

## Section 1: 10-K (10-K)

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
**FORM 10-K**

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 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: 000-32987

# 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)

Registrant's telephone number, including area code (559) 248-4943

Securities registered pursuant to Section 12(b) of the Act: Common Stock, no par value on Nasdaq  
(Title of Class)

Securities registered pursuant to Section 12(g) of the Act: NONE

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 if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) 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 if disclosure of delinquent filers pursuant to item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrants knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K.

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

Accelerated filer

Non-accelerated filer

Small reporting company

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.

Aggregate market value of the Common Stock held by non-affiliates as of the last business day of the registrant's most recently completed second fiscal quarter - June 30, 2018: \$149,471,739

Shares outstanding as of February 28, 2019: 16,946,622

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

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Items 10, 11, 12, 13 and 14 of Part III of this Annual Report on Form 10-K will be found in the Company's definitive proxy statement for its 2019 Annual Meeting of Shareholders, to be filed pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended, and such information is incorporated herein by this reference.

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## PART 1

Certain matters discussed or incorporated by reference in this Annual Report on Form 10-K (this “Report”) including, but not limited to, those described in “Item 7 - Management’s Discussion and Analysis of Financial Condition and Results of Operations,” are forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. All statements contained in this Form 10-K that are not clearly historical in nature are forward-looking, and the words “anticipate,” “assume,” “intend,” “believe,” “forecast,” “expect,” “estimate,” “plan,” “continue,” “will,” “should,” “look forward” and similar expressions are generally intended to identify forward-looking statements. You should not place undue reliance on these statements as they involve risks, uncertainties and contingencies, many of which are beyond our control, which may cause actual results, performance, or achievements to differ materially from those expressed in them. Actual results could differ materially from those anticipated in such forward-looking statements as a result of risks and uncertainties more fully described under “Item 1A. Risk Factors.” Factors that might cause such differences include, but are not limited to:

- our ability to compete effectively against other financial service providers in our markets;
- the effect of the current low interest rate environment or impact of changes in interest rates or levels of market activity, especially on the fair value of our loan and investment portfolios;
- economic deterioration or a recession that may affect the ability of borrowers to make contractual payments on loans and may affect the value of real property or other property held as collateral for such loans;
- changes in credit quality and the effect of credit quality on our allowance for loan and lease losses;
- our ability to attract and retain deposits and other sources of funding or liquidity;
- the need to retain capital for strategic or regulatory reasons;
- the impact of the Dodd-Frank Act on our business, business strategies and cost of operations;
- compression of the net interest margin due to changes in the interest rate environment, forward yield curves, loan products offered, spreads on newly originated loans and leases and/or asset mix;
- reduced demand for our services due to strategic or regulatory reasons;
- our ability to successfully execute on initiatives relating to enhancements of our technology infrastructure, including client-facing systems and applications;
- legislative or regulatory requirements or changes, including an increase to capital requirements, and increased political and regulatory uncertainty;
- the impact on our reputation and business from our interactions with business partners, counterparties, service providers and other third parties;
- higher than anticipated increases in operating expenses;
- inability for the bank to pay dividends to the holding company;
- a deterioration in the overall macroeconomic conditions or the state of the banking industry that could warrant further analysis of the carrying value of goodwill and could result in an adjustment to its carrying value resulting in a non-cash charge;
- the effectiveness of our risk management framework and quantitative models;
- the costs and effects of legal, compliance, and regulatory actions, changes and developments, including the impact of adverse judgments or settlements in litigation, the initiation and resolution of regulatory or other governmental inquiries or investigations, and/or the results of regulatory examinations or reviews;
- the impact of the Tax Cuts and Jobs Act on our business and business strategies, or if other changes are made to tax laws or regulations affecting our business, including the disallowance of tax benefits by tax authorities and/or changes in tax filing jurisdictions or entity classifications; and
- our success at managing risks involved in the foregoing items and all other risk factors described in our audited consolidated financial statements, and other risk factors described in this Form 10-K and other documents filed or furnished by the Company with the SEC.

Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company.

### Item 1 - Business

#### General

United Security Bancshares is a California corporation incorporated in March 2001 and is registered with the Board of Governors of the Federal Reserve System (“FRB”) as a bank holding company under the Bank Holding Company Act of 1956, as amended (the “BHCA”). The stock of United Security Bancshares is listed on NASDAQ under the symbol “UBFO.”

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United Security Bank was chartered under the laws of the State of California in 1987 as a commercial bank. On June 12, 2001, United Security Bank reorganized into the bank holding company form of ownership and thereby became the wholly-owned subsidiary of United Security Bancshares and each share of United Security Bank stock was exchanged for a share of United Security Bancshares stock on a one-to-one basis. The principal business of United Security Bancshares is to serve as the holding company for United Security Bank.

References to the “Bank” refer to United Security Bank together with its wholly-owned subsidiary, USB Investment Trust Inc., a special purpose real estate investment trust organized under the laws of the State of Maryland. References to “we,” “us,” or the “Company” refer to United Security Bancshares together with its subsidiaries on a consolidated basis. References to the “Holding Company,” refer to United Security Bancshares, the parent company, on a stand-alone basis.

### ***United Security Bank***

The Bank is a California state-chartered bank headquartered in Fresno, California. At December 31, 2018, the Bank operates three branches (including its main office), one construction lending office, and one commercial lending office in Fresno, California and one branch each, in Oakhurst, Caruthers, San Joaquin, Firebaugh, Coalinga, Bakersfield, Taft, and Campbell, California. The Bank has ATMs at all branch locations and off-site ATMs at nine different non-branch locations. In addition, the Holding Company and the Bank have administrative headquarters located at 2126 Inyo Street, Fresno, California, 93721.

### ***USB Investment Trust Inc.***

USB Investment Trust Inc. was incorporated effective December 31, 2001 as a special purpose real estate investment trust (REIT) under Maryland law. The REIT is a subsidiary of the Bank and was funded with \$133.0 million in real estate-secured loans contributed by the Bank. USB Investment Trust was originally formed to give the Bank flexibility in raising capital, and reduce the expenses associated with holding the assets contributed to USB Investment Trust. The REIT also provided state tax benefits beginning in 2002.

### ***USB Capital Trust II***

During July 2007, the Holding Company formed USB Capital Trust II as a wholly-owned special purpose entity for the purpose of issuing Trust Preferred Securities. USB Capital Trust II is a Variable Interest Entity (VIE) and a deconsolidated entity pursuant to current accounting standards related to variable interest entities. On July 23, 2007, USB Capital Trust II issued \$15 million in Trust Preferred Securities. These securities have a thirty-year maturity and bear a floating rate of interest (repricing quarterly) of 1.29% over the three-month LIBOR rate. Interest is payable quarterly. Concurrent with the issuance of the Trust Preferred Securities, USB Capital Trust II used the proceeds of the Trust Preferred Securities offering to purchase a like amount of junior subordinated debentures issued by the Holding Company. The Holding Company pays interest on the junior subordinated debentures to USB Capital Trust II, which represents the sole source of dividend distributions to the holders of the Trust Preferred Securities. Effective September 30, 2009 and beginning with the quarterly interest payment due October 1, 2009, the Holding Company elected to defer interest payments on the \$15.0 million of junior subordinated debentures relating to the Trust Preferred Securities. The terms of the debentures and trust indentures allow for the Holding Company to defer interest payments for up to 20 consecutive quarters without default or penalty. During this deferral period, the Holding 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, as of December 31, 2018, was current on its quarterly interest payments. During 2015, \$3.0 million of the \$15.0 million principal balance of the subordinated debentures related to the Trust Preferred Securities was purchased by the Bank and subsequently purchased by the Company. The Company redeemed the \$3.0 million in par value of the subordinated debentures, resulting in a remaining contractual principal balance of \$12.0 million since year-end 2015. The Company may redeem the junior subordinated debentures at any time at par.

The following discussion of our services should be read in conjunction with "Item 7 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS."

### ***Bank Services***

We offer a full range of commercial banking services primarily to the business and professional community and individuals located in Fresno, Madera, Kern, and Santa Clara Counties, including a variety of deposit instruments including personal and business checking accounts and savings accounts, interest-bearing negotiable order of withdrawal (NOW) accounts, money market accounts and time certificates of deposit. Most of our deposits are comprised of accounts from individuals and from small- and medium-sized business-related sources. Time deposits have provided a significant portion of the Bank's deposit base amounting to 10.23% and 9.43% of total deposits at December 31, 2018 and 2017, respectively.

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We also offer a full complement of lending activities, including real estate mortgage (49.2% of total loans at December 31, 2018), commercial and industrial (9.7% of total loans at December 31, 2018), real estate construction (18.5% of total loans at December 31, 2018), as well as agricultural (10.4% of total loans at December 31, 2018), and installment loans (12.2% of total loans at December 31, 2018). Approximately 67.7% of our loans are secured by real estate at December 31, 2018. A loan may be secured (in whole or in part) by real estate even though the purpose of the loan is not to facilitate the purchase or development of real estate. At December 31, 2018, we had loans (net of unearned fees) outstanding of \$587,814,000, which represented approximately 73.0% of our total deposits and approximately 63.0% of our total assets.

Our real estate mortgage loans are secured by deeds of trust primarily on commercial property. The repayment of real estate mortgage loans generally is from the cash flow of the borrower. Commercial and industrial loans have a high degree of industry diversification. Our loans may be originated in our market area, or participated with other financial institutions outside our market area. A substantial portion of our commercial and industrial loans are secured by accounts receivable, inventory, leases or other collateral. The remainder are unsecured. However, extensions of credit are predicated on the financial capacity of the borrower to repay. Repayment of commercial loans is generally from the cash flow of the borrower. Our real estate construction loans consist of loans to residential contractors, which are secured by single-family residential properties. All real estate loans have established equity requirements. The repayment of real estate construction loans is generally from long-term mortgages with other lending institutions. Our agricultural loans are generally secured by land, equipment, inventory and receivables. Repayment of agricultural loans is generally from the expected cash flow of the borrower.

Although we have a high concentration of commercial real estate loans, we are not in the business of making residential mortgage loans to individuals. Residential mortgage loans totaled \$59,431,000, or 10.11% of the portfolio at December 31, 2018. The residential mortgage loan portfolio is primarily comprised of purchased residential mortgage pools. We do not originate, or have in our loan portfolio, any subprime, Alt-A, or option adjustable rate loans. We do originate interest-only loans which are generally revolving lines of credit to commercial and agricultural businesses or for real estate development where the borrowers business may be seasonal or cash flows may be restricted until the completion of the project. In addition, we have restructured certain loans to allow the borrower to continue to perform on the loan under a troubled debt restructuring plan.

We purchase loan participations from, and sell loan participations to, other financial institutions. The underwriting standards for loan participations or purchases are the same as non-participated loans, and are subject to the same limitations, collateral requirements, and borrower requirements. We have reduced our level of loan participations over the past several years and as of December 31, 2018, we do not have any participation purchased loans. Loan participations sold comprised 1.2% and 1.3% of the total loan portfolio at December 31, 2018 and 2017, respectively.

In the normal course of business, we make various loan commitments and incur certain contingent liabilities. Due to the nature of the business of our customers, there is no absolute predictability to the utilization of unused loan commitments and therefore, we are unable to forecast the extent to which these commitments will be exercised within the current year. Although we can provide no assurances, we do not believe that any such utilization will constitute a material liquidity demand. The Company does however have collateralized and uncollateralized lines of credit which could be utilized if such loan commitments were to be exercised in excess of normal expectations.

In addition to the loan and deposit services discussed above we also offer a wide range of specialized services designed to attract and service the needs of commercial customers and account holders. These services include online banking, mobile banking, safe deposit boxes, Interactive (Virtual) Teller "ITM" services, ATM services, payroll direct deposit, cashier's checks, and cash management services. We do not operate a trust department; however, we make arrangements with our correspondent bank to offer trust services to our customers upon request. Most of our business originates within Fresno, Madera, Kern, and Santa Clara Counties.

### ***Competition and Market Share***

The banking business in California generally, and in the market areas we serve specifically, is highly competitive with respect to both loans and deposits. We compete for loans and deposits with other commercial banks, savings and loan associations, money market funds, credit unions and other financial institutions, including a number that are substantially larger than us. We compete for loans and deposits by offering competitive interest rates and by seeking to provide a higher level of personalized service than is generally offered by larger competitors. Regulatory restrictions on interstate bank branching and acquisitions and on banks providing a broader array of financial services, such as securities underwriting and insurance, have been reduced or eliminated. The availability of banking services over the Internet and on mobile devices continues to expand. Changes in laws and regulations governing the financial services industry cannot be predicted; however, past legislation has served to

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intensify the competitive environment. Many of the major commercial banks operating in our market areas offer certain services such as trust and international banking services, which we do not offer directly. In addition, banks with larger capitalization have larger lending limits and are thereby able to serve larger customers.

Our primary market area at December 31, 2018 was located in Fresno, Madera, and Kern Counties, within California, in which approximately 30 FDIC-insured financial institutions compete for business. Santa Clara County was added during February 2007, with the Legacy Bank acquisition, in which approximately 50 FDIC-insured financial institutions compete for business. The following table sets forth information regarding deposit market share and ranking by county as of June 30, 2018, which is the most current information available.

|  | Rank | Share |
|--|------|-------|
| Fresno County                          | 8th  | 4.30% |
| Madera County                          | 8th  | 6.16% |
| Kern County                            | 14th | 0.76% |
| Total of Fresno, Madera, Kern Counties | 7th  | 3.08% |
| Santa Clara County                     | 43rd | 0.01% |

## ***Supervision and Regulation***

### *Introduction*

We are subject to extensive regulation under federal and state banking laws that establish a comprehensive framework for our operations. Such regulation is intended to, among other things, protect the interests of customers, including depositors, and the federal deposit insurance fund, as well as to minimize risk to the banking system as a whole. These regulations are not, however, generally charged with protecting the interests of our shareholders or creditors. Described below are elements of selected laws and regulations applicable to our Holding Company and/or our Bank. The descriptions are not intended to be complete and are qualified in their entirety by reference to the full text of the statutes and regulations described. Changes in applicable law or regulations, and in their application by regulatory agencies, cannot be predicted, and they may have a material effect on the business, operations, and results of our Company or the Bank. Recent political developments, including the change in the political composition of the U.S. Congress and the ongoing investigation of the current administration, have added additional uncertainty to the implementation, scope, and timing of regulatory reforms, including those related to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

The following discussion of statutes and regulations is a summary and does not purport to be complete nor does it address all applicable statutes and regulations. This discussion is also qualified in its entirety by reference to the full text and to the implementation and enforcement of the statutes and regulations referred to in this discussion.

### *Dodd-Frank Wall Street Reform and Consumer Protection Act*

Substantial changes to the regulation of bank holding companies and their subsidiaries have occurred as a result of the enactment in 2010 of the Dodd-Frank Act. Changes in applicable law or regulation, and in their application by regulatory agencies, have had and will continue to have a material effect on the business and results of the Company and its subsidiaries.

The Dodd-Frank Act significantly changed the regulatory framework for financial services companies, and since its enactment has required significant rulemaking and numerous studies and reports. Among other things, it created a new Financial Stability Oversight Council (the “Council”) with broad authority to make recommendations covering enhanced prudential standards and more stringent supervision for large bank holding companies and certain non-bank financial services companies. The Dodd-Frank Act significantly reduced interchange fees on debit card transactions, changed the preemption of state laws applicable to national banks, increased the regulation of consumer mortgage banking and made numerous other changes.

In addition to the Dodd-Frank Act, other legislative and regulatory proposals affecting banks have been made in recent years both domestically and internationally. Among other things, these proposals include significant additional capital and liquidity requirements and limitations on the size or types of activity in which banks may engage.

### ***The Holding Company***

*General*

The Holding Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and is registered with, and regulated and examined by, the Board of Governors of the Federal Reserve System, or FRB. In addition, the Bank is subject to extensive regulation and periodic examination, principally by the California Department of Business Oversight, or DBO and, as a member bank, the FRB. The Federal Deposit Insurance Corporation, or FDIC, insures the Bank's deposits up to certain prescribed limits. The Holding Company is also subject to regulation by the Securities and Exchange Commission ("SEC") and to the disclosure and regulatory requirements of the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and through the listing of its common stock on NASDAQ, the Holding Company is subject to the listing standards and rules of NASDAQ.

*Source of Strength*

The Dodd-Frank Act codified existing FRB policy requiring the Holding Company to act as a source of financial strength to the Bank, and to commit resources to support the Bank in circumstances where it might not otherwise do so. However, because the Gramm-Leach-Bliley Act ("GLBA") provides for functional regulation of financial holding company activities by various regulators, the GLBA prohibits the FRB from requiring payment by a holding company to a depository institution if the functional regulator of the depository institution objects to the payment. In those cases, the FRB could instead require the divestiture of the depository institution and impose operating restrictions pending the divestiture. As a result of the Dodd-Frank Act, non-bank subsidiaries of a holding company that engage in activities permissible for an insured depository institution must be examined and regulated in a manner that is at least as stringent as if the activities were conducted by the lead depository institution of the holding company.

*Bank Holding Company Liquidity*

As a legal entity, separate and distinct from the Bank, the Holding Company has the ability to raise capital on its own behalf or borrow from external sources. We may also obtain additional funds from dividends paid by, and fees charged for services provided to, the Bank. However, regulatory constraints on the Bank may restrict or totally preclude the payment of dividends by the Bank to the Holding Company.

*Transactions with Affiliates and Insiders*

The Holding Company and any subsidiaries it may purchase or organize are deemed to be affiliates of the Bank within the meaning of Sections 23A and 23B of the Federal Reserve Act, and the FRB's Regulation W. Under Sections 23A and 23B and Regulation W, loans by the Bank to affiliates, investments by them in affiliates' stock, and taking affiliates' stock as collateral for loans to any borrower is limited to 10% of the Bank's capital, in the case of any one affiliate, and is limited to 20% of the Bank's capital, in the case of all affiliates. In addition, transactions between the Bank and other affiliates must be on terms and conditions that are consistent with safe and sound banking practices, in particular, a bank and its subsidiaries generally may not purchase from an affiliate a low-quality asset, as defined in the Federal Reserve Act. These restrictions also prevent a bank holding company and its other affiliates from borrowing from a banking subsidiary of the bank holding company unless the loans are secured by marketable collateral of designated amounts.

The Holding Company and the Bank are also subject to certain restrictions with respect to engaging in the underwriting, public sale and distribution of securities.

