loan Bank (FHLB) lines of credit totaling \$4,687,000. At June 30, 2018, the Company had uncollateralized lines of credit with both Pacific Coast Bankers Bank ("PCBB"), Union Bank, and Zion's Bank, totaling \$10,000,000, \$10,000,000, and \$20,000,000, respectively. These lines of credit generally have interest rates tied to either the Federal Funds rate, short-term U.S. Treasury rates, or LIBOR. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time. At June 30, 2018 and June 30, 2017, the Company had no outstanding borrowings. The Company had collateralized FRB lines of credit of \$305,236,000, collateralized FHLB lines of credit totaling \$13,363,000, and uncollateralized lines of credit of \$10,000,000 with PCBB, \$10,000,000 with Union Bank, and \$20,000,000 with Zions Bank at December 31, 2017.

### ***Asset Quality and Allowance for Credit Losses***

Lending money is the Company's 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 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 subjective and contingent upon economic, environmental, and other conditions which cannot be predicted with certainty. When determining the adequacy of the allowance for credit losses, the Company follows, 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. The Company segments 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 evaluated individually for specific impairment under the asset-specific component of the allowance.

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 and certain unfunded loan commitments. 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 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;

## Table of Contents

- 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 the Company's 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, as defined by the Company, include impaired loans and loans categorized as substandard, doubtful, and loss which are not considered impaired. At June 30, 2018, impaired and classified loans totaled \$31,485,000, or 5.8%, of gross loans as compared to \$27,311,000, or 5.2%, of gross loans at December 31, 2017.

Loan participations are reviewed for allowance adequacy under the same guidelines as other loans in the Company's 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 the Company, and are reviewed for geographic location as well as the well-being of the underlying agent bank.

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 the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations, and other business conditions.

Table 8. Allowance for Loan Losses

The following table summarizes the specific allowance, formula allowance, and unallocated allowance at June 30, 2018 and December 31, 2017, as well as classified loans at those period-ends.

(in 000's)	June 30, 2018	December 31, 2017
Specific allowance – impaired loans	\$ 1,740	\$ 1,888
Formula allowance – classified loans not impaired	1,104	1,136
Formula allowance – special mention loans	57	181
Total allowance for special mention and classified loans	<u>2,901</u>	<u>3,205</u>
Formula allowance for pass loans	4,687	4,806
Unallocated allowance	837	1,256
Total allowance for loan losses	<u>\$ 8,425</u>	<u>\$ 9,267</u>
Impaired loans	19,696	14,790
Classified loans not considered impaired	11,789	12,521
Total classified loans / impaired loans	<u>\$ 31,485</u>	<u>\$ 27,311</u>
Special mention loans not considered impaired	<u>\$ 8,386</u>	<u>\$ 10,201</u>

While impaired loans increased \$4,906,000 between December 31, 2017 and June 30, 2018, the specific allowance related to impaired loans decreased \$148,000 between December 31, 2017 and June 30, 2018 due to the addition of two new collateral dependent impaired loans in the period. The increase in impaired loans is primarily due to a increase in non-performing loans. The formula allowance related to classified and special mention unimpaired loans decreased by \$156,000 between December 31, 2017 and June 30, 2018 as a result of improvements in loss factors. The unallocated allowance decreased from \$1,256,000 at December 31, 2017 to \$837,000 at June 30, 2018. The decrease in the unallocated allowance is primarily the result of a reversal in provision. Although there has been a reduction in required loss reserves as economic conditions have improved, the Company has a concentration in loans to finance CRE, construction and land development activities not secured by real estate. These loans have inherently higher risk characteristics and management believes maintaining additional, unallocated reserves to address the inherent losses in these loans is reasonable and appropriate. The level of “pass” loans decreased approximately \$30,009,000 between December 31, 2017 and June 30, 2018. The related formula allowance decreased \$119,000 during the same period. The formula allowance for “pass loans” is derived from the loan loss factors under migration analysis.