The Federal Reserve Act and FRB Regulation O place limitations and conditions on loans or extensions of credit to a bank or bank holding company's executive officers, directors and principal shareholders; any company controlled by any such executive officer, director or shareholder; or any political or campaign committee controlled by such executive officer, director or principal shareholder. Additionally, such loans or extensions of credit must comply with loan-to-one-borrower limits; require prior full board approval when aggregate extensions of credit to the person exceed specified amounts; must be made on substantially the same and follow credit-underwriting procedures no less stringent than those prevailing at the time for comparable transactions with non-insiders; must not involve more than the normal risk of repayment or present other unfavorable features; and must not exceed the bank's unimpaired capital and unimpaired surplus in the aggregate.

*Limitations on Business and Investment Activities*



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Under the BHCA, a bank holding company must obtain the FRB's approval before: (i) directly or indirectly acquiring more than 5% ownership or control of any voting shares of another bank or bank holding company; (ii) acquiring all or substantially all of the assets of another bank; (iii) or merging or consolidating with another bank holding company.

The FRB may allow a bank holding company to acquire banks located in any state of the United States without regard to whether the acquisition is prohibited by the law of the state in which the target bank is located. In approving interstate acquisitions, however, the FRB must give effect to applicable state laws limiting the aggregate amount of deposits that may be held by the acquiring bank holding company and its insured depository institutions in the state in which the target bank is located, provided that those limits do not discriminate against out-of-state depository institutions or their holding companies, and state laws which require that the target bank have been in existence for a minimum period of time, not to exceed five years, before being acquired by an out-of-state bank holding company.

In addition to owning or managing banks, bank holding companies may own subsidiaries engaged in certain businesses that the FRB has determined to be "so closely related to banking as to be a proper incident thereto." The Holding Company, therefore, is permitted to engage in a variety of banking-related businesses.

Additionally, qualifying bank holding companies making an appropriate election to the FRB may engage in a full range of financial activities, including insurance, securities and merchant banking. The Holding Company has not elected to qualify for these financial services.

Federal law prohibits a bank holding company and any subsidiary banks from engaging in certain tie-in arrangements in connection with the extension of credit. Thus, for example, the Bank may not extend credit, lease or sell property, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that:

- the customer must obtain or provide some additional credit, property or services from or to the Bank other than a loan, discount, deposit or trust services;
- the customer must obtain or provide some additional credit, property or service from or to the Holding Company or any subsidiaries; or
- the customer must not obtain some other credit, property or services from competitors, except reasonable requirements to assure soundness of credit extended.

### *Capital Adequacy*

Bank holding companies must maintain minimum levels of capital under the FRB's risk-based capital adequacy guidelines. If capital falls below minimum guideline levels, a bank holding company, among other things, may be denied approval to acquire or establish additional banks or non-bank businesses.

The FRB's risk-based capital adequacy guidelines, discussed in more detail below in the section entitled "Capital Standards," assign various risk percentages to different categories of assets and capital are measured as a percentage of risk assets. Under the terms of the guidelines, bank holding companies are expected to meet capital adequacy guidelines based both on total risk assets and on total assets, without regard to risk weights.

The risk-based guidelines are minimum requirements. Higher capital levels will be required if warranted by the particular circumstances or risk profiles of individual organizations. For example, the FRB's capital guidelines contemplate that additional capital may be required to take adequate account of, among other things, interest rate risk, or the risks posed by concentrations of credit, nontraditional activities or securities trading activities. Moreover, any banking organization experiencing or anticipating significant growth or expansion into new activities, particularly under the expanded powers under the Gramm-Leach-Bliley Act, would be expected to maintain capital ratios, including tangible capital positions, well above the minimum levels.

### *Limitations on Dividend Payments*

As applicable to the Holding Company, California Corporations Code Section 500 provides that neither the Holding Company nor any of its subsidiaries shall make a distribution to the Holding Company's shareholders unless the board of directors has determined in good faith that either:

- The amount of retained earnings of the Holding Company immediately prior to the distribution equals or exceeds the sum of (A) the amount of the proposed distribution plus (B) the preferential dividends arrear amount; or

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- Immediately after the distribution, the value of the Holding Company's assets would equal or exceed the sum of its total liabilities plus the preferential rights amount.

Additionally, the FRB's policy regarding dividends provides that a bank holding company should not pay cash dividends exceeding its net income or which can only be funded in ways that weaken the bank holding company's financial health, such as by borrowing. The FRB also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations.

### *Securities Registration and Listing*

Our common stock is registered with the SEC under the Exchange Act and, as a result, we are subject to the information, proxy solicitation, insider trading, corporate governance, and other disclosure requirements and restrictions of the Exchange Act, as well as the Securities Act, both administered by the SEC. We are required to file annual, quarterly and other current reports with the SEC. The SEC maintains an Internet site, <http://www.sec.gov>, at which our filings with the SEC may be accessed. Our SEC filings are also available on our website at <http://investors.unitedsecuritybank.com/Docs>.

Our common stock is listed on NASDAQ and trades under the symbol "UBFO." As a company listed on NASDAQ, we are subject to NASDAQ standards for listed companies. NASDAQ has also adopted corporate governance rules, which are intended to allow shareholders and investors to more easily and efficiently monitor the performance of companies and their directors.

### **The Bank**

As a California state-chartered bank and a member of the FRB, the Bank is subject to regulation, supervision and regular examination by the FRB, and the DBO. The Bank is subject to California laws insofar as they are not preempted by federal banking law. Deposits of the Bank are insured by the FDIC up to the applicable limits in an amount up to \$250,000 per customer and, as such, the Bank is subject to the applicable provisions of the FDIA and the regulations of the FDIC. As a consequence of the extensive regulation of commercial banking activities in California and the United States, the Bank's business is particularly susceptible to changes in California and federal legislation and regulation, which may have the effect of increasing the cost of doing business, limiting permissible activities or increasing competition.

Various other requirements and restrictions under the laws of the United States and the State of California affect the operations of the Bank. Federal and California statutes and regulations relate to many aspects of the Bank's operations, including capital requirements and disclosure requirements to depositors and borrowers, requirements to maintain reserves against deposits, limitations on interest rates payable on deposits, loans, investments, and restrictions on borrowings and on payment of dividends. The DBO regulates the number and location of branch offices of a state-chartered bank, and may permit a bank to maintain branches only to the extent allowable under state law for state banks. California law presently permits a bank to locate a branch in any locality in the state. Additionally, California law exempts banks from California usury laws.

### *Capital Standards*

In addition to the Dodd-Frank Act, the international oversight body of the Basel Committee on Banking Supervision, or Basel III, reached agreements that introduced a minimum common equity tier 1 capital requirement of 4.50 percent, along with a capital conservation buffer of 2.50 percent to bring total common equity capital requirements to 7.00 percent. The federal banking agencies issued final rules that implemented Basel III and certain other revisions to the Basel capital framework, as well as the minimum leverage and risk-based capital requirements of the Dodd Frank Act. Federal regulators periodically propose amendments to the risk-based capital guidelines and the related regulatory framework and consider changes to the capital standards that could significantly increase the amount of capital needed to meet applicable standards. The timing of adoption, ultimate form and effect of any such proposed amendments cannot be determined at this time.

The following are among the requirements that were phased in beginning January 1, 2015:

- An increase in the minimum Tier 1 capital ratio from 4.00% to 6.00% of risk-weighted assets;
- A new category and a required 4.50% of risk-weighted assets ratio is established for "common equity Tier 1" as a subset of Tier 1 capital limited to common equity;
- A minimum non-risk-based leverage ratio is set at 4.00% eliminating a 3.00% exception for higher rated banks;

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- Changes in the permitted composition of Tier 1 capital to exclude trust preferred securities, mortgage servicing rights and certain deferred tax assets and include unrealized gains and losses on available for sale debt and equity securities;
- An additional capital conservation buffer of 2.5% of risk-weighted assets over each of the required capital ratios will be phased in beginning January 2016 at 0.625% of risk-weighted assets until fully implemented in January 2019. This conservation buffer level must be met to avoid limitations on the ability to pay dividends, repurchase shares or pay discretionary bonuses;
- The risk weights of certain assets for purposes of calculating the risk-based capital ratios are changed for high volatility commercial real estate acquisition, development and construction loans, certain past due non-residential mortgage loans and certain mortgage-backed and other securities exposures; and
- An additional “countercyclical capital buffer” is required for larger and more complex institutions.

As of December 31, 2018, the Company and the Bank were “well-capitalized” under these capital standards. The regulatory capital guidelines as well as the actual capitalization for the Bank and the Company as of December 31, 2018 are set forth under the section entitled “MANAGEMENT’S DISCUSSION AND ANALYSIS OF OPERATIONS - Regulatory Matters - Capital Adequacy.”

### *Liquidity Requirements*

Historically, regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, both in the U.S. and internationally, without required formulaic measures. The Basel III framework requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward will be required by regulation. One test, referred to as the liquidity coverage ratio (“LCR”), is designed to ensure that the banking entity maintains an adequate level of unencumbered high-quality liquid assets equal to the entity’s expected net cash outflow for a 30-day time horizon (or, if greater, then 25% of its expected total cash outflow) under an acute liquidity stress scenario. The other test, referred to as the net stable funding ratio (“NSFR”), is designed to promote more medium- and long-term funding of the assets and activities of banking entities over a one-year time horizon. These requirements will incentivize banking entities to increase their holdings of U.S. Treasury securities and other sovereign debt as a component of assets and increase the use of long-term debt as a funding source.

In September 2014, the federal banking agencies approved final rules implementing the LCR for advanced approaches banking organizations (i.e., banking organizations with \$250 billion or more in total consolidated assets or \$10 billion or more in total on-balance sheet foreign exposure) and a modified version of the LCR for bank holding companies with at least \$50 billion in total consolidated assets that are not advanced approach banking organizations, neither of which apply to the Company or the Bank. On October 31, 2014, the Basel Committee on Banking Supervision issued its final standards for the NSFR, entitled “Basel III: The Net Stable Funding Ratio.” On May 3, 2016, the FRB issued a proposed requiring bank holding companies to maintain a minimum level of stable funding relative to the liquidity of their assets, derivatives, and commitments, over a one-year period and to publicly disclose information about their NSFR levels each quarter. However, this proposed rule would not apply to holding companies with less than \$50 billion in total consolidated assets and would not apply to community banks and, therefore, would not apply to the Company and the Bank.

### *Prompt Corrective Action*

The Federal Deposit Insurance Corporation Improvement Act (“FDICIA”) requires each federal banking agency to take prompt corrective action to resolve the problems of insured depository institutions, including but not limited to those that fall below one or more prescribed minimum capital ratios. Pursuant to FDICIA, the FRB promulgated regulations defining the following five categories in which an insured depository institution will be placed, based on the level of its capital ratios:

Under the regulations, a bank shall be deemed to be:

- “well capitalized” if it has a total risk-based capital ratio of 10% or more, has a Tier 1 risk-based capital ratio of 6% or more, has a leverage capital ratio of 5% or more and is not subject to specified requirements to meet and maintain a specific capital level for any capital measure;

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- “adequately capitalized” if it has a total risk-based capital ratio of 8% or more, a Tier 1 risk-based capital ratio of 4% or more and a leverage capital ratio of 4% or more (3% under certain circumstances) and does not meet the definition of “well capitalized”;
- “undercapitalized” if it has a total risk-based capital ratio that is less than 8%, a Tier 1 risk-based capital ratio that is less than 4%, or a leverage capital ratio that is less than 4% (3% under certain circumstances)
- “significantly undercapitalized” if it has a total risk-based capital ratio that is less than 6%, a Tier 1 risk-based capital ratio that is less than 3% or a leverage capital ratio that is less than 3%; and
- “critically undercapitalized” if it has a ratio of tangible equity to total assets that is equal to or less than 2%.

A bank’s category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank’s overall financial condition or prospects for other purposes.

While these benchmarks have not changed, due to market turbulence, the regulators have strongly encouraged and, in many instances, required, banks and bank holding companies to achieve and maintain higher ratios as a matter of safety and soundness.

Banks are prohibited from paying dividends or management fees to controlling persons or entities if, after making the payment, the bank would be “undercapitalized,” that is, the bank fails to meet the required minimum level for any relevant capital measure. Asset growth and branching restrictions apply to “undercapitalized” banks. Banks classified as “undercapitalized” are required to submit acceptable capital plans guaranteed by its holding company, if any. Broad regulatory authority was granted with respect to “significantly undercapitalized” banks, including forced mergers, growth restrictions, ordering new elections for directors, forcing divestiture by its holding company, if any, requiring management changes and prohibiting the payment of bonuses to senior management. Even more severe restrictions are applicable to “critically undercapitalized” banks. Restrictions for these banks include the appointment of a receiver or conservator. All of the federal banking agencies have promulgated substantially similar regulations to implement this system of prompt corrective action.

A bank, based upon its capital levels, that is classified as “well capitalized,” “adequately capitalized” or “undercapitalized” may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for a hearing, determines that an unsafe or unsound condition, or an unsafe or unsound practice, warrants such treatment. Further, a bank that otherwise meets the capital levels to be categorized as “well capitalized,” will be deemed to be “adequately capitalized,” if the bank is subject to a written agreement requiring that the bank maintain specific capital levels. At each successive lower capital category, an insured bank is subject to more restrictions. The federal banking agencies, however, may not treat an institution as “critically undercapitalized” unless its capital ratios actually warrant such treatment. In addition to measures taken under the prompt corrective action provisions, insured banks may be subject to potential enforcement actions by the federal banking agencies for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties. The enforcement of such actions through injunctions or restraining orders may be based upon a judicial determination that the agency would be harmed if such equitable relief was not granted.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations, such as the Bank, may be subject to potential enforcement actions by the federal or state banking agencies for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance for deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties. The enforcement of such actions through injunctions or restraining orders may be based upon a judicial determination that the agency would be harmed if such equitable relief was not granted.

### *Premiums for Deposit Insurance*

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The deposit insurance fund of the FDIC insures our customers' deposits up to prescribed limits for each depositor. In October 2010, the FDIC under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") adopted a new restoration plan to ensure that the deposit insurance fund (the "DIF") reserve ratio reaches 1.35% by September 30, 2020. At least semi-annually, the FDIC will update its loss and income projections for the DIF and, if needed, increase or decrease assessment rates. On February 7, 2011, the FDIC adopted a final rule modifying the risk-based assessment system from a domestic deposit base to a scorecard based assessment system, effective April 1, 2011. Effective as of April 1, 2011, the Bank was categorized as a small institution as the Bank has less than \$10 billion in assets. After potential adjustments related to unsecured debt and brokered deposit balances, the final total assessment rates range from 2.5 to 45 basis points. Initial base assessment rates for small institutions ranged from five to 35 basis points. Any material increase in assessments or the assessment rate could have a material adverse effect on our business, financial condition, results of operations or cash flows, depending on the amount of the increase. Furthermore, the FDIC is authorized to raise insurance premiums under certain circumstances.

The Federal Deposit Insurance Reform Act of 2005 (the "Reform Act") increased the deposit insurance limit for certain retirement plan deposit accounts from \$100,000 to \$250,000 and the Dodd-Frank Act permanently raised the current standard maximum federal deposit insurance amount from \$100,000 to \$250,000 per qualified account.

The FDIC is authorized to terminate a depository institution's deposit insurance upon a finding by the FDIC that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the institution's regulatory agency. The termination of deposit insurance would result in the forced closure of the Bank which would have a material adverse effect on the Company's business, financial condition and results of operations.

### *Federal Home Loan Bank System*

The Bank is a member of the Federal Home Loan Bank of San Francisco (the "FHLB-SF"). Among other benefits, each Federal Home Loan Bank ("FHLB") serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB. The FHLB-SF utilizes a single class of stock with a par value of \$100 per share, which may be issued, exchanged, redeemed and repurchased only at par value. As an FHLB member, the Bank is required to own FHLB –SF capital stock in an amount equal to the greater of:

- a membership stock requirement with an initial cap of \$25 million (100% of "membership asset value" as defined), or
- an activity based stock requirement (based on percentage of outstanding advances).

The FHLB – SF capital stock is redeemable on five years written notice, subject to certain conditions. At December 31, 2018 the Bank owned 28,228 shares of the FHLB-SF capital stock.

### *Federal Reserve Bank*

The FRB requires all depository institutions to maintain non-interest bearing reserves at specified levels against their transaction accounts and non-personal time deposits. At December 31, 2018, the Bank was in compliance with these requirements.

### *Consumer Regulation*

We are subject to a number of federal and state consumer protection laws that extensively govern our relationship with our customers. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act and these laws' respective state-law counterparts, as well as state usury laws and laws regarding unfair and deceptive acts and practices. Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual damages, restitution and attorneys' fees. Federal bank regulators, state attorneys general and state and local consumer protection agencies may also seek to enforce consumer protection requirements and obtain these and other remedies, including regulatory sanctions, customer rescission rights, action by the state and local attorneys general in each jurisdiction in which we operate, and civil money penalties. Failure to comply with consumer protection regulations may also result in our failure to obtain any required bank regulatory approval for merger or acquisition transactions we may wish to pursue or our prohibition from engaging in such transactions even if approval is not required.

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The CFPB has broad rulemaking, supervisory, and enforcement powers under various federal consumer financial protection laws. The CFPB is also authorized to engage in consumer financial education, track consumer complaints, request data, and promote the availability of financial services to underserved consumers and communities. The Bank is subject to direct oversight and examination by the CFPB. The CFPB has broad supervisory, examination, and enforcement authority over various consumer financial products and services, including the ability to require reimbursements and other payments to customers for alleged legal violations and to impose significant penalties, as well as injunctive relief that prohibits lenders from engaging in allegedly unlawful practices. The CFPB also has the authority to obtain cease and desist orders providing for affirmative relief or monetary penalties. State regulation of financial products and potential enforcement actions could also adversely affect our business, financial condition, or results of operations.

### *USA PATRIOT Act and Anti-Money Laundering*

The PATRIOT Act, designed to deny terrorists and others the ability to obtain access to the United States financial system, has significant implications for depository institutions, brokers, dealers and other businesses involved in the transfer of money. The PATRIOT Act, as implemented by various federal regulatory agencies, requires the Company and the Bank to establish and implement policies and procedures with respect to, among other matters, anti-money laundering, compliance, suspicious activity and currency transaction reporting and due diligence on customers and prospective customers. The PATRIOT Act and its underlying regulations permit information sharing for counter-terrorist purposes between federal law enforcement agencies and financial institutions, as well as among financial institutions, subject to certain conditions, and require the FRB, the FDIC and other federal banking agencies to evaluate the effectiveness of an applicant in combating money laundering activities when considering a bank holding company acquisition and/or a bank merger act application.

We regularly evaluate and continue to enhance our systems and procedures to continue to comply with the PATRIOT Act and other anti-money laundering initiatives. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal, strategic, and reputational consequences for the institution and result in material fines and sanctions.

### *Office of Foreign Assets Control Regulation*

The United States has imposed economic sanctions that affect transactions with designated foreign countries, designated nationals and others. These rules are based on their administration by OFAC. The OFAC-administered sanctions targeting designated countries take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on “U.S. persons” engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal, strategic, and reputational consequences, and result in civil money penalties on the Company and the Bank.

### *Community Reinvestment Act*

The CRA generally requires the Bank to identify the communities it serves and to make loans and investments, offer products, make donations in, and provide services designed to meet the credit needs of these communities. The CRA also requires the Bank to maintain comprehensive records of its CRA activities to demonstrate how we are meeting the credit needs of our communities. These documents are subject to periodic examination by the FDIC. During these examinations, the FDIC rates such institutions’ compliance with CRA as “Outstanding,” “Satisfactory,” “Needs to Improve” or “Substantial Noncompliance.” The CRA requires the FDIC to take into account the record of a bank in meeting the credit needs of all of the communities served, including low-and moderate-income neighborhoods, in determining such rating. Failure of an institution to receive at least a “Satisfactory” rating could inhibit such institution or its holding company from undertaking certain activities, including acquisitions. The Bank received a CRA rating of “Satisfactory” as of its most recent examination. In the case of a bank holding company, such as the Company, when applying to acquire a bank, savings association, or a bank holding company, the FRB will assess the CRA record of each depository institution of the applicant bank holding company in considering the application.

### *Customer Information Privacy and Cybersecurity*

The FRB and other bank regulatory agencies have adopted guidelines for safeguarding confidential, personal, non-public customer information. These guidelines require each financial institution, under the supervision and ongoing oversight of its



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board of directors or an appropriate committee thereof, to create, implement, and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazard to the security or integrity of such information, and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. We have adopted a customer information security program to comply with these requirements.

In March 2015, federal regulators issued two related statements regarding cybersecurity. One statement indicates that financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing Internet-based services of the financial institution. The other statement indicates that a financial institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack involving destructive malware. A financial institution is also expected to develop appropriate processes to enable recovery of data and business operations and address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyber-attack. If we fail to observe the regulatory guidance, we could be subject to various regulatory sanctions, including financial penalties. For a further discussion of risks related to cybersecurity, see "Item 1A. Risk Factors" included in this Form 10-K.

### *Privacy*

The GLBA and the California Financial Information Privacy Act require financial institutions to implement policies and procedures regarding the disclosure of non-public personal information about consumers to non-affiliated third parties. In general, the statutes require disclosures to consumers on policies and procedures regarding the disclosure of such non-public personal information and, except as otherwise required by law, prohibit disclosing such information except as provided in the Bank's policies and procedures. We have implemented privacy policies addressing these restrictions that are distributed regularly to all existing and new customers of the Bank.

### *Other Aspects of Banking Law*

The Bank is also subject to federal statutory and regulatory provisions covering, among other things, security procedures, management interlocks, funds availability and truth-in-savings. There are also a variety of federal statutes that regulate acquisitions of control and the formation of bank holding companies, and the activities beyond owning banks that are permissible.

### *Employees*

At December 31, 2018, the Company employed 125 persons on a full-time equivalent basis. The Company believes its employee relations are excellent.

### *Available Information*

The Company files period reports and other reports under the Securities and Exchange Act of 1934 with the Securities and Exchange Commission (SEC). These reports, as well as the Company's Code of Ethics, are posted and are available at no cost on the Company's website at <http://www.unitedsecuritybank.com> as soon as reasonably practical after the Company files such reports with the SEC. The Company's periodic and other reports filed with the SEC are also available at the SEC's website (<http://www.sec.gov>).

## **Item 1A - Risk Factors**

**An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes may affect our business are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this Annual Report. The risks and uncertainties described below are not the only ones facing our business. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may adversely impact our business operations. If any of the events described in the following risk factors occur, our business, results of operations and financial condition could be materially**

adversely affected. In addition, the trading price of our common stock could decline due to any of the events described in these risk factors.

### **Risks Relating to Our Bank and to the Business of Banking in General**

*Deterioration of economic conditions could adversely affect our business.*

We conduct banking operations principally in California's Central Valley. As a result, our financial condition, results of operations and cash flows are subject to changes in the economic conditions in California's 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 adverse economic conditions could have a material adverse effect upon us. In addition, the Central Valley remains largely dependent on agriculture. A downturn in agriculture and agricultural related business could indirectly and adversely affect our results of operations and financial condition.

We can provide no assurance that economic conditions in the United States in general and in the State of California and within our operating markets will not deteriorate or that such deterioration will not materially affect us. A deterioration in economic conditions locally, regionally or nationally could result in an economic downturn in the Central Valley with the following consequences, any of which could further adversely affect our business:

- Loan delinquencies and defaults may increase;
- Problem assets and foreclosures may increase;
- Demand for loans or other products and services offered by us may decline;
- Low cost or noninterest bearing deposits may decrease;
- Decline in the value of our loans or other assets secured by real estate could occur;
- Foreclosed assets may not be able to be sold;
- Decrease in our stock price;
- An impairment of goodwill or certain intangible assets; or
- An increase in operating expenses associated with attending to the effects of the above-listed circumstances.

*Our allowance for loan losses may not be adequate to cover actual losses.*

The risk of credit losses on loans and leases varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower, and, in the case of collateralized loans, the value and marketability of the collateral. We maintain an allowance for loan losses based upon, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, our management makes various assumptions and determinations about the ultimate collectability of the loan portfolio and provides an allowance for losses based upon a percentage of the outstanding balances and for specific loans where their collectability is considered to be questionable.

As of December 31, 2018, our allowance for loan losses was \$8,395,000, representing 1.43% of outstanding loans. While we believe that our allowance for loan losses is appropriate for the risk identified in our loans and lease portfolio, we cannot assure you that we will not further increase the allowance for loan losses, that it will be sufficient to address losses we actually incur, or that regulators will not require us to increase this allowance. Any of these occurrences could have a material adverse effect on our business, financial condition and results of operations. See "Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations" for more information.

*Our concentration of commercial real estate, construction and land development, and commercial and industrial loans exposes us to increased lending risks.*

Commercial real estate, construction and land development, and commercial and industrial loans, which comprised approximately 67% of our total loan portfolio as of December 31, 2018, expose us to a greater risk of loss than residential real estate and consumer loans, which were a smaller percentage of the total loan portfolio. Commercial real estate and land development loans typically involve relatively large balances to a borrower or a group of related borrowers, and an adverse development with respect to a larger commercial loan relationship would expose us to greater risk of loss than would an adverse development with respect to a smaller residential mortgage loan or consumer loan.

If any particular industry or market sector were to experience economic difficulties, the overall timing and amount of collections on our loans to clients operating in those industries may differ from what we expected, which could have a material adverse impact on our financial condition or results of operations.

*If we foreclose on collateral property, we may be subject to the increased costs associated with the ownership of real property, resulting in reduced revenues.*



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We may need to foreclose on collateral property to protect our investment and may thereafter own and operate such property, in which case we will be exposed to the risks inherent in the ownership of real estate. The amount that we, as a mortgagee, may realize after a default is dependent upon factors outside of our control, including, but not limited to: (i) general or local economic conditions; (ii) neighborhood values; (iii) interest rates; (iv) real estate tax rates; (v) operating expenses of the mortgaged properties; (vi) environmental remediation liabilities; (vii) ability to obtain and maintain adequate occupancy of the properties; (viii) zoning laws; (ix) governmental rules, regulations and fiscal policies; and (x) natural calamities. Certain expenditures associated with the ownership of real estate, principally real estate taxes, insurance, and maintenance costs, may adversely affect the income from the real estate, and as a result, we may be required to dispose of the real property at a loss. The foregoing expenditures and costs could adversely affect our ability to generate revenues, resulting in reduced levels of profitability.

*Our financial performance is subject to interest rate risk.*

Our operations are greatly influenced by general economic conditions and by related monetary and fiscal policies of the federal government. Deposit flows and funding costs are influenced by interest rates of competing investments and general market rates of interest. Lending activities are affected by the demand for loans, which in turn is affected by the interest rates at which such financing may be offered or by other factors affecting the availability of funds.

Our performance is substantially dependent on net interest income, which is the difference between the interest income received from interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities. To reduce our exposure to interest rate fluctuations, management seeks to manage the balances of interest sensitive assets and liabilities, and maintain appropriate maturity and repricing parameters for these assets and liabilities. A mismatch between the amount of rate sensitive assets and rate sensitive liabilities in any time period may expose us to interest rate risk. Generally, if rate sensitive assets exceed rate sensitive liabilities, the net interest margin will be positively impacted during a rising rate environment and negatively impacted during a declining rate environment. When rate sensitive liabilities exceed rate sensitive assets, the net interest margin will generally be positively impacted during a declining rate environment and negatively impacted during a rising rate environment. Increases in interest rates may reduce the overall level of loans we originate, and, thus, the amount of loan and commitment fees earned, as well as the market value of investment securities and other interest-earning assets. Moreover, fluctuations in interest rates may also result in disintermediation, which is the flow of funds away from depository institutions into direct investments, such as corporate securities and other investment vehicles which, because of the absence of federal deposit insurance, generally pay higher rates of return than depository institutions.

*We operate in a highly regulated environment and we may be adversely affected by new laws and regulations or changes in existing laws and regulations. Regulations may prevent or impair our ability to pay dividends, engage in acquisitions or operate in other ways.*

We are subject to extensive regulation, supervision and examination by federal and state banking authorities. Any change in applicable regulations or federal or state legislation could have a substantial impact on us and our operations. Additional legislation and regulations may be enacted or adopted in the future that could significantly affect our powers, authority and operations, which could have a material adverse effect on our financial condition and results of operations. Further, regulators have significant discretion and power to prevent or remedy unsafe or unsound practices or violations of laws by banks and bank holding companies in the performance of their supervisory and enforcement duties. The exercise of this regulatory discretion and power may have a negative impact on us.

*If we cannot attract deposits, our growth may be inhibited.*

Our ability to increase our assets depends in large part on our ability to attract additional deposits at favorable rates. We intend to seek additional deposits by offering deposit products that are competitive with those offered by other financial institutions in our markets and by establishing personal relationships with our customers. We provide no assurances that these efforts will be successful. Our inability to attract additional deposits at competitive rates could have a material adverse effect on our business, financial condition, results of operations and cash flows.

*Our ability to attract and retain qualified employees is critical to our success.*

Our employees are our most important resource, and in many areas of the financial services industry, competition for qualified personnel is intense. We endeavor to attract talented and diverse new employees and retain and motivate our existing employees to assist in executing our growth, acquisition, and business strategies. If for any reason we are unable to continue to attract or retain qualified employees, our performance, including our competitive position, could be materially and adversely affected.

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*Our controls over financial reporting and related governance procedures may fail or be circumvented. As a result, current and potential shareholders could lose confidence in our financial reporting, which would harm our business and the value of our common stock.*

Management regularly reviews and updates our internal control over financial reporting, disclosure controls and procedures, and corporate governance policies and procedures. We maintain controls and procedures to mitigate risks such as processing system failures or errors and customer or employee fraud, and we maintain insurance coverage for certain of these risks. Any system of controls and procedures, however well designed and operated, is based in part on certain assumptions and provides only reasonable, not absolute, assurances that the objectives of the system are met. Events could occur which are not prevented or detected by our internal controls, are not insured against, or are in excess of our insurance limits. Any failure or circumvention of our controls and procedures, or failure to comply with regulations related to controls and procedures, could have an adverse effect on our business.

*Our decisions regarding the fair value of assets acquired could be inaccurate which could materially and adversely affect our business, financial condition, result of operation, and future prospects.*

To comply with U.S. GAAP, our management must exercise judgment in selecting, determining, and applying accounting methods, assumptions, and estimates. Management makes various estimates and judgments about the collectability of acquired loans, including the creditworthiness of borrowers and the value of the real estate and other assets serving as collateral for the repayment of secured loans. If the actual performance of the acquired loans and/or the value of the collateral differs materially from management's estimates, any resulting losses or increased credit loss provisions could have a negative effect on our business, financial condition, or results of operations.

*Changes in accounting standards may affect our performance.*

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. The FASB and SEC continually change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can materially impact how we report and record our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in a retrospective adjustment to prior financial statements.

One such change is ASU 2016-13, which was released by the FASB in 2016 and which the Company is required to adopt no later than January 1, 2020. Currently, the impairment model used by financial institutions is based on incurred losses, and loans are recognized as impaired when there is no longer an assumption that future cash flows will be collected in full under the originally contracted terms. This model will be replaced by the current expected credit loss ("CECL") model, in which financial institutions will be required to use historical information, current conditions and reasonable forecasts to estimate the expected loss over the life of the loan. The transition to the CECL model will necessitate significantly greater data requirements and changes to methodologies to accurately account for expected losses over the life of a loan. There can be no assurance that we will not be required to increase our reserves and allowance for loan loss as a result of the implementation of CECL. Increased provisions for loan losses may adversely affect our results of operations and financial condition.

*We rely on communications, information, operating and financial control systems technology and we may suffer an interruption in or breach of the security of those systems.*

The financial services industry is experiencing rapid technological changes with frequent introductions of new technology-driven products and services. Effective use of technology increases efficiency and enables financial institutions to better serve customers and reduce costs. Many of our competitors have substantially greater resources to invest in technological improvements than we do. Our future success will depend, to some degree, on our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience, as well as create additional efficiencies in our operations. We may not be able to effectively implement new technology-driven products or service, or be successful in marketing such products and services. Additionally, the implementation of technological changes and upgrades to maintain current systems and integrate new ones may cause service interruptions, transaction processing errors and system conversion delays, and may cause us to fail to comply with applicable laws. Even with extraordinary care, due to the extensive work by computer hackers and others, we are also subject to potential data breaches that may result in revealing confidential information. There can be no assurance that we will be able to successfully manage the risks associated with increased dependency on technology.

*Our business is highly reliant on technology and our ability and our third party service providers to manage the operational risks associated with technology.*

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We depend, and will continue to depend to a significant extent, on in-house hosted software and on a number of relationships with third party technology service providers. Specifically, we utilize software and hardware systems for transaction processing, essential web hosting, debit card processing, merchant bankcard processing, internet banking systems and other processing services from third party service providers. If these third party service providers experience difficulties or terminate their services, and we are unable to replace them with other qualified service providers, or we experience turnover of key staff, our operations could be interrupted. If an interruption were to continue for a significant period of time, our business, financial condition and results of operations could be materially adversely affected.

*We rely on other companies to provide key components of our business infrastructure.*

We rely on certain third parties to provide products and services necessary to maintain day-to-day operations, such as data processing and storage, recording and monitoring transactions, on-line banking interfaces and services, Internet connections, telecommunications, and network access. Even though we have a vendor management program to help us carefully select and monitor the performance of third parties, we do not control their actions. The failure of a third-party to perform in accordance with the contracted arrangements under service level agreements as a result of changes in the third party's organizational structure, financial condition, support for existing products and services, strategic focus, system interruption or breaches, or for any other reason, could be disruptive to our operations, which could have a material adverse effect on our business, financial condition and results of operations.

*We are subject to liquidity risk, which could adversely affect our financial condition and results of operations.*

Effective liquidity management is essential for the operation of our business. Although we have implemented strategies to maintain sufficient and diverse sources of funding to accommodate planned, as well as unanticipated, changes in assets, liabilities, and off-balance sheet commitments under various economic conditions, an inability to raise funds through deposits, borrowings, the sale of investment securities and other sources could have a material adverse effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity due to a market disruption, a decrease in the borrowing capacity assigned to our pledged assets by our secured creditors, or adverse regulatory action against us. Deterioration in economic conditions and the loss of confidence in financial institutions may increase our cost of funding and limit our access to some of our customary sources of liquidity, including, but not limited to, inter-bank borrowings, repurchase agreements and borrowings from the discount window of the FRBSF. Our ability to acquire deposits or borrow could also be impaired by factors that are not specific to us, such as a severe disruption of the financial markets or negative views and expectations about the prospects for the financial services industry generally as a result of conditions faced by banking organizations in the domestic and international credit markets.

*We may be adversely affected by changes in the actual or perceived soundness or condition of other financial institutions.*

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial and financial soundness of other financial institutions. Financial institutions are closely related as a result of trading, investment, liquidity management, clearing, counterparty and other relationships. Loss of public confidence in any one institution, including through default, could lead to liquidity and credit problems, losses, or defaults for other institutions. Even the perceived lack of creditworthiness of, or questions about, a counterparty may lead to market-wide liquidity and credit problems, losses, or defaults by various institutions. This systemic risk may adversely affect financial intermediaries, such as clearing agencies, banks and exchanges we interact with on a daily basis or key funding providers such as the Federal Home Loan Banks, any of which could have a material adverse effect on our access to liquidity or otherwise have a material adverse effect on our business, financial condition, or results of operations.

## **Risks Relating to Dividends and our Common Stock**

*Our future ability to pay dividends is subject to restrictions.*

As a holding company with no significant assets other than the Bank, we depend on dividends from the Bank to fund our operating expense, payments of interest on our junior subordinated debentures, and estimated tax payments. Our ability to continue to pay dividends depends in large part upon our receipt of dividends or other capital distributions from the Bank. The ability of the Bank to pay dividends or make other capital distributions to us is subject to the restrictions in the California Financial Code. In addition, it is possible, depending upon the financial condition of the Bank and other factors, that the FRB, the FDIC and/or the DBO could assert that payment of dividends or other payments is an unsafe or unsound practice. The amount that the Bank may pay in dividends is further restricted due to the fact that the Bank must maintain a certain minimum amount of capital to be considered a "well capitalized" institution as well as a separate capital conservation buffer, as further

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described under “Item 7 - Management's Discussion and Analysis of Operations - Regulatory Matters- Dividends” in this report.

In the event the Bank is unable to pay dividends to the Holding Company, it is likely that we, in turn, would have to discontinue capital distributions in the form of dividends or share repurchases and may have difficulty meeting our other financial obligations, including payments in respect of any outstanding indebtedness or subordinated debentures. The inability of the Bank to pay dividends to the Holding Company could have a material adverse effect on our business, including the market price of our common stock.

Our Holding Company expenses and obligations with respect to our trust preferred securities and corresponding junior subordinated deferrable interest debentures issued by us may also limit or impair our ability to declare or pay dividends.

As of December 31, 2018, the Bank paid approximately \$6,947,000 in dividends to our Holding Company. No assurances can be given that our future performance will justify the payment of dividends in any particular year.