The Company’s methodology includes features that are intended to reduce the difference between estimated and actual 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 the Company’s 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. These positive factors were partially offset by the Company including other real estate owned (OREO) financial results in loss history and extending the look back period used to capture the loss history for the quantitative portion of the allowance for loan and lease losses (ALLL). In the third quarter of 2013, the look back period was changed from 4 years to stake-in-the-ground (December 31, 2005), in an effort to include higher losses experienced during the credit crisis. Changes in the mix of historical losses in the look back period resulted in a reallocation of the general reserve component of the allowance amount within the various loan segments as compared to June 30, 2018, as loss experience by segment has

## Table of Contents

fluctuated over time. The 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. 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. The Company's Loan Committee meets weekly and 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.

The Company considers a loan to be impaired when, based upon current information and events, it believes 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 loan 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.

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 has been performing for a prescribed period of time under the current contractual terms, income is recognized under the accrual method. At June 30, 2018, included in impaired loans, were troubled debt restructures totaling \$7,641,000. Nonaccrual loans, totaling \$3,378,000, were included in that total, with \$4,263,000 in troubled debt restructures considered current with regards to payments, and were performing according to their modified contractual terms.

Commercial and industrial loans and real estate mortgage loans, respectively, comprised approximately 16.54% and 18.25% of total impaired loan balances at June 30, 2018. Of the \$3,258,000 in commercial and industrial impaired loans reported at June 30, 2018, two loans, with a total recorded investment of \$734,000, were secured by real estate. 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 at June 30, 2018, approximately \$16,155,000, or 82.0%, are secured by real estate. The majority of impaired real estate construction and development loans are for the purpose of residential construction, residential and commercial acquisition and development, and land development. Residential construction loans are made for the purpose of building residential 1-4 single family homes. Residential and commercial acquisition and development loans are made for the purpose of purchasing land, developing that land if required, and developing real estate or commercial construction projects on those properties. Land development loans are made for the purpose of converting raw land into construction-ready building sites.

### Table 9. Impaired Loans and Specific Reserves

*The following table summarizes the components of impaired loans and their related specific reserves at June 30, 2018 and December 31, 2017.*

(in 000's)	Impaired Loan Balance		Reserve		Impaired Loan Balance		Reserve	
	June 30, 2018		June 30, 2018		December 31, 2017		December 31, 2017	
Commercial and industrial	\$	3,258	\$	444	\$	3,318	\$	534
Real estate – mortgage		3,595		590		4,296		488
RE construction & development		11,764		—		5,972		—
Agricultural		1,017		706		1,204		866
Installment/other		62		—		—		—
<b>Total Impaired Loans</b>	<b>\$</b>	<b>19,696</b>	<b>\$</b>	<b>1,740</b>	<b>\$</b>	<b>14,790</b>	<b>\$</b>	<b>1,888</b>

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 maximize collection. The Company makes various types of concessions when structuring TDRs including rate reductions, payment extensions, and forbearance. At June 30, 2018, approximately \$3,582,000 of the total \$7,641,000 in TDRs was comprised of real estate mortgages. An additional \$2,939,000 was related to real estate construction and development loans. There were no reserve amounts for real estate construction and development impaired loans and impaired installment loans at December 31, 2017 and June 30, 2018, due to the value of the collateral securing those loans.

Total troubled debt restructurings decreased 32.75% between June 30, 2018 and December 31, 2017. Nonaccrual TDRs decreased by 36.00% while accruing TDRs decreased by 29.93% over the same period. Total residential mortgages and real estate construction TDRs decreased slightly to 32.95%. Many of these credits are related to real estate projects that slowed significantly or stalled during the recession, leading the Company to pursue restructuring of the qualified credits allowing the real estate market time to recover and developers opportunity to finish projects at a slower pace. Concessions granted in these circumstances 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.