Our holding company expenses and obligations with respect to our trust preferred securities and corresponding junior subordinated deferrable interest debentures issued by us may limit or impair our ability to declare or pay dividends. No assurance can be given that our future performance will justify the payment of dividends in any particular year. Finally, our ability to pay dividends is also subject to the restrictions of the California Corporations Code.

*We may issue additional common stock or other equity securities in the future which could dilute the ownership interest of existing shareholders.*

In order to maintain our capital at desired or regulatory-required levels, or to fund future growth, our board of directors may decide from time to time to issue additional shares of common stock, or securities convertible into, exchangeable for, or representing rights to acquire shares of our common stock. The sale of these shares may significantly dilute your ownership interest as a shareholder. New investors in the future may also have rights, preferences and privileges senior to our current shareholders which may adversely impact our current shareholders

*Holders of our junior subordinated debentures have rights that are senior to those of our common shareholders.*

On July 25, 2007 we issued \$15,464,000 of floating rate junior subordinated debentures in connection with a \$15,000,000 trust preferred securities issuance by its subsidiary, United Security Bancshares Capital Trust II. At December 31, 2017, the contractual principal balance of our debentures relating to its trust preferred securities is \$12,000,000. The junior subordinated debentures mature in July 2037.

We conditionally guarantee payments of the principal and interest on the trust preferred securities. Our junior subordinated debentures are senior to holders of common stock. As a result, we must make payments on the junior subordinated debentures (and the related trust preferred securities) before any dividends can be paid on our common stock and, in the event of bankruptcy, dissolution or liquidation, the holders of the debentures must be satisfied before any distributions can be made to the holders of common stock.

### **Item 1B. - Unresolved Staff Comments**

The Company had no unresolved staff comments at December 31, 2018.

### **Item 2 - Properties**

The Bank's main bank branch is located at 2151 West Shaw Avenue, Fresno, California. The Company owns the building and leases the land under a sublease dated December 1, 1986, between Central Bank and USB. The current sublessor under the master ground lease is Bank of the West, which acquired the position through the purchase of Central Bank. The lessor under the ground lease (Master Lease) is Thomas F. Hinds. The lease was renewed on January 1, 2016 set to expire December 31, 2020. The Company has options to extend the term for three (3) additional periods of five (5) years under the same terms and conditions.

The Company leases the banking premises of approximately 6,450 square feet for its second of three Fresno branches at 7088 N. First St, Fresno, California., under a lease which commenced August 2005 and renewed July 2015 for a term of 10 years expiring July 2025. The facility provides space for the branch as well as the Real Estate Construction Department and the Indirect Consumer Lending Department. The branch was previously located at 1041 E. Shaw Avenue, Fresno, California, under a lease extension expiring February 28, 2005.

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The Company leases the Oakhurst bank branch located at the Old Mill Village Shopping Center, 40074 Highway 49, Oakhurst, California. The branch facility consists of approximately 5,000 square feet. The original lease agreement was signed April 1999 for 15 years with two 5-year options to extend the lease. In April 2014, the Company exercised the first option which will be ending in April 2019.

The Company owns the Caruthers bank branch located at 13356 South Henderson, Caruthers, California, which consists of approximately 5,000 square feet of floor space.

The Company owns the San Joaquin bank branch facility located at 21574 Manning Avenue, San Joaquin, California. The bank branch is approximately 2,500 square feet.

The Company owns the Firebaugh bank branch located at 1067 O Street, Firebaugh, California. The premises are comprised of approximately 4,666 square feet of office space situated on land totaling approximately one-third of an acre.

The Company owns the Coalinga bank branch located at 145 East Durian, Coalinga, California. The office building has a total of 6,184 square feet of interior floor space situated on approximately 0.45 acres of land.

The Company leases the Convention Center bank branch located at 855 "M" Street, Suite 130, Fresno, California. Total space leased is approximately 4,520 square feet, and was occupied during March 2004. The fifteen-year lease expires in March 2019. There are no extension provisions.

The Company owns the Taft bank branch office premises located at 523 Cascade Place, Taft, California. The branch facility consist of approximately 9,200 square feet of office space.

The Company owns the Bakersfield bank branch facility located at 3404 Coffee Road, Bakersfield, California, which has approximately 6,130 square feet of office space located on 1.15 acres.

The Company leases the Campbell bank branch located at 1875 S. Bascom Ave., Suite 19, Campbell, California, which has approximately 2,984 square feet. The lease commenced on January 1, 2011 and expires on December 31, 2020.

The Company owns its administrative headquarters at 2126 Inyo Street, Fresno, California and is occupied by the Company's administrative staff. The facility consists of approximately 21,400 square feet. A portion of the premises has been subleased to a third-party under a lease term which expires in March 2020 with a 5-year option for renewal.

The Company also has nine remote ATM or ITM locations leased from unrelated parties.

### **Item 3 - Legal Proceedings**

From time to time, the Company is party to claims and legal proceedings arising in the ordinary course of business. At this time, the management of the Company is not aware of any material pending litigation proceedings to which it is a party or has recently been party to, which will have a material adverse effect on the financial condition or results of operations of the Company.

### **Item 4 – Mine Safety Disclosures**

Not applicable

**PART II****Item 5 - Market for the Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities****Trading History**

Our common stock trades on The Nasdaq Global Select Market and is traded under the symbol UBFO. At December 31, 2018, there were approximately 597 record holders of our common stock. This does not reflect the number of persons or entities who hold their stock in nominee or street name through various brokerage firms.

The following table sets forth the high and low closing sales prices by quarter for our common stock, for the years ended December 31, 2018 and 2017.

| Quarter          | Closing Prices |          | Volume    |
|------------------|----------------|----------|-----------|
|                  | High           | Low      |           |
| 4th Quarter 2018 | \$ 11.18       | \$ 9.41  | 877,712   |
| 3rd Quarter 2018 | \$ 11.50       | \$ 10.65 | 753,907   |
| 2nd Quarter 2018 | \$ 11.45       | \$ 10.70 | 745,092   |
| 1st Quarter 2018 | \$ 10.75       | \$ 10.15 | 1,134,156 |
| 4th Quarter 2017 | \$ 11.10       | \$ 9.20  | 1,339,681 |
| 3rd Quarter 2017 | \$ 9.85        | \$ 8.75  | 1,134,983 |
| 2nd Quarter 2017 | \$ 9.85        | \$ 7.05  | 2,668,596 |
| 1st Quarter 2017 | \$ 8.12        | \$ 7.13  | 541,529   |

**Dividends**

The Company's shareholders are entitled to dividends when and as declared by our Board of Directors out of funds legally available therefore. Dividends paid to our shareholders are subject to restrictions set forth in the California General Corporation Law, which provides that a California corporation may make a distribution, including paying dividends on its capital stock, from retained earnings to the extent that the retained earnings exceed (a) the amount of the proposed distribution plus (b) the amount, if any, of dividends in arrears on shares with preferential dividend rights. Alternatively, a California corporation may make a distribution, if, immediately after the distribution, the value of its assets equals or exceeds the sum of (a) its total liabilities plus (b) the liquidation preference of any shares which have a preference upon dissolution over the rights of shareholders receiving the distribution. As a bank holding company without significant assets other than its equity position in the Bank, our ability to pay dividends to our shareholders depends primarily upon dividends we receive from the Bank. Such dividends paid by the Bank to our Holding Company are subject to certain limitations. See "Management's Discussion and Analysis of Financial and Results of Operations - Regulatory Matters."

We declared and paid a \$0.07 cash dividend to our shareholders on January 4, 2018, a \$0.09 cash dividend to our shareholders on April 9, 2018 and July 9, 2018, and a \$0.10 cash dividend to our shareholders on October 9, 2018. We declared and issued a 1% stock dividend to our shareholders on April 7, 2017, and declared and paid a \$0.05 cash dividend to shareholders on May 8, 2017 and July 7, 2017, and a \$0.07 cash dividend to shareholders on October 10, 2017.

The amount and payment of dividends to our shareholders are set by our Board of Directors with numerous factors being taken into consideration including but not limited to our earnings, financial condition and the need for capital for expanded growth and general economic conditions. No assurance can be given that cash or stock dividends will be paid in the future.

**Securities Authorized for Issuance under Equity Compensation Plans**

The following table sets forth securities authorized for issuance under equity compensation plans as of December 31, 2018.

| Plan Category  | Number of securities to be issued upon exercise of outstanding options, warrants and rights (column a) | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|--|--|---|---|
| Equity compensation plans approved by security holders     | 94,601   | (1) \$ 7.87   | 532,265   |
| Equity compensation plans not approved by security holders | N/A  | N/A   | N/A   |
| Total  | 94,601   | \$ 7.87   | 532,265   |

(1) Under the United Security Bancshares 2015 Equity Incentive Award Plan (the "2015 Plan"), we are authorized to issue restricted stock awards. Restricted stock awards are not included in the total in column (a). At December 31, 2018, there were 59,217 shares of restricted stock issued and outstanding.

A complete description of the above plans is included in Note 11 of our Financial Statements, in Item 8 of this Report, and is hereby incorporated by reference.

***Recent Sales of Unregistered Securities and Use of Proceeds***

None.

***Purchases of Equity Securities by Affiliates and Associated Purchasers***

On April 25, 2017, the Company's Board of Directors approved the repurchase of up to \$3 million of the outstanding common stock of the Company. The duration of the program is open-ended and the timing of purchases will depend on market conditions. We did not repurchase any common shares under the stock repurchase plan during the years ended December 31, 2018 and 2017.

**Item 6 - Selected Consolidated Financial Data**

The following table sets forth our selected historical consolidated financial information for each of the years in the five-year period ended December 31, 2018. The selected financial data should be read in conjunction with our "Management's Discussion and Analysis of Financial Condition and Results of Operations," our audited consolidated financial statements as of December 31, 2018 and 2017, and the related Notes to Consolidated Financial Statements contained in "Item 8. Financial Statements and Supplementary Data."



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|   | For the Year Ended December 31, |           |           |           |           |  |
|---|---------------------------------|-----------|-----------|-----------|-----------|--|
| <i>(in thousands except per share data and ratios)</i>                        | 2018                            | 2017      | 2016      | 2015      | 2014      |  |
| <b>Summary of Year-to-Date Earnings:</b>                                      |                                 |           |           |           |           |  |
| Interest income and loan fees   | \$ 36,615                       | \$ 32,930 | \$ 29,473 | \$ 27,410 | \$ 24,962 |  |
| Interest expense  | 2,703                           | 1,730     | 1,409     | 1,281     | 1,345     |  |
| Net interest income   | 33,912                          | 31,200    | 28,064    | 26,129    | 23,617    |  |
| (Recovery of provision) provision for credit losses                           | (1,764)                         | 24        | (21)      | (41)      | (845)     |  |
| Net interest income after (recovery of provision) provision for credit losses | 35,676                          | 31,176    | 28,085    | 26,170    | 24,462    |  |
| Noninterest income  | 4,605                           | 4,306     | 4,514     | 4,735     | 5,161     |  |
| Noninterest expense   | 20,932                          | 19,803    | 20,345    | 19,598    | 19,215    |  |
| Income before taxes on income   | 19,349                          | 15,679    | 12,254    | 11,307    | 10,408    |  |
| Taxes on income   | 5,332                           | 7,039     | 4,869     | 4,497     | 4,192     |  |
| Net income  | \$ 14,017                       | \$ 8,640  | \$ 7,385  | \$ 6,810  | \$ 6,216  |  |

**Per Share Data:**

|                                      |            |            |            |            |            |  |
|--------------------------------------|------------|------------|------------|------------|------------|--|
| Net income- Basic                    | \$ 0.83    | \$ 0.51    | \$ 0.44    | \$ 0.40    | \$ 0.37    |  |
| Net income - Diluted                 | \$ 0.83    | \$ 0.51    | \$ 0.44    | \$ 0.40    | \$ 0.37    |  |
| Average shares outstanding - Basic   | 16,899,960 | 16,885,587 | 16,881,379 | 16,880,563 | 16,686,896 |  |
| Average shares outstanding - Diluted | 16,938,772 | 16,904,915 | 16,889,027 | 16,882,787 | 16,692,646 |  |
| Book value per share                 | \$ 6.45    | \$ 6.00    | \$ 5.79    | \$ 5.58    | \$ 5.37    |  |

**Financial Position at Period-end:**

|                            |            |            |            |            |            |  |
|----------------------------|------------|------------|------------|------------|------------|--|
| Total assets               | \$ 933,058 | \$ 805,836 | \$ 787,972 | \$ 725,644 | \$ 663,169 |  |
| Total net loans and leases | 579,419    | 593,123    | 561,931    | 505,663    | 446,824    |  |
| Total deposits             | 805,643    | 687,693    | 676,629    | 621,805    | 565,373    |  |
| Total shareholders' equity | 109,240    | 101,353    | 96,654     | 89,635     | 82,826     |  |

**Selected Financial Ratios:**

|   |         |         |        |        |         |  |
|---|---------|---------|--------|--------|---------|--|
| Return on average assets  | 1.61 %  | 1.07 %  | 0.98%  | 0.98%  | 0.93 %  |  |
| Return on average equity  | 13.23 % | 8.63 %  | 7.86%  | 7.88%  | 7.8 %   |  |
| Average equity to average assets  | 12.14 % | 12.46 % | 12.43% | 12.41% | 11.88 % |  |
| Net interest margin (1)   | 4.28 %  | 4.27 %  | 4.11%  | 4.22%  | 4.01 %  |  |
| Allowance for credit losses as a percentage of total nonperforming assets | 38.81 % | 52.62 % | 47.15% | 30.26% | 36.41 % |  |
| Net (recoveries) charge-offs to average loans                             | (0.20)% | (0.06)% | 0.14%  | 0.2%   | (0.14)% |  |
| Allowance of credit losses as a percentage of period-end loans            | 1.43 %  | 1.54 %  | 1.56%  | 1.88%  | 2.35 %  |  |
| Dividend payout ratio   | 33.76 % | 33.22 % | —%     | —%     | —%      |  |
| 1. Fully taxable equivalent   |         |         |        |        |         |  |



## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Overview**

#### ***The Company***

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

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

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

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

The residential real estate markets in the five county region from Merced to Kern has strengthened since 2013 and that trend has continued into the fourth quarter of 2018. The severe declines in residential construction and home prices that began in 2008 have ended and home prices are now rising on a year-over-year basis. The sustained period of double-digit price declines from 2008–2011 adversely impacted our operations and increased the levels of nonperforming assets, increased expenses related to foreclosed properties, and decreased profit margins. As we continue our business development and expansion efforts throughout our market areas, we will also maintain our commitment to the reduction of nonperforming assets and provision of options for borrowers experiencing difficulties. Those options include combinations of rate and term concessions, as well as forbearance agreements with borrowers. Median sales prices and housing start numbers improved in the five county region from Merced to Kern beginning in 2013.

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

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

#### **Application of Critical Accounting Policies and Estimates**

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at

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fair value inherently may result in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When third-party information is not available, valuation adjustments are estimated using our own assumptions in regard to the assumptions that market participants would use in pricing the asset or liability.

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

### *Allowance for Credit Losses*

The allowance for credit losses represents management's estimate of probable incurred credit losses inherent in the loan portfolio. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheet. Note 1 to the consolidated financial statements describes the methodology used to determine the allowance for credit losses. A discussion of the factors driving changes in the amount of the allowance for credit losses is included in the Asset Quality and Allowance for Credit Losses section of this financial review.

### *Other Real Estate Owned*

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

### *Impairment of Investment Securities*

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

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

### *Revenue Recognition*

Our primary sources of revenue are interest income from loans and investment securities. Interest income is generally recorded on an accrual basis, unless the collection of such income is not reasonably assured or cannot be reasonably estimated. Pursuant to accounting standards related to revenue recognition, nonrefundable fees and costs associated with originating or acquiring loans are recognized as a yield adjustment to the related loans by amortizing them into income over the term of the loan using a method which approximates the interest method. Other credit-related fees, such as standby letter of credit fees, loan placement fees and annual credit card fees are recognized as noninterest income during the period the related service is performed.

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

### *Fair Value*

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

### *Income Taxes*

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

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

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

### **Results of Operations**

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

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

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

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

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

**Net Interest Income**

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

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

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

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

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

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|                     |              |              |              |
|---------------------|--------------|--------------|--------------|
| Net interest margin | <u>4.28%</u> | <u>4.27%</u> | <u>4.11%</u> |
|---------------------|--------------|--------------|--------------|

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

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

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

Table 2. Rate and Volume Analysis

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

The net interest margin rose slightly in 2018 due to increase in loan portfolio yields, yields of overnight investments with the Federal Reserve Bank, and investment securities yields. We seek to mitigate the low interest rate environment with loan floors included in new and renewed loans when practical. Loans yielded 5.57% during the year ended December 31, 2018, as compared to 5.42% and 5.21% for the years ended December 31, 2017 and 2016, respectively. For the year ended December 31, 2018, total interest income increased approximately \$3,685,000, or 11.19%, as compared to the year ended December 31, 2017, reflective of an increase of \$1,566,000 in loan interest income. Average interest-earning assets increased approximately \$62,827,000 between 2018 and 2017 and the rate on interest-earning assets increased 11 basis points during the two periods. The increase in average earning assets between 2018 and 2017 consisted of increases of \$49,004,000 in interest-bearing deposits held at the Federal Reserve Bank, increases of \$12,142,000 in loans, and increases of \$2,325,000 in investment securities. Average interest-earning assets increased approximately \$48,155,000 between 2017 and 2016 and the rate on interest-earning assets increased 19 basis points during the two periods. The average rates on loans increased 21 basis points between the two periods, and the average rate on investment securities increased approximately 6 basis points during the year ended December 31, 2017, as compared to the same period of 2016. The rate on interest-earning assets increased during the year ended December 31, 2017 due to increases in loans, overnight deposit yields, and investment securities.

For the year ended December 31, 2018, total interest expense increased approximately \$973,000, or 56.24%, as compared to the year ended December 31, 2017. Between those two periods, average interest-bearing liabilities increased by \$52,169,000, and the average rates paid on these liabilities increased by 17 basis points. CDARs reciprocal deposits, which are preferred by some depositors, have increased from \$12.1 million to \$19.5 million.

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

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

**Provision for Credit Losses**

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

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

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

**Noninterest Income**

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

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



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

Noninterest income for the year ended December 31, 2018 increased \$299,000, or 6.94%, when compared to the same period of 2017. Customer service fees, the primary component of noninterest income, decreased \$307,000, or 7.97%, between the two periods presented. The decrease was due primarily to the closing of the Financial Services department. The increase in noninterest income of \$299,000 between the two periods is the result of a decrease in the loss on the fair value of junior subordinated debentures of \$424,000 during 2018 as compared to a loss of \$882,000 during 2017. The change in the fair value of junior subordinated debentures was primarily caused by fluctuations in the LIBOR yield curve. The cost of our subordinated debentures issued by USB Capital Trust II has increased in concert with market rates over the last three or four years. With pricing at 3-month-LIBOR plus 129 basis points, the effective cost of the subordinated debt was 3.73% and 3.20% at December 31, 2018 and 2017, respectively.

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

**Noninterest Expense**

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

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

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

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

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

### *Income Taxes*

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

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

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

### **Financial Condition**

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

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

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

### *Loans*

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

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

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

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

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

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

At December 31, 2018, approximately 55.3% of commercial and industrial loans have floating rates and, although some may be secured by real estate, many are secured by accounts receivable, inventory, and other business assets. Real estate mortgage loans decreased \$17,093,000 during 2018 due to paydowns on purchased residential mortgage loans. Real estate construction loans decreased \$14,175,000, or 11.5%, during 2018, and \$7,717,000, or 5.9%, during 2017. Construction loans are generally short-term, floating-rate obligations, which consist of both residential and commercial projects. Agricultural loans, which primarily consist of short-term, floating rate loans for crop financing, increased \$1,668,000, or 2.8%, between December 31, 2017 and December 31, 2018. Commercial loans, consisting primarily of loans for non real estate business operations, increased \$9,952,000, or 21.16%.

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

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Included within the installment loan portfolio are \$68,221,000 in student loans as of December 31, 2018, as compared to \$59,853,000 at December 31, 2017, an increase of \$8,368,000. The student loan portfolio consists of unsecured loans to medical and pharmacy students currently enrolled in medical and pharmacy schools in the US and the Caribbean. The medical student loans are made to US citizens attending medical schools in the US and Antigua, while the pharmacy student loans are made to pharmacy students attending pharmacy school in the US. Upon graduation the loan is automatically placed on deferment for 6 months. This may be extended up to 48 months for graduates enrolling in Internship, Medical Residency or Fellowship. As approved the student may receive additional deferment for hardship or administrative reasons in the form of forbearance for a maximum of 24 months throughout the life of the loan. The outstanding balance of student loans that have not entered repayment status totaled \$52,695,000 at December 31, 2018. Accrued interest on loans that have not entered repayment status totaled \$5,612,000 at December 31, 2018. At December 31, 2018, there were 595 loans within repayment, deferment, and forbearance which represented \$15,526,000, \$1,945,000, and \$7,336,000 in outstanding balances respectively. Repayment of the unsecured student loans is premised on the medical and pharmacy students graduating and becoming high wage earners. Underwriting is premised on qualifying credit scores. The weighted average credit score for the portfolio is in the mid-700s. In addition, there are non-student co-borrowers for roughly one-third of the portfolio that provide additional repayment capacity. Graduation and employment placement rates are high for both medical and pharmacy students. The average student loan balance per borrower as of December 31, 2018 was approximately \$90,000. Loan interest rates range from 4.875% to 9.875%. At December 31, 2018, \$15,526,000 in loans were in repayment compared to \$6,473,000 as of December 31, 2017. Accrued interest on student loans was \$5,984,000 and \$4,261,000 as of December 31, 2018 and 2017, respectively. As of December 31, 2017 the student loan portfolio was insured through a surety bond issued by ReliaMax Surety Company which provided us a reasonable expectation of collection. As such the allowance calculated for the portfolio was included within the calculation of our general reserves. In June 2018, ReliaMax Surety Company was declared insolvent by the South Dakota Division of Insurance and is now in liquidation. As a result of the insolvency, we assessed the risks within the student loan portfolio and determined that along with the calculation of the general reserve of \$880,000 an additional allowance of \$640,000 was appropriate for a total reserve against the student loan portfolio of \$1,520,000 as of December 31, 2018. At December 31, 2017 the reserve against the student loan portfolio was \$772,000. Additionally, as of December 31, 2018, \$26,000 in accrued interest receivable was reversed, due to charge-offs of \$388,000. There were no TDR's within the portfolio as of December 31, 2018 or 2017.

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

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

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

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.

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

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

Forbearance - The period of time during which the borrower may postpone making principal and interest payments, which may be granted for either hardship or administrative reasons. Interest will continue to accrue on loans during periods of authorized forbearance. If the borrower is delinquent at the time the forbearance is granted, the delinquency will be covered by the forbearance and all accrued and unpaid interest from the date of delinquency or if none, from the date of beginning of the forbearance period, will be capitalized at the end of each forbearance period. The term of the loan will not change and payments may be increased to allow the loan to pay off in the required time frame. A forbearance that results in only a delay in payment considered insignificant, is not a concessionary change in terms provided the borrower affirms the obligation. Forbearance is not an uncommon status designation, this designation is standard industry practice, and is consistent with the succession of students migrating to employed medical professionals.

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

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

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

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

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

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

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

**Securities**

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

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

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

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

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

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

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



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securities. The ASU requires marketable equity securities to be reported at fair value with changes recorded through earnings. As of January 1, 2018, unrealized losses of \$184,000 were reversed from accumulated other comprehensive income to retained earnings.

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

**Deposits**

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

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

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

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

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

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

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

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

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

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

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

### **Short-term Borrowings**

We have the ability to obtain borrowed funds consisting of federal funds purchased, discount window borrowings, securities sold under agreements to repurchase ("repurchase agreements") and Federal Home Loan Bank ("FHLB") advances as alternatives to retail deposit funds. We have established collateralized and uncollateralized lines of credit with several correspondent banks, the FRB discount window, as well as a securities dealer, for the purpose of obtaining borrowed funds as needed. We may continue to borrow funds in the future as part of our asset/liability strategy, and may use these funds to acquire certain other assets as deemed appropriate by our management for investment purposes and to better utilize the capital resources of the Bank. Federal funds purchased represent temporary overnight borrowings from correspondent banks and are generally unsecured. Repurchase agreements are collateralized by mortgage backed securities and securities of U.S. Government agencies, and generally have maturities of one to six months, but may have longer maturities if deemed appropriate as part of our asset/liability management strategy. FHLB advances are collateralized by our investment in FHLB stock, securities, and certain qualifying mortgage loans. In addition, we have the ability to obtain borrowings from the Federal Reserve Bank of San Francisco ("FRB"), collateralized by certain pledged loans in our loan portfolio. The lines of credit are subject to periodic review of the Company's financial statements by the grantors of the credit lines. Lines of credit may be modified or revoked at any time if the grantors feel there are adverse trends in our financial position.

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

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

Lending money is our principal business activity, and ensuring appropriate evaluation, diversification, and control of credit risks is a primary management responsibility. Losses are implicit in lending activities and the amount of such losses will vary,



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depending on the risk characteristics of the loan portfolio as affected by local economic conditions and the financial experience of borrowers.

The allowance for credit losses is maintained at a level deemed appropriate by our management to provide for known and inherent risks in existing loans and commitments to extend credit. The adequacy of the allowance for credit losses is based upon management's continuing assessment of various factors affecting the collectability of loans and commitments to extend credit; including current economic conditions, past credit experience, collateral, and concentrations of credit. There is no precise method of predicting specific losses or amounts which may ultimately be charged off on particular segments of the loan portfolio. The conclusion that a loan may become uncollectible, either in part or in whole is judgmental and subject to economic, environmental, and other conditions which cannot be predicted with certainty. When determining the adequacy of the allowance for credit losses, we follow in accordance with GAAP, the guidelines set forth in the Revised Interagency Policy Statement on the Allowance for Loan and Lease Losses ("Statement") issued by banking regulators in December 2006. The Statement is a revision of the previous guidance released in July 2001, and outlines characteristics that should be used in segmentation of the loan portfolio for purposes of the analysis including risk classification, past due status, type of loan, industry or collateral. It also outlines factors to consider when adjusting the loss factors for various segments of the loan portfolio, and updates previous guidance that describes the responsibilities of the board of directors, management, and bank examiners regarding the allowance for credit losses. Securities and Exchange Commission Staff Accounting Bulletin No. 102 was released during July 2001, and represents the SEC staff's view relating to methodologies and supporting documentation for the Allowance for Loan and Lease Losses that should be observed by all public companies in complying with the federal securities laws and the Commission's interpretations. It is also generally consistent with the guidance published by the banking regulators.

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

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

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

(1) Consumer Loans

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

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

The formula allowance is calculated by applying loss factors to outstanding loans and certain unfunded loan commitments. Loss factors are based on our historical loss experience and on the internal risk grade of those loans and, may be adjusted for

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significant factors that, in management's judgment, affect the collectability of the portfolio as of the evaluation date. Factors that may affect collectability of the loan portfolio include:

- Levels of, and trends in delinquencies and nonaccrual loans;
- Trends in volumes and term of loans;
- Effects of any changes in lending policies and procedures including those for underwriting, collection, charge-off, and recovery;
- Experience, ability, and depth of lending management and staff;
- National and local economic trends and conditions; and
- Concentrations of credit that might affect loss experience across one or more components of the portfolio, including high-balance loan concentrations and participations.

Management determines the loss factors for problem graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates loan losses over the previous quarters as determined by management (time horizons adjusted as business cycles or environment changes) and loss factors are adjusted to recognize and quantify the loss exposure from changes in market conditions and trends in our loan portfolio. For purposes of this analysis, loans are grouped by internal risk classifications and categorized as pass, special mention, substandard, doubtful, or loss. Certain loans are homogeneous in nature and are therefore pooled by risk grade. These homogeneous loans include consumer installment and home equity loans. Special mention loans are currently performing but are potentially weak, as the borrower has begun to exhibit deteriorating trends which, if not corrected, could jeopardize repayment of the loan and result in further downgrades. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as doubtful has critical weaknesses that make full collection of the obligation improbable. Classified loans include impaired loans and loans categorized as substandard, doubtful, and loss, which are not considered impaired. At December 31, 2018, impaired and classified loans totaled \$18,717,000, or 3.18%, of gross loans as compared to \$27,311,000, or 4.54%, of gross loans at December 31, 2017.

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

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

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

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

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

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

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

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

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

Our methodology attempts to accurately estimate losses. The specific allowance portion of the analysis is designed to be self-correcting by taking into account the current loan loss experience based on that portion of the portfolio. By analyzing the estimated losses inherent in the loan portfolio on a quarterly basis, management is able to adjust specific and inherent loss

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estimates using the most recent information available. In performing the periodic migration analysis, management believes that historical loss factors used in the computation of the formula allowance need to be adjusted to reflect current changes in market conditions and trends in our loan portfolio. There are a number of other factors which are reviewed when determining adjustments in the historical loss factors. Those factors include 1) trends in delinquent and nonaccrual loans, 2) trends in loan volume and terms, 3) effects of changes in lending policies, 4) concentrations of credit, 5) competition, 6) national and local economic trends and conditions, 7) experience of lending staff, 8) loan review and Board of Directors oversight, 9) high balance loan concentrations, and 10) other business conditions.

The general reserve requirements (ASC 450-70) decreased with the continued strengthening of local, state, and national economies and their impact on our local lending base, which has resulted in a lower qualitative component for the general reserve calculation. Our stake-in-the-ground methodology requires the Company to use December 31, 2005 as the starting point of the look back period to capture loss history and better capture an entire economic cycle. Time horizons are subject to Management's assessment of the current period, taking into consideration changes in business cycles and environment changes.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

For a restructured loan to return to accrual status there needs to be at least 6 months successful payment history. In addition, the Company's Credit Administration performs a financial analysis of the credit to determine whether the borrower has the ability to continue to perform successfully over the remaining life of the loan. This includes, but is not limited to, a review of financial statements and a cash flow analysis of the borrower. Only after determining that the borrower has the ability to perform under the terms of the loans will the restructured credit be considered for accrual status.

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

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

The Company focuses on competition and other economic conditions within its market area and other geographical areas in which it does business, which may ultimately affect the risk assessment of the portfolio. The Company continues to experience increased competition from major banks, local independents and non-bank institutions which creates pressure on loan pricing. The Company continues to place increased emphasis on reducing both the level of nonperforming assets and the level of losses on the disposition of these assets. It is in the best interest of both the Company and the borrowers to seek alternative options to foreclosure in an effort to reduce the impacts on the real estate market. As part of this strategy, the Company has increased its level of troubled debt restructurings, when it improves collection prospects. While business and consumer spending show improvement, it is difficult to forecast what impact Federal Reserve rate increases will have on the economy. Local unemployment rates in the San Joaquin Valley have improved, but remain elevated compared with other regions and historically are higher as a result of the area's agricultural dynamics. The Company believes that the Central San Joaquin Valley will continue to grow and diversify as property and housing costs remain low relative to other areas of the state. Management recognizes increased risk of loss due to the Company's exposure to local and worldwide economic conditions, as well as potentially volatile real estate markets, and takes these factors into consideration when analyzing the adequacy of the allowance for credit losses.

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

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

Loan charge-offs increased \$391,000 during the year ended December 31, 2018, when compared to the year ended December 31, 2017. Loan recoveries increased \$942,000 during the same period. There were student loan charge-offs totaling \$388,000 during the fourth quarter and an addition to the overdraft reserve of \$1,000.

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

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

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



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

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

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

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

During 2017, reserve allocations as a percentage of loans decreased for commercial and industrial, real estate mortgage, real estate construction and development, and installment loans. These decreases are a result of a combination of factors including decreases in charge-offs, classified and past due loans, and credit quality improvements. Increases in reserve allocation for agricultural loans was primarily due to the growth of the loan segment, adjusted by the change in the qualitative factors related to the nature and volume of the portfolio.

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

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

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

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

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

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

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

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

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

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

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

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

Non-performing assets decreased \$2,646,000 between December 31, 2017 and December 31, 2016, due to decreases of \$1,968,000 in nonaccrual loans and \$726,000 in other real estate owned, offset by an increase of \$938,000 in accruing restructured loans.

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

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

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

Nonperforming assets, which are primarily related to the real estate loans and other real estate owned portfolio, increased \$4,019,000 from a balance of \$17,610,000 at December 31, 2017 to a balance of \$21,629,000 at December 31, 2018. Nonaccrual loans totaling \$12,052,000 at December 31, 2018, increased \$6,756,000 from the balance of \$5,296,000 reported at December 31, 2017. In determining the adequacy of the underlying collateral related to these loans, management monitors trends within specific geographical areas, loan-to-value ratios, appraisals, and other credit issues related to the specific loans. Impaired loans increased \$3,893,000 during the year ended December 31, 2018 to a balance of \$18,683,000 at December 31, 2018 due primarily to the addition of two large-balance loans secured by real estate, offset by decreases in impaired TDRs. Other real estate owned remained at the same balance at December 31, 2017 and December 31, 2018. As a result of these events, nonperforming assets as a percentage of total assets increased from 2.19% at December 31, 2017 to 2.32% at December 31, 2018.

While real estate markets have strengthened over the last few years, management continues to monitor economic conditions in the real estate market for signs of either deterioration or improvement which may impact the level of the allowance for loan losses required to cover identified losses in the loan portfolio. Management continues to monitor and reduce the level of problem assets by working with borrowers to identify options, including loan restructures, in order to work through difficulties a borrower might face. Restructured loans numbers have been greatly reduced over the last four years. Net loan recoveries during the year ended December 31, 2018 totaled \$892,000, as compared to net loan recoveries of \$341,000 for the year ended December 31, 2017. We charged-off approximately 9 loans during the year ended December 31, 2018, compared to 6 loans during the year ended December 31, 2017. Net loan recoveries totaling \$892,000 during the year ended December 31, 2018, included \$38,000 in net recoveries during the quarter ended March 31, 2018, \$445,000 in net recoveries during the quarter ended June 30, 2018, \$746,000 in net recoveries during the quarter ended September 30, 2018, and \$337,000 in net charge-offs during the fourth quarter of 2018. The percentage of net recoveries to average loans was 0.15%, for the year ended December 31, 2018.

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

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

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

Loans past due more than 30 days are receiving increased management attention and are monitored for increased risk. As of December 31, 2018 and 2017 past due loans more than 30 days totaled \$9,515,000 and \$1,445,000, respectively. We continue to move past due loans to nonaccrual status in its ongoing effort to recognize loan problems at an earlier point in time when

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they may be dealt with more effectively. As impaired loans, nonaccrual and restructured loans are reviewed for specific reserve allocations and the allowance for credit losses is adjusted accordingly.

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

### **Liquidity and Asset/Liability Management**

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

#### ***Liquidity***

Liquidity management may be described as the ability to maintain sufficient cash flows to fulfill both on- and off-balance sheet financial obligations, including loan funding commitments and customer deposit withdrawals, without straining the Company's equity structure. To maintain an adequate liquidity position, the Company relies on, in addition to cash and cash equivalents, cash inflows from deposits and short-term borrowings, repayments of principal on loans and investments, and interest income received. The Company's principal cash outflows are for loan origination, purchases of investment securities, depositor withdrawals and payment of operating expenses. Other sources of liquidity not on the balance sheet at December 31, 2018, include unused collateralized and uncollateralized lines of credit from other banks, the Federal Home Loan Bank, Pacific Coast Banker's Bank, Zion's Bank, Union Bank, and from the Federal Reserve Bank totaling \$331,565,000.

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

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

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

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

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

Liquidity risk arises from the possibility the Company may not be able to satisfy current or future financial commitments, or the Company may become unduly reliant on alternative funding sources. The Company maintains a liquidity risk management policy to address and manage this risk. The policy identifies the primary sources of liquidity, sets wholesale funding limits, establishes procedures for monitoring and measuring liquidity, and establishes minimum liquidity requirements, which comply with regulatory guidance. The liquidity position is continually monitored and reported on a monthly basis to the Board of Directors.