Table 10. TDRs

*The following tables summarize TDRs by type, classified separately as nonaccrual or accrual, which are included in impaired loans at June 30, 2018 and December 31, 2017.*

(in 000's)	Total TDRs		Nonaccrual TDRs		Accruing TDRs	
	June 30, 2018		June 30, 2018		June 30, 2018	
Commercial and industrial	\$	110	\$	—	\$	110
Real estate - mortgage:						
Commercial real estate		1,363		439		924
Residential mortgages		2,219		—		2,219
Total real estate mortgage		3,582		439		3,143
RE construction & development		2,939		2,939		—
Agricultural		1,010		—		1,010
<b>Total Troubled Debt Restructurings</b>	<b>\$</b>	<b>7,641</b>	<b>\$</b>	<b>3,378</b>	<b>\$</b>	<b>4,263</b>

[Table of Contents](#)

(in 000's)	Total TDRs		Nonaccrual TDRs		Accruing TDRs	
	December 31, 2017		December 31, 2017		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
RE construction & development		5,951		4,342		1,609
Installment/other		—		—		—
Total Troubled Debt Restructurings	\$	11,362	\$	5,278	\$	6,084

Of the \$7,641,000 in total TDRs at June 30, 2018, \$3,378,000 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 June 30, 2018, the Company has no commercial real estate (CRE) workouts whereby an existing loan was restructured into multiple new loans (i.e., A Note/B Note structure).

For a restructured loan to return to accrual status there needs to be at least 6 months successful payment history and continued satisfactory performance is expected. To this end, the Company typically 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 loans. 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.

Table 11. Credit Quality Indicators for Outstanding Student Loans

The following table summarizes the credit quality indicators for outstanding student loans as of June 30, 2018 and December 31, 2017 (in 000's, except for number of borrowers):

	June 30, 2018		December 31, 2017	
	Number of Loans	Amount	Number of Loans	Amount
School	992	\$ 37,565	1,216	\$ 48,825
Grace	294	13,724	55	1,446
Repayment	184	6,129	201	6,473
Deferment	40	1,270	32	1,128
Forbearance	92	3,006	50	1,981
Claim	1	67	—	—
Total	1,603	\$ 61,761	1,554	\$ 59,853

**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.

Table of Contents

**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.

**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 the South Dakota Division of Insurance and is now in liquidation. No future claims will be filed with ReliaMax.

Table 12. Nonperforming Assets

The following table summarizes the components of nonperforming assets as of June 30, 2018 and December 31, 2017 (in 000's), and the percentage of nonperforming assets to total gross loans, total assets, and the allowance for loan losses:

(in 000's)	<b>June 30, 2018</b>		<b>December 31, 2017</b>	
Nonaccrual Loans (1)	\$	12,202	\$	5,296
Restructured Loans		4,263		6,084
Loans past due 90 days or more, still accruing		67		485
<b>Total nonperforming loans</b>		<b>16,532</b>		<b>11,865</b>
Other real estate owned		5,745		5,745
<b>Total nonperforming assets</b>	<b>\$</b>	<b>22,277</b>	<b>\$</b>	<b>17,610</b>
Nonperforming loans to total gross loans		2.88%		1.97%
Nonperforming assets to total assets		2.53%		2.19%
Allowance for loan losses to nonperforming loans		50.96%		78.10%

- (1) Included in nonaccrual loans at June 30, 2018 and December 31, 2017 are restructured loans totaling \$3,378,000 and \$5,278,000, respectively.

Non-performing loans increased \$4,667,000 between December 31, 2017 and June 30, 2018. Nonaccrual loans increased \$6,906,000 between December 31, 2017 and June 30, 2018, with real estate mortgage and real estate construction loans comprising 100.00% of total nonaccrual loans at June 30, 2018. The increase in non-performing loans is primarily attributed to the addition of two nonaccrual loans, made to the same borrower, totaling \$8,825,000. The ratio of the allowance for loan losses to nonperforming loans decreased from 78.10% at December 31, 2017 to 50.96% at June 30, 2018.