The policy also includes a contingency funding plan to address liquidity needs in the event of an institution-specific or a systemic financial market crisis. In addition to unused lines of credit from other banks totaling \$331,565,000, the contingency plan includes identified funding sources, and steps that may be taken in the event the total liquidity ratio falls or is projected to fall below policy limits for any extended period of time. One of the primary directives of the contingency funding plan is to limit the Company's overall level of wholesale funding to no more than 40% of deposits. The current funding program uses

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both asset-based and liability-based principles, and identifies core deposits as the favored funding source when attainable at a reasonable cost. The policy identifies a number of funding sources or methods the Bank ALCO committee may utilize to fulfill the Company's liquidity funding requirements:

- 1) Local core deposits are the Company's primary funding source. The Company works to attract these deposits through service-related and competitive pricing tactics. Other liquidity funding sources are considered if local core deposits are not attractive because of maturity or pricing.
- 2) Unsecured Federal Funds lines with correspondent banks may be used to fund short-term peaks in loan demand or deposit run-off. Currently, unsecured borrowing lines with correspondents are limited and may not be reliable for long periods of time or in times of economic stress.
- 3) Other funding sources such as secured credit lines with the Federal Home Loan Bank or the Federal Reserve may be used for longer periods. The Company collateralized these available lines with a combination of investment securities and pledged loans. The Company has utilized specific loan pledging with both the FHLB and the Federal Reserve to better ensure the continued availability of those lines of credit.
- 4) The Company presently has a Discount Window facility available from the Federal Reserve Bank of San Francisco collateralized with loans as discussed above. At December 31, 2018, the Company had available credit of \$287,446,000 from the Federal Reserve based upon the loans pledged at that date. The Federal Reserve will monitor use of the Discount Window closely given the current status of the Company and the economy as a whole. This credit facility may not be competitively priced under certain economic conditions. As such, the Company does not expect to use this facility except for short periods, but does consider this to be a key contingency funding source.
- 5) As long as the Bank remains "Well Capitalized," the Company may rely on brokered deposits when core deposit rates are higher in the marketplace or maturity structures are not desirable. The Company's current policy limit for brokered deposits is 25% of total deposits. The Company may also utilize other wholesale deposit sources such as memberships that advertise the Bank's time deposit rates to other subscribers, typically banks and credit unions. The Company's current policy limit on other wholesale deposits is 10% of total deposits.
- 6) The Bank may sell whole loans or participations in loans to provide additional liquidity. During economic downturns or other crises events, these funding sources may be difficult to achieve in a short period of time or at a reasonable price. As such, this strategy is better used as a long-term asset/liability management tool to effectively balance assets and liabilities to reduce liquidity risk.
- 7) The Company currently has Bank-Owned Life Insurance (BOLI) and Corporate-Owned Life Insurance (COLI) policies issued by highly rated insurance companies which may be sold to increase liquidity.
- 8) The Company owns certain real estate including its administration building and several of its branches. These may be sold and vacated or leased back from the purchaser after sale to provide additional liquidity if needed. The sales process may require substantial time to complete, and may have an adverse impact on earnings depending on market rates and other factors at the time of sale.
- 9) Investments near maturity may be sold to meet temporary funding needs but may need to be replaced to maintain liquidity ratios within acceptable limits. At the current time approximately half of the investment portfolio is pledged to secure public deposits and borrowing lines. The Company seeks to maintain an investment-grade securities portfolio to ensure quality collateral for pledging against borrowing lines of credit as well as to provide liquidity in times of needs.

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

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

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borrowing lines totaled \$421,393,000 at December 31, 2018. For further discussion of the Company's borrowing lines, see "Short Term Borrowings" included previously in the financial condition section of this financial review.

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

**Regulatory Matters****Capital Adequacy**

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

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

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

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

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

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



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

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

### ***Dividends***

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

During the year ended December 31, 2018, the Holding Company paid \$4,732,000 in cash dividends to our shareholders and the Bank paid cash dividends of \$6,947,000 to the Holding Company in order to fund the Holding Company's operating costs, payments of interest on our junior subordinated debentures, estimated tax payments, redemption of junior subordinated debentures, and cash dividends paid to shareholders. During 2015, \$3.0 million of the Company's \$15.0 million in junior subordinated debt was retired. The balance of junior subordinated debentures remained at \$12.0 million for the years ended December 31, 2018 and December 31, 2017.

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

### ***Reserve Balances***

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

## **Item 8 - Financial Statements and Supplementary Data**

### **Index to Consolidated Financial Statements:**

Management's Report on Internal Control over Financial Reporting

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets - December 31, 2018 and 2017

Consolidated Statements of Income -  
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Years Ended December 31, 2018, 2017, and 2016

Consolidated Statements of Comprehensive Income -  
Years Ended December 31, 2018, 2017, and 2016

Consolidated Statements of Cash Flows -  
Years Ended December 31, 2018, 2017, and 2016

Notes to Consolidated Financial Statements

## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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

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

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

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

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

## **Report of Independent Registered Public Accounting Firm**

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

### ***Opinions on the Financial Statements and Internal Control over Financial Reporting***

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

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

### ***Basis for Opinions***

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

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

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

### ***Definition and Limitations of Internal Control Over Financial Reporting***

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

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

/s/ Moss Adams LLP

Sacramento, California

March 1, 2019

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

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**United Security Bancshares and Subsidiaries**  
**Consolidated Balance Sheets**  
**December 31, 2018 and 2017**

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

See accompanying notes to consolidated financial statements

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**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Income**  
**Years Ended December 31, 2018, 2017, and 2016**

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

See accompanying notes to consolidated financial statements



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**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Comprehensive Income**  
**Years Ended December 31, 2018, 2017, and 2016**

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

See accompanying notes to consolidated financial statements

**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**Years Ended December 31, 2018, 2017, and 2016**

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

See accompanying notes to consolidated financial statements

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**United Security Bancshares and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**Years Ended December 31, 2018, 2017, and 2016**

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

|   |                   |                   |                   |
|---|-------------------|-------------------|-------------------|
| <b>Cash and cash equivalents at beginning of year</b> | 107,934           | 113,032           | 125,751           |
| <b>Cash and cash equivalents at end of year</b>       | <u>\$ 220,337</u> | <u>\$ 107,934</u> | <u>\$ 113,032</u> |

See accompanying notes to consolidated statements

## Notes to Consolidated Financial Statements

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

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

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

During July 2007 the Company formed USB Capital Trust II and issued \$15.0 million in Trust Preferred Securities with terms similar to those originally issued under USB Capital Trust I. During 2015, the Bank purchased \$3.0 million of the Company's junior subordinated debentures related to the Company's trust preferred securities at a fair value discount of 40%. Subsequently, the Company purchased those shares from the Bank and canceled \$3.0 million in par value of the junior subordinated debentures, realizing a \$78,000 gain on redemption. The contractual principal balance of the Company's debentures relating to its trust preferred securities is \$12.0 million as of December 31, 2018. (See Note 8. “Junior Subordinated Debt/Trust Preferred Securities”).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The allowance for credit losses is increased by provisions charged to operations during the current period and reduced by negative provisions and loan charge-offs, net of recoveries. Loans are charged against the allowance when management believes that the collection of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing loans, based on evaluations of the probability of collection. In evaluating the probability of collection, management is required to make estimates and assumptions that affect the reported amounts of loans, allowance for credit losses and the provision for credit losses charged to operations. Actual results could differ significantly from those estimates. These evaluations take into consideration such factors as the composition of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrowers' ability to pay.

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

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

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

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in impaired loans. For impaired loans, specific allowances are determined based on the collateralized value of the underlying properties, the net present value of the anticipated cash flows, or the market value of the underlying assets.

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

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

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

|           |          |                         |           |
|-----------|----------|-------------------------|-----------|
| Buildings | 31 years | Furniture and equipment | 3-7 Years |
|-----------|----------|-------------------------|-----------|



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

Goodwill amounts resulting from the acquisitions of Taft National Bank during April 2004, and Legacy Bank during February 2007 are considered to have an indefinite life and are not amortized. At December 31, 2018, goodwill related to Taft National Bank totaled \$1.6 million, and goodwill related to Legacy Bank totaled \$2.9 million. Impairment testing of goodwill is performed at the reporting level during December of each year for Taft, and during March of each year for Legacy. During 2018 and 2017, the Company did not recognize impairment adjustments on the goodwill related to the Legacy or Taft Bank acquisitions.

- h. *Income Taxes* - Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities using the liability method, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. For the use in estimates the enacted tax rate of the period is utilized.
- i. *Net Income per Share* - Basic income per common share is computed based on the weighted average number of common shares outstanding. Diluted income per share includes the effect of stock options and other potentially dilutive securities using the treasury stock method to the extent they have a dilutive impact. Net income per share has been retroactively adjusted for all stock dividends declared. The number of potentially dilutive common shares included in quarterly diluted income per share is computed using the average market prices during the three months included in the reporting period under the treasury stock method. The number of potentially dilutive common shares included in year-to-date diluted income per share is a year-to-date weighted average of potentially dilutive common shares included in each quarterly diluted net income per share computation.
- j. *Cash Flow Reporting* - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing amounts due from banks, federal funds sold and securities purchased under agreements to resell. Federal funds and securities purchased under agreements to resell are generally sold for one-day periods. Net cash flows are reported for interest-bearing deposits with other banks, loans to customers, and deposits held for customers.
- k. *Transfers of Financial Assets* - Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.
- l. *Advertising Costs* - The Company expenses marketing costs as they are incurred. Advertising expense was \$85,000, \$154,000, and \$126,000 for the years ended December 31, 2018, 2017, and 2016, respectively.
- m. *Stock Based Compensation* - The Company has a stock-based employee compensation plan, which is described more fully in Note 11. The Company accounts for all share-based payments to employees, including grants of employee stock options and restricted stock units and awards, to be recognized in the financial statements based on the grant date fair value of the award. The fair value is amortized over the requisite service period (generally the vesting period). Included in salaries and employee benefits for the years ended December 31, 2018, 2017, and 2016 are \$744,000, \$97,000, and \$30,000, respectively, of share-based compensation. The related tax benefit, recorded in the provision for income taxes, was not significant. All share data contained within the financial statements has been retroactively restated for stock based transactions (i.e. stock splits and stock dividends.)
- n. *Federal Home Loan Bank stock and Federal Reserve Stock* - As a member of the Federal Home Loan Bank (FHLB), the Company is required to maintain an investment in capital stock of the FHLB. In addition, as a member of the Federal Reserve Bank (FRB), the Company is required to maintain an investment in capital stock of the FRB. The investments in both the FHLB and the FRB are carried at cost, which approximates their fair value, in the accompanying consolidated balance sheets under other assets and are subject to certain redemption requirements by the FHLB and FRB. Stock redemptions are at the discretion of the FHLB and FRB.

While technically these are considered equity securities, there is no market for the FHLB or FRB stock. Therefore, the shares are considered as restricted investment securities. Management periodically evaluates the stock for other-than-temporary impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB or FRB as compared to the capital stock amount of the FHLB or FRB and the length of time this situation has persisted, (2) commitments by the FHLB or FRB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB or FRB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB or FRB, and (4) the liquidity position of the FHLB or FRB.

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

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

- r. *New Accounting Standards:*

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). The guidance affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements of financial instruments. ASU 2016-01 was effective for the Company on January 1, 2018 and resulted in separate classification of equity securities previously included in available for sale securities on the consolidated balance sheets with changes in the fair value of the equity securities captured in the consolidated statements of income. See Note 2 – Investment Securities for disclosures related to equity securities. Adoption of the standard also resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 14 – Fair Value Disclosures for further information regarding the valuation of these loans. Additionally, adoption of the standard resulted in separately recognizing the instrument-specific credit risk associated with the Company's Junior Subordinated Debt. See Note 9 - Junior Subordinated Debt / Trust Preferred Securities for additional information.

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842). The FASB is issuing this Update to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the FASB

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Accounting Standards Codification® and creating Topic 842, Leases. This Update, along with IFRS 16, Leases, are the results of the FASB's and the International Accounting Standards Board's (IASB's) efforts to meet that objective and improve financial reporting. This ASU will be effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. The Company estimates the impact of this standard will be recognize as of January 1, 2019 a new \$3,388,000 lease right of use asset, and a new \$3,479,000 lease liability, which will be offset by a \$91,000 accrued rent asset. The Company does not expect any other significant impact from this ASU.

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

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

In January 2017, FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350). The FASB is issuing this Update to eliminate the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge. Instead, entities will record an impairment charge based on the excess of a reporting unit's carrying amount over its fair value. This ASU will be effective for public business entities for annual periods beginning after December 15, 2019 (i.e. calendar periods beginning on January 1, 2020, and interim periods therein. The Company does not expect any impact on the Company's consolidated financial statements resulting from the adoption of this Update.

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

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

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

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

**2. Investment Securities**

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

(In thousands)

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

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

The amortized cost and fair value of securities available for sale at December 31, 2018, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns. Mutual funds are included in the "due in one year or less" category below.

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

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

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

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

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

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

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

The Company evaluates investment securities for other-than-temporary impairment (“OTTI”) at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities of high credit quality are generally evaluated for OTTI under ASC Topic 320-10, “Investments – Debt and Equity Instruments.” Certain purchased beneficial interests, including non-agency mortgage-backed securities, asset-backed securities, and collateralized debt obligations, are evaluated under ASC Topic 325-40, “Beneficial Interest in Securitized Financial Assets.”

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

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

Other-than-temporary-impairment occurs when the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis, the other-than-temporary-impairment shall be recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, the other-than-temporary-impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary-impairment related to the credit loss is recognized in earnings, and is determined based on the difference between

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the present value of cash flows expected to be collected and the current amortized cost of the security. The amount of the total other-than-temporary-impairment related to other factors shall be recognized in other comprehensive (loss) income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary-impairment recognized in earnings shall become the new amortized cost basis of the investment.

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

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

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

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

### 3. Loans

*Loans are comprised of the following:*

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

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

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



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

- Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and commercial properties, including: office buildings, shopping centers; apartments and motels; owner occupied buildings; manufacturing facilities and more. Commercial real estate mortgage loans can also be used to refinance existing debt. Although real estate associated with the business is the primary collateral for commercial real estate mortgage loans, the underlying real estate is not the source of repayment. Commercial real estate loans are made under the premise that the loan will be repaid from the borrower's business operations, rental income associated with the real property, or personal assets.
- Residential mortgage loans are provided to individuals to finance or refinance single-family residences. Residential mortgages are not a primary business line offered by the Company, and a majority are conventional mortgages that were purchased as a pool. Most residential mortgages originated by the Company are of a shorter term than conventional mortgages, with maturities ranging from three to fifteen years on average.
- Home Improvement and Home Equity loans comprise a relatively small portion of total real estate mortgage loans, and are offered to borrowers for the purpose of home improvements, although the proceeds may be used for other purposes. Home equity loans are generally secured by junior trust deeds, but may be secured by 1<sup>st</sup> trust deeds.

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

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

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

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At December 31, 2018 and 2017, these financial instruments include commitments to extend credit of \$144,643,000 and \$99,958,000, respectively, and standby letters of credit of \$1,183,000 and \$2,058,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

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

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Substantially all of these commitments are at floating interest rates based on the Prime rate. Commitments generally have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties.

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

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



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

Past Due Loans

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

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

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

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

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

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Nonaccrual Loans

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

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

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

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

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

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

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

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

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

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

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

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

[Impaired Loans](#)

A loan is considered impaired when based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement.

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

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

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

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

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

The method for recognizing interest income on impaired loans is dependent on whether the loan is on nonaccrual status or is a troubled debt restructure. For income recognition, the existing nonaccrual and troubled debt restructuring policies are applied to impaired loans. Generally, except for certain troubled debt restructurings which are performing under the restructure agreement, the Company does not recognize interest income received on impaired loans, but reduces the carrying amount of the loan for financial reporting purposes.

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

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

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

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

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

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

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

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

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

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

Troubled Debt Restructurings

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

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

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

- A transfer from the borrower to the Company of receivables from third parties, real estate, other assets, or an equity interest in the borrower is granted to fully or partially satisfy the loan.
- A modification of terms of a debt such as one or a combination of:
  - The reduction (absolute or contingent) of the stated interest rate.

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- The extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
- The reduction (absolute or contingent) of the face amount or maturity amount of debt as stated in the instrument or agreement.
- The reduction (absolute or contingent) of accrued interest.

For a restructured loan to return to accrual status there needs to be, among other factors, at least 6 months successful payment history. In addition, the Company performs a financial analysis of the credit to determine whether the borrower has the ability to continue to meet payments over the remaining life of the loan. This includes, but is not limited to, a review of financial statements and cash flow analysis of the borrower. Only after determination that the borrower has the ability to perform under the terms of the loans, will the restructured credit be considered for accrual status. Although the Company does not have a policy which specifically addresses when a loan may be removed from TDR classification, as a matter of practice, loans classified as TDRs generally remain classified as such until the loan either reaches maturity or its outstanding balance is paid off.

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

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



Year ended December 31, 2017

|  | Number of<br>Contracts | Pre-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Post-<br>Modification<br>Outstanding<br>Recorded<br>Investment | Number of<br>Contracts in<br>Default | Recorded<br>Investment on<br>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                | 2                      | 404   | 404  | —                                    | —   |
| Home improvement and home equity loans         | —                      | —   | —  | —                                    | —   |
| Real estate construction and development loans | 1                      | 790   | 790  | 1                                    | 288   |
| Agricultural loans                             | 3                      | 2,112   | 2,112  | —                                    | —   |
| Installment and student loans                  | —                      | —   | —  | —                                    | —   |
| Overdraft protection lines                     | —                      | —   | —  | —                                    | —   |
| <b>Total loans</b>                             | <b>8</b>               | <b>\$ 3,553</b>   | <b>\$ 3,553</b>  | <b>1</b>                             | <b>\$ 288</b>                               |

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

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

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

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

Credit Quality Indicators

As part of its credit monitoring program, the Company utilizes a risk rating system which quantifies the risk the Company estimates it has assumed during the life of a loan. The system rates the strength of the borrower and the facility or transaction, and is designed to provide a program for risk management and early detection of problems.