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

(in 000's)	<b>Balance</b>		<b>Balance</b>		<b>Change from</b>
	<b>June 30, 2018</b>		<b>December 31, 2017</b>		<b>December 31, 2017</b>
Nonaccrual Loans:					
Commercial and industrial	\$	—	\$	212	\$ (212)
Real estate - mortgage		438		742	(304)
RE construction & development		11,764		4,342	7,422
Installment/other		—		—	—
<b>Total Nonaccrual Loans</b>	<b>\$</b>	<b>12,202</b>	<b>\$</b>	<b>5,296</b>	<b>\$ 6,906</b>

Loans past due more than 30 days receive increased management attention and are monitored for increased risk. The Company continues to move past due loans to nonaccrual status in an ongoing effort to recognize and address loan problems as early and most effectively as possible. As impaired loans, nonaccrual and restructured loans are reviewed for specific reserve allocations, the allowance for credit losses is adjusted accordingly.

Table of Contents

Except for the nonaccrual loans included in the above table, or those included in the impaired loan totals, there were no loans at June 30, 2018 where the known credit problems of a borrower caused the Company 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.

Nonperforming assets, which are primarily related to the real estate loan and other real estate owned portfolio, increased \$4,667,000 from a balance of \$17,610,000 at December 31, 2017 to a balance of \$22,277,000 at June 30, 2018, and remained relatively high compared to peers during the six months ended June 30, 2018. Nonaccrual loans, totaling \$12,202,000 at June 30, 2018, increased \$6,906,000 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 \$4,906,000 during the six months ended June 30, 2018 to a balance of \$19,696,000 at June 30, 2018. Other real estate owned through foreclosure remained the same at \$5,745,000 for the period ended June 30, 2018 as compared to the balance recorded at December 31, 2017. Nonperforming assets as a percentage of total assets increased from 2.19% at December 31, 2017 to 2.53% at June 30, 2018.

*The following table summarizes various nonperforming components of the loan portfolio, the related allowance for credit losses and provision for credit losses for the periods shown.*

(in 000's)	June 30, 2018	December 31, 2017	June 30, 2017
Recovery of provision for credit losses year-to-date	\$ (1,325)	\$ (189)	\$ (31)
Allowance as % of nonperforming loans	50.96%	78.10%	66.63%
Nonperforming loans as % total loans	2.88%	1.97%	2.46%
Restructured loans as % total loans	1.33%	1.89%	2.46%

Management continues to monitor economic conditions in the real estate market for signs of deterioration or improvement which may impact the level of the allowance for loan losses required to cover identified losses in the loan portfolio. Focus has been placed on monitoring and reducing the level of problem assets, while working with borrowers to find more options, including loan restructures. Restructured loan balances are comprised of 17 loans totaling \$7,641,000 at June 30, 2018, compared to 25 loans totaling \$11,362,000 at December 31, 2017.

*The following table summarizes special mention loans by type at June 30, 2018 and December 31, 2017.*

(in thousands)	June 30, 2018	December 31, 2017
Commercial and industrial	\$ 10	\$ —
Real estate - mortgage:		
Commercial real estate	8,376	8,487
Residential mortgages	636	643
Total real estate mortgage	9,012	9,130
RE construction & development	—	720
Agricultural	—	994
Total Special Mention Loans	\$ 9,022	\$ 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



[Table of Contents](#)

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 possible credit losses, provisions made to that allowance, and charge-off and recovery activity affecting the allowance for the six months ended June 30, 2018 and June 30, 2017.