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

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

*Facility Rating:*

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

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

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

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

*Borrower Rating:*

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

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

The Company assigns risk ratings to loans other than consumer loans and other homogeneous loan pools based on the following scale. The risk ratings are used when determining borrower ratings as well as facility ratings. When the borrower rating and the facility ratings differ, the lowest rating applied is:

- *Grades 1 and 2* – These grades include loans which are given to high quality borrowers with high credit quality and sound financial strength. Key financial ratios are generally above industry averages and the borrower’s strong earnings history or net worth. These may be secured by deposit accounts or high-grade investment securities.
- *Grade 3* – This grade includes loans to borrowers with solid credit quality with minimal risk. The borrower’s balance sheet and financial ratios are generally in line with industry averages, and the borrower has historically demonstrated the ability to manage economic adversity. Real estate and asset-based loans assigned this risk rating must have characteristics, which place them well above the minimum underwriting requirements for those departments. Asset-based borrowers assigned this rating must exhibit extremely favorable leverage and cash flow characteristics, and consistently demonstrate a high level of unused borrowing capacity.
- *Grades 4 and 5* – These include “pass” grade loans to borrowers of acceptable credit quality and risk. The borrower’s balance sheet and financial ratios may be below industry averages, but above the lowest industry quartile. Leverage is above and liquidity is below industry averages. Inadequacies evident in financial performance and/or management sufficiency are offset by readily available features of support, such as adequate collateral, or good guarantors having the liquid assets and/or cash flow capacity to repay the debt. The borrower may have recognized a loss over three or four years, however recent earnings trends, while perhaps somewhat cyclical, are improving and cash flows are adequate to cover debt service and fixed obligations. Real estate and asset-borrowers fully comply with all underwriting standards and are performing according to projections would be assigned this rating. These also include grade 5 loans which are “leveraged” or on management’s “watch list.” While still considered pass loans (loans given a grade 5), the borrower’s financial condition, cash flow or operations evidence more than average risk and short term weaknesses, these loans warrant a higher than average level of monitoring, supervision and attention from the Company, but do not reflect credit weakness trends that weaken or inadequately protect the Company’s credit position. Loans with a grade rating of 5 are not normally acceptable as new credits unless they are adequately secured or carry substantial endorser/guarantors.
- *Grade 6* – This grade includes “special mention” loans which are loans that are currently protected but are potentially weak. This generally is an interim grade classification and should usually be upgraded to an Acceptable rating or downgraded to Substandard within a reasonable time period. Weaknesses in special mention loans may, if not checked or corrected, weaken the asset or inadequately protect the Company’s credit position at some future date. Special mention loans are often loans with weaknesses inherent from the loan origination, loan servicing, and perhaps some technical deficiencies. The main theme in special mention credits is the distinct probability that the classification will deteriorate to a more adverse class if the noted deficiencies are not addressed by the loan officer or loan management.
- *Grade 7* – This grade includes “substandard” loans which are inadequately supported by the current sound net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well-defined weakness or weaknesses that may impair the regular liquidation of the debt. Substandard loans exhibit a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Substandard loans also include impaired loans.
- *Grade 8* - This grade includes “doubtful” loans which exhibit the same characteristics as the Substandard loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing

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facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include a proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.

- *Grade 9* - This grade includes loans classified “loss” which are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off the asset even though partial recovery may be achieved in the future.

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

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

| <b>December 31, 2017</b><br><i>(In thousands)</i> | <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 December 31, 2018 and 2017 (in thousands).

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

Allowance for Loan Losses

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

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

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

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

Residential mortgages – This segment is considered to have low risk factors both from the Company and peer statistics. These loans are secured by first deeds of trust. The losses experienced over the past sixteen quarters are isolated to approximately six loans and are generally the result of short sales.

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

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

Agricultural loans – This segment is considered to have risks associated with weather, insects, and marketing issues. In addition, concentrations in certain crops or certain agricultural areas can increase risk. Additionally, from time to time, California experiences severe droughts, which could significantly harm the business of our customers and the credit quality of the loans to those customers. We closely monitor the water resources and the related issues affecting our customers, and will remain vigilant for signs of deterioration within the loan portfolio in an effort to manage credit quality and work with borrowers where possible to mitigate any losses.

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

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

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**December 31, 2018**

|   | <b>Commercial<br/>and Industrial</b> | <b>Real Estate<br/>Mortgage</b> | <b>Real Estate<br/>Construction<br/>Development</b> | <b>Agricultural</b> | <b>Installment &amp;<br/>Student Loans</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 | (739)                                | (149)                           | (479)   | (500)               | 766  | (663)              | (1,764)      |
| Charge-offs   | (98)                                 | (47)                            | —   | —                   | (409)                                      | —                  | (554)        |
| Recoveries  | 1,102                                | 29                              | —   | —                   | 315  | —                  | 1,446        |
| Net recoveries (charge-offs)                        | 1,004                                | (18)                            | —   | —                   | (94)                                       | —                  | 892          |
| Ending balance                                      | \$ 1,673                             | \$ 1,015                        | \$ 2,424  | \$ 1,131            | \$ 1,559                                   | \$ 593             | \$ 8,395     |
| Period-end amount allocated to:                     |                                      |                                 |   |                     |  |                    |              |
| Loans individually evaluated for impairment         | 787                                  | 469                             | —   | 520                 | —  | —                  | 1,776        |
| Loans collectively evaluated for impairment         | 886                                  | 546                             | 2,424   | 611                 | 1,559                                      | 593                | 6,619        |
| Ending balance                                      | \$ 1,673                             | \$ 1,015                        | \$ 2,424  | \$ 1,131            | \$ 1,559                                   | \$ 593             | \$ 8,395     |

**December 31, 2017**

|   | <b>Commercial<br/>and Industrial</b> | <b>Real Estate<br/>Mortgage</b> | <b>Real Estate<br/>Construction<br/>and<br/>Development</b> | <b>Agricultural</b> | <b>Installment</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 | (493)                                | (320)                           | (475)   | 944                 | (191)              | 559                | 24           |
| Charge-offs   | (122)                                | (23)                            | —   | —                   | (18)               | —                  | (163)        |
| Recoveries  | 180                                  | 95                              | —   | 21                  | 208                | —                  | 504          |
| Net recoveries (charge-offs)                        | 58                                   | 72                              | —   | 21                  | 190                | —                  | 341          |
| Ending balance                                      | \$ 1,408                             | \$ 1,182                        | \$ 2,903  | \$ 1,631            | \$ 887             | \$ 1,256           | \$ 9,267     |
| Period-end amount allocated to:                     |                                      |                                 |   |                     |                    |                    |              |
| Loans individually evaluated for impairment         | 534                                  | 488                             | —   | 866                 | —                  | —                  | 1,888        |
| Loans collectively evaluated for impairment         | 874                                  | 694                             | 2,903   | 765                 | 887                | 1,256              | 7,379        |
| Ending balance                                      | \$ 1,408                             | \$ 1,182                        | \$ 2,903  | \$ 1,631            | \$ 887             | \$ 1,256           | \$ 9,267     |

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

December 31, 2018

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

December 31, 2017

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

#### 4. Student Loans

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



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included within the calculation of our general reserves. In June 2018, ReliaMax Surety Company was declared insolvent by the South Dakota Division of Insurance and is now in liquidation. As a result of the insolvency, we assessed the risks within the student loan portfolio and determined that along with the calculation of the general reserve of \$880,000 an additional allowance of \$640,000 was appropriate for a total reserve against the student loan portfolio of \$1,520,000 as of December 31, 2018. At December 31, 2017 the reserve against the student loan portfolio was \$772,000. There were no TDR's within the portfolio as of December 31, 2018 or 2017.

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

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

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

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

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

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

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

Forbearance - The period of time during which the borrower may postpone making principal and interest payments, which may be granted for either hardship or administrative reasons. Interest will continue to accrue on loans during periods of authorized forbearance. If the borrower is delinquent at the time the forbearance is granted, the delinquency will be covered by the forbearance and all accrued and unpaid interest from the date of delinquency or if none, from the date of beginning of the forbearance period, will be capitalized at the end of each forbearance period. The term of the loan will not change and payments may be increased to allow the loan to pay off in the required time frame. A forbearance that results in only a delay in payment considered insignificant, is not a concessionary change in terms provided the borrower affirms the obligation. Forbearance is not an uncommon status designation, this designation is standard industry practice, and is consistent with the succession of students migrating to employed medical professionals.

Claim - Occurs after a loan has been delinquent for a period of time in which the servicer believes payment may not be received. A claim can be filed at any point in the delinquency, but typically not until 180 - 210 days. ReliaMax Surety Company

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

Student Loan Aging

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

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

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

**5. Premises and Equipment**

The components of premises and equipment are as follows:

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

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

**6. Investment in Limited Partnership**

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

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

**7. Deposits**

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Deposits include the following:

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

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

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

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

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

#### 8. Short-term Borrowings/Other Borrowings

At December 31, 2018, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling \$287,446,000, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$4,119,000. At December 31, 2018, the Company had uncollateralized lines of credit with Pacific Coast Bankers Bank ("PCBB") and Union Bank totaling \$10,000,000 each and a Fed Funds line of \$20,000,000 with Zions First National Bank. At December 31, 2018, and for the year then ended, the Company had no outstanding borrowing balances. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time. These lines of credit have interest rates that are generally tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by the Company's stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of December 31, 2018, \$4,338,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, \$421,393,000 in real estate-secured loans were pledged at December 31, 2018, as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling \$287,446,000. At December 31, 2018, the Company had no outstanding borrowing balances.

The Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling \$305,236,000, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$13,363,000 at December 31, 2017. At December 31, 2017, the Company had uncollateralized lines of credit with Pacific Coast Bankers Bank ("PCBB") and Union Bank totaling \$10,000,000 each and a Fed Funds line of \$20,000,000 with Zions First National Bank. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by the Company's stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of December 31, 2017, \$17,049,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, \$473,364,000 in secured and unsecured loans were pledged at December 31, 2017, as collateral for used and unused borrowing lines with the

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Federal Reserve Bank totaling \$305,236,000. At December 31, 2017, and for the year then ended, the Company had no outstanding borrowing balances.

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

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

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

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

Effective September 30, 2009 and beginning with the quarterly interest payment due October 1, 2009, the Company elected to defer interest payments on the Company’s \$15.0 million of junior subordinated debentures relating to its trust preferred securities. The terms of the debentures and trust indentures allow for the Company to defer interest payments for up to 20 consecutive quarters without default or penalty. During the period that the interest deferrals were elected, the Company continued to record interest expense associated with the debentures. As of June 30, 2014, the Company ended the extension period, paid all accrued and unpaid interest, and is currently making quarterly interest payments. At December 31, 2018 and 2017, the Company had \$113,000 and \$80,000, respectively, in accrued and unpaid interest on the junior subordinated debt.

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

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

At December 31, 2018 the Company performed a fair value measurement analysis on its junior subordinated debt using a cash flow model approach to determine the present value of those cash flows. The cash flow model utilizes the forward 3-month LIBOR curve to estimate future quarterly interest payments due over the thirty-year life of the debt instrument. These cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for additional credit and liquidity risks associated with the junior subordinated debt. We believe the 5.86% discount rate used represents what a market participant would consider under the circumstances based on current market assumptions. At December 31, 2018, the total cumulative gain recorded on the debt is \$2,400,000.

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

For the twelve months ended December 31, 2018, the net \$392,000 (\$278,000, net of tax) fair value loss adjustment was separately presented as a \$424,000 loss (\$301,000, net of tax) recognized on the consolidated statements of income, and a

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\$32,000 gain (\$23,000, net of tax) associated with the instrument specific credit risk recognized in other comprehensive income. The adoption of ASU 2016-01's resulting impact on basic and diluted earnings per share was less than \$0.01.

**10. Taxes on Income**

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

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

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

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

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

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

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

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

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

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

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

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

**11. Stock Based Compensation**

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

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

In May 2015, the Company adopted the United Security Bancshares 2015 Equity Incentive Award Plan (2015 Plan). The 2015 Plan provides for the granting of up to 758,000 shares of authorized and unissued shares of common stock in the form of stock options, restricted stock units, and restricted stock awards. The 2015 Plan requires that the exercise price may not be less than the fair value of the stock at the date the option is granted, and that the option price must be paid in full at the time it is exercised.

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

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

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

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

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

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

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

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



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Included in salaries and employee benefits for the years ended December 31, 2018, 2017, and 2016, is \$744,000, \$97,000, and \$30,000 of share-based compensation, respectively. The related tax benefit on share-based compensation recorded in the provision for income taxes was not material to any year.

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

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

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

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

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

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

The Bank expenses the fair value of the option on a straight-line basis over the vesting period for each separately vesting portion of the award. The Bank estimates forfeitures and only recognizes expense for those shares expected to vest. Based upon historical evidence, the Company has determined that because options are granted to a limited number of key employees rather than a broad segment of the employee base, expected forfeitures, if any, are not material. The Company granted 61,007 restricted stock units and no stock options during 2018. The Company granted 41,917 restricted stock units and 60,000 options during 2017.

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

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

\* No stock option grants in 2018.

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

## **12. Employee Benefit Plans**

### 401K Plan

The Company has a Cash or Deferred 401(k) Stock Ownership Plan (the “401(k) Plan”) organized under Section 401(k) of the Code. All employees of the Company are initially eligible to participate in the 401(k) Plan upon the first day of the month after date of hire. Under the terms of the plan, the participants may elect to make contributions to the 401(k) Plan as determined by the Board of Directors. Participants are automatically vested 100% in all employee contributions. Participants may direct the investment of their contributions to the 401(k) Plan in any of several authorized investment vehicles. The Company contributes funds to the Plan up to 4% of the employees’ eligible annual compensation. Company contributions are immediately 100% vested at the time of contribution. The Company made matching contributions of \$266,000, \$255,000, and \$280,000 to the 401(k) Plan for the years ended December 31, 2018, 2017, and 2016, respectively.

### Salary Continuation Plan

The Company has an unfunded, non-qualified Salary Continuation Plan for senior executive officers and certain other key officers of the Company, which provides additional compensation benefits upon retirement for a period of at least 15 years. Future compensation under the Plan is earned by the employees for services rendered through retirement and vests over a period of 12 to 32 years. In 2015, the Company entered into Salary Continuation agreements with three officers of the Bank. The Company purchased company owned life insurance (COLI) policies on the life of the officers in connection with the Salary Continuation agreements. Life insurance premium expense totaled \$43,000 for the insurance policies purchased. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the Plan. The Company’s current benefit liability is determined based upon vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for high-quality investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which averages approximately 20 years. At December 31, 2018 and 2017, \$4,141,000 and \$4,084,000, respectively, had been accrued to date, based on a discounted cash flow using an average discount rate of 3.66% and 3.04%, respectively, and is included in other liabilities on the consolidated balance sheets. In connection with the implementation of the Salary Continuation Plans, the Company purchased single premium universal life insurance policies on the life of each of the key employees covered under the Plan. The Company is the owner and beneficiary of these insurance policies. The cash surrender value of the policies was \$7,199,000 and \$6,817,000 at December 31, 2018 and 2017, respectively, and is included on the consolidated balance sheet in cash surrender value of life insurance. Income on these policies, net of expense, totaled approximately \$477,000, \$485,000, and \$465,000 for the years ended December 31, 2018, 2017, and 2016, respectively. Although the Plan is unfunded, the Company intends to utilize the proceeds of such policies to settle the Plan obligations. Under Internal Revenue Service regulations, the life insurance policies are the property of the Company and are available to satisfy the Company’s general creditors.

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

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

Salary continuation expense is included in salaries and benefits expense, and totaled \$254,000, \$223,000, and \$137,000 for the years ended December 31, 2018, 2017, and 2016, respectively.

### Officer Supplemental Life Insurance Plan

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

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### 13. Commitments and Contingent Liabilities

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

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

*(In thousands):*

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

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

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

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Substantially all of these commitments are at floating interest rates based on the Prime rate, and most have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis, and the amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties. Many of the commitments are expected to expire without being drawn upon and, as a result, the total commitment amounts do not necessarily represent future cash requirements of the Company.

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

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

### 14. Fair Value Measurements and Disclosure

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

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

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

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

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

| December 31, 2017             |                 |                      |  |   |   |  |
|-------------------------------|-----------------|----------------------|--|---|---|--|
| <i>(In thousands)</i>         | Carrying Amount | Estimated Fair Value | Quoted Prices In Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |  |
| <b>Financial Assets:</b>      |                 |                      |  |   |   |  |
| Cash and cash equivalents     | \$ 107,934      | \$ 107,934           | \$ 107,934   | \$ —  | \$ —                                    |  |
| Investment securities         | 45,722          | 45,722               | 3,737  | 41,985                                      | —                                       |  |
| Loans                         | 593,123         | 588,938              | —  | —   | 588,938                                 |  |
| Accrued interest receivable   | 6,526           | 6,526                | —  | 6,526                                       | —                                       |  |
| <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 available-for-sale securities (AFS) and junior subordinated debt are performed on a recurring basis, while others, such as collateral dependent impaired loans, other real estate owned, goodwill and other intangibles, are performed on a nonrecurring basis.

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

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

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

| Description of Liabilities   | December 31,<br>2018 | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|------------------------------|----------------------|---|---|--|
| Junior subordinated debt (2) | \$ 10,155            | \$ —  | \$ —  | \$ 10,155  |
| <b>Total</b>                 | <b>\$ 10,155</b>     | <b>\$ —</b>   | <b>\$ —</b>   | <b>\$ 10,155</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,<br>2017 | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|----------------------|---|---|--|
| AFS Securities (2):                             |                      |   |   |  |
| U.S. Government agencies                        | \$ 19,954            | \$ —  | \$ 19,954   | \$ —   |
| U.S Govt collateralized mortgage obligations    | 22,031               | —   | 22,031  | —  |
| <b>Total AFS securities</b>                     | <b>41,985</b>        | <b>—</b>  | <b>41,985</b>   | <b>—</b>   |
| Marketable equity securities - mutual funds (2) | 3,737                | 3,737   | —   | —  |
| <b>Total</b>                                    | <b>\$ 45,722</b>     | <b>\$ 3,737</b>   | <b>\$ 41,985</b>  | <b>\$ —</b>  |

| Description of Liabilities   | December 31,<br>2017 | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(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>                                    |





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- (1) Nonrecurring
- (2) Recurring

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

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

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

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

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

**Investments** – Available for sale securities are valued based upon open-market price quotes obtained from reputable third-party brokers that actively make a market in those securities. Market pricing is based upon specific CUSIP identification for each individual security. To the extent there are observable prices in the market, the mid-point of the bid/ask price is used to determine fair value of individual securities. If that data is not available for the last 30 days, a Level 2-type matrix pricing approach based on comparable securities in the market is utilized. Level-2 pricing may include using a forward spread from the last observable trade or may use a proxy bond like a TBA mortgage to come up with a price for the security being valued. Changes in fair market value are recorded through other comprehensive loss as the securities are available for sale.