**Table 13. Allowance for Credit Losses - Summary of Activity**

(in 000's)	June 30, 2018	June 30, 2017
Total loans outstanding at end of period before deducting allowances for credit losses	\$ 574,351	\$ 568,163
Average loans outstanding during period	590,905	560,282
Balance of allowance at beginning of period	9,267	8,902
Loans charged off:		
Real estate	—	(2)
Commercial and industrial	(88)	(105)
Installment and other	(11)	(10)
Total loans charged off	(99)	(117)
Recoveries of loans previously charged off:		
Real estate	20	14
Commercial and industrial	408	185
Installment and other	154	54
Total loan recoveries	582	253
Net loans recovered	483	136
Recovery of provision charged to operating expense	(1,325)	(31)
Balance of allowance for credit losses at end of period	\$ 8,425	\$ 9,007
Net loan recoveries to total average loans (annualized)	(0.16)%	(0.05)%
Net loan recoveries to loans at end of period (annualized)	(0.17)%	(0.03)%
Allowance for credit losses to total loans at end of period	1.47 %	1.59 %
Net loan recoveries to allowance for credit losses (annualized)	(11.47)%	(3.02)%
Recovery of provision for credit losses to net recoveries (annualized)	(548.65)%	(45.59)%

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. Management believes its estimate of the allowance for credit losses adequately covers estimated losses inherent in the loan portfolio and, based on the condition of the loan portfolio, management believes the allowance is sufficient to cover risk elements in the loan portfolio. For the six months ended June 30, 2018, the recovery of provision for the allowance for credit losses was \$1,325,000 as compared to a provision of \$31,000 for the six months ended June 30, 2017.

Net recoveries during the six months ended June 30, 2018 totaled \$483,000 as compared to net recoveries of \$136,000 for the six months ended June 30, 2017. The Company charged-off, or had partial charge-offs on 6 loans during the six months ended June 30, 2018, as compared to one loan during the same period ended June 30, 2017, and 6 loans during the year ended December 31, 2017. The annualized percentage net recoveries to average loans were 0.16% for the six months ended June 30, 2018 and 0.06% for the year ended December 31, 2017, and 0.05% for the six months ended June 30, 2017. The Company's loans net of unearned fees increased from \$568,163,000 at June 30, 2017 to \$574,351,000 at June 30, 2018.

## Table of Contents

The allowance at June 30, 2018 was 1.47% of outstanding loan balances at June 30, 2018, as compared to 1.54% at December 31, 2017, and 1.59% at June 30, 2017.

At June 30, 2018 and June 30, 2017, \$346,000 and \$376,000, respectively, of the formula allowance is allocated to unfunded loan commitments and is, therefore, reported separately in other liabilities on the consolidated balance sheet. Management believes that the 1.47% credit loss allowance at June 30, 2018 is adequate to absorb known and inherent risks in the loan portfolio. No assurance can be given, however, regarding economic conditions or other circumstances which may adversely affect the Company's service areas and result in future losses to the loan portfolio.

### **Asset/Liability Management – Liquidity and Cash Flow**

The primary functions of asset/liability management are to provide adequate liquidity and maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities. In a changing rate environment an imbalance in interest-sensitive assets and interest-sensitive liabilities will impact earnings. For example, in an increasing rate environment if interest-sensitive liabilities reprice sooner than interest sensitive assets, net interest income will be negatively impacted.

#### *Liquidity*

Liquidity management may be described as the ability to maintain sufficient cash flows to fulfill financial obligations, including loan funding commitments and customer deposit withdrawals, without straining the Company's equity structure. To maintain an adequate liquidity position, the Bank 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 Bank's principal cash outflows are for loan origination, purchases of investment securities, depositor withdrawals and payment of operating expenses.

The Bank continues to emphasize liability management as part of its overall asset/liability strategy. Through the discretionary acquisition of short term borrowings, the Bank has, when needed, been able to provide liquidity to fund asset growth while, at the same time, better utilizing its capital resources, and better controlling interest rate risk. This does not preclude the Bank from selling assets such as investment securities to fund liquidity needs but, with favorable borrowing rates, the Bank has maintained a positive yield spread between borrowed liabilities and the assets which those liabilities fund. If, at some time, rate spreads become unfavorable, the Bank has the ability to utilize an asset management approach and, either control asset growth or fund further growth with maturities or sales of investment securities. At June 30, 2018, the Bank had no borrowings, as its deposit base currently provides funding sufficient to support its asset values.

The Banks 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, is maintained at a level deemed sufficient to provide the cash outlay necessary to fund loan growth as well as any customer deposit runoff that may occur. Additional liquidity requirements may be funded with overnight or term borrowing arrangements with various correspondent banks, FHLB and the Federal Reserve Bank. 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 June 30, 2018, the loan portfolio totaled 65.31% of total assets and the loan to deposit ratio was 74.76%, compared to 74.75% and 86.25%, respectively, at December 31, 2017. Liquid assets at June 30, 2018, included cash and cash equivalents totaling \$191,128,000 as compared to \$107,934,000 at December 31, 2017. Other sources of liquidity include collateralized lines of credit from the Federal Home Loan Bank, and from the Federal Reserve Bank totaling \$284,137,000 and uncollateralized lines of credit from Pacific Coast Banker's Bank (PCBB) of \$10,000,000, Union Bank of \$10,000,000, and Zion's Bank of \$20,000,000 at June 30, 2018.

The liquidity of the Holding Company, United Security Bancshares, is primarily dependent on the payment of cash dividends by its subsidiary, the Bank, subject to limitations imposed by the Financial Code of the State of California. During the six months ended June 30, 2018, the Holding Company has received \$3,282,000 in cash dividends from the Bank.

#### *Cash Flow*

The period-end balances of cash and cash equivalents for the periods shown are as follows (from Consolidated Statements of Cash Flows – in 000's):

## Table of Contents

(in 000's)	Balance
December 31, 2016	\$ 113,032
June 30, 2017	\$ 109,508
December 31, 2017	\$ 107,934
June 30, 2018	\$ 191,128

Cash and cash equivalents increased \$83,194,000 during the six months ended June 30, 2018, compared to an decrease of \$3,524,000 during the six months ended June 30, 2017.

The Company had a net cash inflow from operating activities of \$2,944,000 for the six months ended June 30, 2018 and a cash inflow from operations totaling \$2,250,000 for the period ended June 30, 2017. The Company experienced net cash inflows from investing activities of \$12,501,000 related to a \$27,839,000 decrease in loan balances and principal payments on available-for-sale securities of \$4,698,000, partially offset by \$19,860,000 in purchases of available-for-sale securities during the six months ended June 30, 2018. For the six months ended June 30, 2017, the Company experienced net cash inflows from investing activities of \$5,384,000 due a decrease of \$2,654,000 in loan balances.

During the six months ended June 30, 2018, the Company experienced net cash inflows from financing activities totaling \$67,749,000, primarily as the result of increases of \$67,299,000 in demand deposits and savings accounts, offset by decreases of \$1,970,000 in time deposits and purchased brokered deposits. For the six months ended June 30, 2017, the Company experienced net cash outflows of \$11,158,000 from financing activities due to decreases in demand deposit accounts, time deposits, and savings accounts.

The Company has the ability to increase or decrease loan growth, increase or decrease deposits and borrowings, or a combination of both to manage balance sheet liquidity.

### **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. 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 capital plan requires the Bank to maintain a ratio of tangible shareholder's equity to total tangible assets equal to or greater than 9.0%. The Bank's ratio of tangible shareholders' equity to total tangible assets was 12.5% and 13.5% at June 30, 2018 and 2017, respectively.

[Table of Contents](#)

The following table sets forth the Company's and the Bank's actual capital positions at June 30, 2018, 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:

Table 14. Capital Ratios

	<b>Ratio at June 30, 2018</b>	<b>Ratio at December 31, 2017</b>	<b>Minimum for Capital Adequacy (1)</b>	<b>Minimum requirement for "Well Capitalized" Institution</b>
<b>Total capital to risk weighted assets</b>				
Company	18.42%	17.54%	9.88%	N/A
Bank	18.32%	17.31%	9.88%	10.00%
<b>Tier 1 capital to risk-weighted assets</b>				
Company	17.18%	16.29%	7.88%	N/A
Bank	17.07%	16.06%	7.88%	8.00%
<b>Common equity tier 1 capital to risk-weighted assets</b>				
Company	15.68%	14.81%	6.38%	N/A
Bank	17.07%	16.06%	6.38%	6.50%
<b>Tier 1 capital to adjusted average assets (leverage)</b>				
Company	13.04%	13.01%	5.88%	N/A
Bank	12.99%	12.90%	5.88%	5.00%

(1) Includes 1.875% Capital Conservation Buffer

The Federal Reserve and the Federal Deposit Insurance Corporation approved final capital rules in July 2013, that substantially amended the then existing capital rules for banks. These new rules reflect, in part, certain standards initially adopted by the Basel Committee on Banking Supervision in December 2010 (commonly referred to as "Basel III") as well as requirements encompassed by the Dodd-Frank Act.

The final rules set a new common equity tier 1 requirement and higher minimum tier 1 requirements for all banking organizations. The final rules also require a Common Equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. The capital buffer requirement is being phased in over three years beginning in 2016, and will effectively raise the minimum required Common Equity Tier 1 RBC Ratio to 7.0%, the Tier 1 RBC Ratio to 8.5%, and the Total RBC Ratio to 10.5% on a fully phased-in basis. Institutions that do not maintain the required capital buffer will become subject to progressively more 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. The rules revise the prompt corrective action framework to incorporate the new regulatory capital minimums. They also enhance risk sensitivity and address weaknesses identified over recent years with the measure of risk-weighted assets.

As of June 30, 2018, the Company and the Bank meet all capital adequacy requirements to which they are subject. Management believes that, under the current regulations, both will continue to meet their minimum capital requirements in the foreseeable future.

### **Dividends**

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

On April 25, 2017, the Board of Directors announced the authorization of the repurchase of up to \$3,000,000 of the outstanding stock of the Holding Company. This amount represents 3% of total shareholders' equity of \$105,216,000 at June 30, 2018. The

## Table of Contents

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. During the six months ended June 30, 2018, the Company did not repurchase any of the shares available.

During the six months ended June 30, 2018, the Bank paid \$3,282,000 in cash dividends to the Holding Company which funded the Holding Company's operating costs and payments of interest on its junior subordinated debt.

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 \$1,520,000 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 regular quarterly cash dividend \$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 \$1,520,000 was transferred from retained earnings to dividends payable to allow for distribution of the dividend to shareholders.

The Bank, as a state-chartered bank, is subject to dividend restrictions set forth in the California Financial Code, as administered by the Commissioner of the DBO ("Commissioner"). As applicable to the Bank, the Financial Code provides that 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 the Holding Company 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 shareholder's equity of the Bank is not adequate or that the declaration of a dividend would be unsafe or unsound, the Commissioner may order the Bank not to pay any dividend. The Reserve Bank 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, 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. At June 30, 2018, the Bank was not subject to a reserve requirement.

### **Item 3 - Quantitative and Qualitative Disclosures about Market Risk**

The Company's assessment of market risk as of June 30, 2018 indicates there are no material changes in the quantitative and qualitative disclosures from those in our Annual Report on Form 10-K, as amended, for the year ended December 31, 2017.

### **Item 4. Controls and Procedures**

#### **Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of June 30, 2018, the end of the period covered by this report, an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures was carried out. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

### **Changes in Internal Control over Financial Reporting**

There have not been any changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2018, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all error and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

[Table of Contents](#)

**PART II. Other Information**

**Item 1. Legal Proceedings**

Not applicable

**Item 1A. Risk Factors**

There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K, as amended, for the fiscal year ended December 31, 2017.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None during the quarter ended June 30, 2018.

**Item 3. Defaults Upon Senior Securities**

Not applicable

**Item 4. Mine Safety Disclosures**

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits:**

(a) Exhibits:

11	<a href="#">Computation of Earnings per Share*</a>
31.1	<a href="#">Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</a>
31.2	<a href="#">Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</a>
32.1	<a href="#">Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</a>
32.2	<a href="#">Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</a>

\* Data required by Accounting Standards Codification (ASC) 260, *Earnings per Share*, is provided in Note 8 to the consolidated financial statements in this report.

## Signatures

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

United Security Bancshares

Date: August 3, 2018

/S/ Dennis R. Woods

---

Dennis R. Woods  
President and Chief Executive Officer

/S/ Bhavneet Gill

---

Bhavneet Gill  
Senior Vice President and Chief Financial Officer

66

[\(Back To Top\)](#)

## Section 2: EX-31.1 (EXHIBIT 31.1 06302018)

**EXHIBIT 31.1**

### CERTIFICATION UNDER SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Dennis R. Woods, certify that:

1. I have reviewed this report on Form 10-Q of United Security Bancshares;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13(a) - 15(e) and 15d - 15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):



a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 3, 2018

/S/ Dennis R. Woods

Dennis R. Woods

President and Chief Executive Officer

A signed original of this written statement required by Section 302 of the Sarbanes-Oxley Act of 2002 has been provided to United Security Bancshares and will be retained by United Security Bancshares and furnished to the SEC or its staff upon request

[\(Back To Top\)](#)

### **Section 3: EX-31.2 (EXHIBIT 31.2 06302018)**

**EXHIBIT 31.2**

#### CERTIFICATION UNDER SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Bhavneet Gill, certify that:

1. I have reviewed this report on Form 10-Q of United Security Bancshares;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13(a) - 15(e) and 15d - 15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are

reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 3, 2018

/S/ Bhavneet Gill

Bhavneet Gill

Senior Vice President and Chief Financial Officer

A signed original of this written statement required by Section 302 of the Sarbanes-Oxley Act of 2002 has been provided to United Security Bancshares and will be retained by United Security Bancshares and furnished to the SEC or its staff upon request

[\(Back To Top\)](#)

## **Section 4: EX-32.1 (EXHIBIT 32.1 06302018)**

**EXHIBIT 32.1**

### **SECTION 906 CERTIFICATION**

The certification set forth below is being submitted to the Securities and Exchange Commission solely for the purpose of complying with Section 1350 of Chapter 63 of Title 18 of the United States Code.

August 3, 2018

Dennis R. Woods, the Chief Executive Officer of United Security Bancshares certifies:

1. that this quarterly report on Form 10-Q for the quarter ended June 30, 2018 fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. that information contained in this quarterly report on Form 10-Q for the quarter ended June 30, 2018 fairly presents, in all material respects, the financial condition and results of operations of United Security Bancshares.

/s/ Dennis R. Woods

Dennis R. Woods

President and Chief Executive Officer

[\(Back To Top\)](#)

## **Section 5: EX-32.2 (EXHIBIT 32.2 06302018)**

**EXHIBIT 32.2**

### **SECTION 906 CERTIFICATION**

The certification set forth below is being submitted to the Securities and Exchange Commission solely for the purpose of complying with Section 1350 of Chapter 63 of Title 18 of the United States Code.

August 3, 2018

Bhavneet Gill, the Chief Financial Officer of United Security Bancshares certifies:

1. that this quarterly report on Form 10-Q for the quarter ended June 30, 2018 fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. that information contained in this quarterly report on Form 10-Q for the quarter ended June 30, 2018 fairly presents, in all material respects, the financial condition and results of operations of United Security Bancshares.

/s/ Bhavneet Gill

Bhavneet Gill

Senior Vice President and Chief Financial Officer

[\(Back To Top\)](#)