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

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

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

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

**Junior Subordinated Debt** – The fair value of the junior subordinated debt was determined based upon a discounted cash flows model utilizing observable market rates and credit characteristics for similar debt instruments. In its analysis, the Company

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

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

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

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

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

|  | December 31, 2018              | December 31, 2017              | December 31, 2016              |
|--|--------------------------------|--------------------------------|--------------------------------|
|  | Junior<br>Subordinated<br>Debt | Junior<br>Subordinated<br>Debt | Junior<br>Subordinated<br>Debt |
| <b>Reconciliation of Liabilities:</b>  |                                |                                |                                |
| Beginning balance  | \$ 9,730                       | \$ 8,832                       | \$ 8,300                       |
| Total losses included in earnings  | 424                            | 882                            | 518                            |
| Total gains included in OCI  | (32)                           | —                              | —                              |
| Capitalized interest   | 33                             | 16                             | 1,050                          |
| Ending balance   | <u>\$ 10,155</u>               | <u>\$ 9,730</u>                | <u>\$ 8,832</u>                |
| The amount of total losses for the period included in earnings attributable to the change in unrealized gains or losses relating to liabilities still held at the reporting date | <u>\$ 424</u>                  | <u>\$ 882</u>                  | <u>\$ 518</u>                  |

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

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

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

**15. Regulatory Matters**

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

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

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

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

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

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

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

In determining the amount of risk-weighted assets for purposes of calculating risk-based capital ratios, an institution's assets, including certain off-balance sheet assets (e.g., recourse obligations, direct credit substitutes, residual interests), are multiplied by a risk weight factor assigned by the regulations based on the risk deemed inherent in the type of asset. Higher levels of capital are required for asset categories believed to present greater risk. For example, a risk weight of 0% is assigned to cash and U.S. government securities, a risk weight of 50% is generally assigned to prudently underwritten first lien one to four-

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family residential mortgages, a risk weight of 100% is assigned to commercial and consumer loans, a risk weight of 150% is assigned to certain past due loans and a risk weight of between 0% to 600% is assigned to permissible equity interests, depending on certain specified factors.

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

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

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

The primary source of funds with which cash dividends are paid to shareholders comes from cash dividends received by the Company from the Bank. The Bank's ability to pay dividends is subject to the restrictions set forth in the California Financial Code. Under the Financial Code, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank's net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the DBO, in an amount not exceeding the greater of: (i) the Bank's retained earnings; (ii) its net income for the last fiscal year; or (iii) its net income for the current fiscal year. During the year ended December 31, 2018 and December 31, 2017, the Bank paid \$6,947,000 and \$4,291,000 in cash dividends to the Company. These dividends funded the Company's operating costs, payments of interest on its junior subordinated debentures, and payments of cash dividends to shareholders. Approval by the Federal Reserve and the DBO was required for the dividend issued during the first quarter 2017, but subsequently deemed unnecessary alongside the termination of the informal agreements. During the year ended December 31, 2015, a redemption of \$3.0 million junior subordinated debt was approved by both agencies.

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

**16. Supplemental Cash Flow Disclosures**

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

**17. Dividends on Common Stock**

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

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

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

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

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

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

### 18. Net Income Per Share

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

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

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

### 19. Common Stock Repurchase Plan

On April 25, 2017, the Company's Board of Directors approved the repurchase of up to \$3 million of the outstanding common stock of the Company. The timing of the purchases will depend on certain factors, including but not limited to, market conditions and prices, available funds, and alternative uses of capital. The stock repurchase program may be carried out through open-market purchases, block trades, or negotiated private transactions.

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

### 20. Accumulated Other Comprehensive Income

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

|  | December 31, 2018                                    |  |   | December 31, 2017                                    |  |   |
|--|--|--|---|--|--|---|
|  | 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 |
| (in 000's)                                     |  |  |   |  |  |   |
| <b>December 31, 2017</b>                       | \$ (248)   | \$ (462)   | \$ —  | \$ (221)   | \$ (383)   | \$ —  |
| Reclassifications upon adoption of ASU 2016-01 | 184  | —  | 1,482   | —  | —  | —   |
| <b>January 1, 2018</b>                         | (64)   | (462)  | 1,482   | (221)  | (383)  | —   |
| Current period comprehensive (loss) income     | (308)  | 3  | 23  | (27)   | (79)   | —   |
| <b>December 31, 2018</b>                       | \$ (372)   | \$ (459)   | \$ 1,505  | \$ (248)   | \$ (462)   | \$ —  |
| Accumulated other comprehensive income (loss)  |  |  | \$ 674  |  |  | \$ (710)  |



**21. Parent Company Only Financial Statements**

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

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

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

**United Security Bancshares – (parent only)**

**Statement of Cash Flows**

**Year ended December 31,**

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

**22. Summary of Quarterly Results of Operations (unaudited)**

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

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

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

### **23. Subsequent Events**

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were issued and no subsequent events occurred requiring accrual or disclosure.

### **Item 9 - Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

### **Item 9A. Controls and Procedures**

#### **CONCLUSION REGARDING THE EFFECTIVENESS OF DISCLOSURE CONTROLS AND PROCEDURES**

The Company's management, with the participation of the President and Chief Executive Officer and the Chief Financial Officer, has conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures as of December 31, 2018 based on the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, the Company's management has determined that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. These disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits is accumulated and communicated to management, including the President and Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Moss Adams LLP, an independent registered public accounting firm, has audited the consolidated financial statements included in this Annual Report on Form 10-K and, as part of their audit, has issued their report, included herein, on the effectiveness of our internal control over financial reporting.

#### **CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). The Company's management conducted an evaluation of the effectiveness of the Company's internal control over financial reporting based on the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission as of December 31, 2018. Based on this evaluation, the Company's management concluded that the Company's internal control over financial reporting is effective as of December 31, 2018.

There were no changes in the Company's internal control over financial reporting that occurred during the fourth quarter of 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

### **Item 9B. Other Information**

None.

## **PART III**

### **Item 10 – Directors, Executive Officers, and Corporate Governance**

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Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Election of Directors and Executive Officers" and "Corporate Governance Principles and Board Matters" set forth in the Company's definitive Proxy Statement for its 2019 Annual Meeting of Shareholders ("Proxy Statement").

**Item 11 - Executive Compensation**

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Executive Compensation" and "Director Compensation" set forth in the Company's definitive Proxy Statement.

**Item 12 - Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled "Shareholdings of Certain Beneficial Owners and Management" set forth in the Company's definitive Proxy Statement.

**Item 13 - Certain Relationships and Related Transactions, and Director Independence**

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Certain Transactions" and "Corporate Governance Principles" set forth in the Company's definitive Proxy Statement.

**Item 14 - Principal Accounting Fees and Services**

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled "Independent Accountant Fees and Services" set forth in the Company's definitive Proxy Statement.

**PART IV**

**Item 15 – Exhibits and Financial Statement Schedules**

**(a)(1) Financial Statements**

The Consolidated Financial Statements and related documents set forth in “Item 8. Financial Statements and Supplementary Data” of this report are filed as part of this report.

**(a)(2) Financial Statement Schedules**

All financial statement schedules are omitted because they are not applicable or not required or because the information is included in the financial statements or notes thereto or is not material.

**(a)(3) Exhibits**

|                       |  |
|-----------------------|--|
| <a href="#">3.1</a>   | Articles of Incorporation of Registrant (1)  |
| <a href="#">3.2</a>   | Bylaws of Registrant (1)   |
| <a href="#">4.1</a>   | Specimen common stock certificate of United Security Bancshares (1)                  |
| <a href="#">10.1</a>  | Amended and Restated Executive Salary Continuation Agreement for Dennis Woods (2)    |
| <a href="#">10.2</a>  | Amended and Restated Employment Agreement for Dennis R. Woods (5)                    |
| <a href="#">10.3</a>  | Amended and Restated Executive Salary Continuation Agreement for David Eytcheson (2) |
| <a href="#">10.4</a>  | Amended and Restated Change in Control Agreement for David Eytcheson (5)             |
| <a href="#">10.5</a>  | USB 2005 Stock Option Plan (3)   |
| <a href="#">10.6</a>  | United Security Bancshares 2015 Equity Incentive Award Plan (4)                      |
| <a href="#">10.7</a>  | Executive Salary Continuation Agreement for Bhavneet Gill (5)                        |
| <a href="#">10.8</a>  | Change in Control Agreement for Bhavneet Gill (5)                                    |
| <a href="#">10.9</a>  | Executive Salary Continuation Agreement for William Yarbenet (5)                     |
| <a href="#">10.10</a> | Change in Control Agreement for William Yarbenet (5)                                 |
| <a href="#">10.11</a> | Employment Agreement for William Yarbenet (5)  |
| <a href="#">10.12</a> | Change in Control Agreement for Robert Oberg (filed herewith)                        |
| <a href="#">11.1</a>  | Computation of earnings per share.   |

## Table of Contents

See Note 18 to Consolidated Financial Statements and related documents set forth in “Item 8. Financial Statements and Supplementary Data” of this report are filed as part of this report.

[21.1](#) Subsidiaries of the Company (filed herewith)

[23.1](#) Consent of Moss Adams LLP, Independent Registered Public Accounting Firm (filed herewith)

[31.1](#) Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)

[31.2](#) Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)

[32.1](#) Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

[32.2](#) Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets as of December 31, 2018 and 2017, (ii) the Consolidated Statements of Income for the years ended December 31, 2018, 2017 and 2016, (iii) the Consolidated Statements of Comprehensive Income for the years ended December 31, 2018, 2017 and 2016, (iv) the Consolidated Statement of Changes in Shareholders' Equity for the years ended December 31, 2018, 2017 and 2016, (v) the Consolidated Statements of Cash Flows for the years ended December 31, 2018, 2017 and 2016, and (vi) the Notes to Consolidated Financial Statements. (Pursuant to Rule 406T of Regulation S-T, this information is deemed furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.) (Filed herewith).

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(1) Previously filed on April 4, 2001 as an exhibit to the Company's filing on Form S-4 (file number 333-58256).

(2) Previously filed on March 17, 2008 as an exhibit to the Company's filing on Form 10-K for the year ended December 31, 2007 (file number 000-32897).

(3) Previously filed on April 18, 2005 as Exhibit B to the Company's 2005 Schedule 14A Definitive Proxy (file number 000-32897).

(4) Previously filed on April 13, 2015 as Appendix A to the Company's 2015 Schedule 14A Definitive Proxy (file number 000-32897).

(5) Previously filed on March 2, 2018 as an exhibit to the Company's filing on Form 10-K for the year ended December 31, 2017 (file number 000-32897).

**(b) Exhibits filed:**

See Exhibit Index under Item 15(a)(3) above for the list of exhibits required to be filed by Item 601 of regulation S-K with this report.

**(c) Financial statement schedules filed:**

See Item 15(a)(2) above.



## Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report on Form 10-K for the year ended December 31, 2018 to be signed on its behalf by the undersigned thereunto duly authorized, in Fresno, California, on the 1st day of March 2019.

### United Security Bancshares

**March 1, 2019**

/S/ Dennis R. Woods

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Dennis R. Woods  
President and Chief Executive Officer

**March 1, 2019**

/S/ Bhavneet Gill

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Bhavneet Gill  
Senior Vice President and Chief Financial Officer

### POWERS OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Dennis R. Woods and Bhavneet Gill, and each of them severally, his or her true and lawful attorney-in-fact with power of substitution and resubstitution to sign in his or her name, place and stead, in any and all capacities, to do any and all things and execute any and all instruments that such attorney may deem necessary or advisable under the Securities Exchange Act of 1934 and any rules, regulations and requirements of the U.S. Securities and Exchange Commission in connection with this Annual Report on Form 10-K and any and all amendments hereto, as fully for all intents and purposes as he or she might or could do in person, and hereby ratifies and confirms all said attorneys-in-fact and agents, each acting alone, and his or her substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities on the date indicated:

|       |                      |  |
|-------|----------------------|--|
| Date: | <u>March 1, 2019</u> | <u>/s/ Stanley J. Cavalla</u><br>Director  |
| Date: | <u>March 1, 2019</u> | <u>/s/ Tom Ellithorpe</u><br>Director      |
| Date: | <u>March 1, 2019</u> | <u>/s/ Benjamin Mackovak</u><br>Director   |
| Date: | <u>March 1, 2019</u> | <u>/s/ Robert M. Mochizuki</u><br>Director |
| Date: | <u>March 1, 2019</u> | <u>/s/ Kenneth D. Newby</u><br>Director    |
| Date: | <u>March 1, 2019</u> | <u>/s/ Sue Quigley</u><br>Director         |
| Date: | <u>March 1, 2019</u> | <u>/s/ Mike Woolf</u><br>Director          |
| Date: | <u>March 1, 2019</u> | <u>/s/ Nabeel Mahmood</u><br>Director      |
| Date: | <u>March 1, 2019</u> | <u>/s/ Brian Tkacz</u><br>Director         |

**Section 2: EX-10.12 (EXHIBIT 10.12)**

**CHANGE IN CONTROL AGREEMENT**

This Change in Control Agreement (this “*Agreement*”) is made this 23rd day of October, 2018, by and between United Security Bancshares (the “*Company*”), a California corporation, and Robert Oberg (“*Executive*”), an individual residing in the state of California, with reference to the following:

**RECITAL**

WHEREAS, it is in the best interests of the Company and Executive for the Company to provide Executive with severance compensation in the event there is a change in control of the Company or its wholly-owned subsidiary, United Security Bank (“*Bank*”), whereby Executive’s employment is terminated without Cause or Executive terminates his employment for Good Reason;

NOW, THEREFORE, in consideration of the premises and of the mutual covenants and conditions herein contained, the parties hereto, intending to be legally bound, do hereby agree as follows:

## AGREEMENT

1. *Definitions.* For purposes of this Agreement, and except as otherwise defined herein, the following terms shall have the following meanings:

“**Board**” means the Board of Directors of the Company.

“**Cause**” means any of the following:

(A) Executive’s continued failure, either due to willful action or as a result of gross neglect, to substantially perform Executive’s duties and responsibilities to the Group (other than any such failure resulting from Executive’s incapacity due to physical or mental illness) that, if capable of being cured, has not been cured within thirty (30) days after written notice is delivered to Executive by the Company, which notice specifies in reasonable detail the manner in which the Company believes Executive has not substantially performed Executive’s duties and responsibilities; or

(B) Executive’s engagement in conduct which is demonstrably and materially injurious to the Group, or that materially harms the reputation or financial position of the Group, unless the conduct in question was undertaken in good faith on an informed basis with due care and with a rational business purpose and based upon the honest belief that such conduct was in the best interests of the Group; or

(C) Executive’s indictment or conviction of, or plea of guilty or *nolo contendere* to, a felony or any other crime involving dishonesty, fraud or moral turpitude; or

(D) Executive being found liable in any Securities and Exchange Commission or other civil or criminal securities law action or entering any cease and desist order with respect to such action (regardless of whether or not Executive admits or denies liability) where the conduct which is the subject of such action is demonstrably and materially injurious to the Group; or

(E) Executive breaches Executive’s fiduciary duties to the Group which may reasonably be expected to have a material adverse effect on the Group; or

(F) Executive’s (i) obstructing or impeding, (ii) endeavoring to influence, obstruct or impede, or (iii) failing to materially cooperate with, any investigation authorized by the Board or any governmental or self-regulatory entity (an “**Investigation**”). However, Executive’s failure to waive attorney-client privilege relating to communications with Executive’s own attorney in connection with an Investigation shall not constitute “Cause;” or

(G) Executive removing, concealing, destroying, purposely withholding, altering or by any other means falsifying any material which is requested in connection with an Investigation; or

(H) Executive's disqualification, bar, order or similar requirement by any governmental or self-regulatory authority from serving as an officer or director of any member of the Group or Executive's loss of any governmental or self-regulatory license that is reasonably necessary for Executive to perform Executive's responsibilities to the Group, *if* (i) the disqualification, bar or loss continues for more than thirty (30) days and (ii) during that period the Group uses its good faith efforts to cause the disqualification or bar to be lifted or the license replaced. While any disqualification, bar or loss continues during Executive's employment, Executive will serve in such executive officer capacity to whatever extent legally permissible and, if Executive's employment is not permissible, Executive will be placed on leave (which will be paid to the extent legally permissible); or

(I) Executive's unauthorized use or disclosure of confidential or proprietary information, or related materials, or the violation of any of the terms of the Company's standard confidentiality policies and procedures, in either case which may reasonably be expected to have a material adverse effect on the Group and that, if capable of being cured, has not been cured within thirty (30) days after written notice is delivered to Executive by the Company, which notice specifies in reasonable detail the alleged unauthorized use or disclosure or violation; or

(J) Executive's violation of the Group's (i) workplace violence policy or (ii) policies on discrimination, unlawful harassment or substance abuse.

For purposes of this definition, no act or omission by Executive will be "willful" unless it is made by Executive in bad faith or without a reasonable belief that Executive's act or omission was in the best interests of the Group.

**"Change in Control"** means any transaction or series of related transactions as a result of which:

(A) The Company consummates a reorganization, merger or consolidation, or sale or other disposition of at least forty percent (40%) of its assets (each a "**Business Combination**"), in each case unless immediately following the consummation of such Business Combination all of the following conditions are satisfied:

(i) Persons, who, immediately prior to such Business Combination, were the beneficial owners of the Outstanding Voting Securities of the Company, beneficially own (within the meaning of Rule 13d-3 promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), directly or indirectly, more than 50% of the combined voting power of the then Outstanding Voting Securities of the entity (the "**Resulting Entity**") resulting from such Business Combination (including, without limitation, an entity which as a result of such transaction owns the Company or all or substantially all of the Company's assets either directly or through one or more subsidiaries);

(ii) no Person beneficially owns (within the meaning of Rule 13d-3), directly or indirectly, more than: (i) 50% of the then outstanding combined voting power of the Outstanding Voting Securities of the Resulting Entity, except to the extent that such Person's beneficial ownership of the Company immediately prior to the Business Combination exceeded such threshold; and

(iii) at least one-half of the members of the board of directors of the Resulting Entity were members of the Board at the time the Board authorized the Company to enter into the definitive agreement providing for such Business Combination; and

(iv) the Company continues to own at least sixty percent (60%) of the assets it held immediately prior to the Business Combination (such percentage to be based on fair market value); or

(B) Any Person acquires beneficial ownership (within the meaning of Rule 13d-3) of more than 50% of the combined voting power (calculated as provided in Rule 13d-3 in the case of rights to acquire securities) of the then Outstanding Voting Securities of the Company; provided, however, that for purposes of this clause, the following acquisitions shall not constitute a Change in Control: (x) any acquisition directly from the Company, (y) any acquisition by the Company, or (z) any acquisition by any employee benefit plan (or related trust) sponsored or maintained by the Company or any entity controlled by the Company; or

(C) A majority of the members of the Board is replaced during any twelve (12) month period by directors whose appointment or election is not endorsed by a majority of the members of the Board prior to the date of their appointment or election.

For purposes of this definition, the involuntary dissolution of the Bank by the regulatory authorities shall not be deemed a "Business Combination."

**"Good Reason"** means the occurrence (without Executive's written consent) of any of the following within the twelve (12)-month period following a Change in Control:

(A) The assignment of duties substantially inconsistent with Executive's position, duties, and responsibilities (except in connection with a for Cause termination); or

(B) A 5% or greater reduction by the Group in Executive's salary and benefits as in effect prior to the Change in Control; or

(C) The Group's requiring Executive to be based anywhere other than within ten (10) miles of Fresno, California, exclusive of required travel on business.

**"Group"** means the Company and its affiliates, including the Bank.

**"Outstanding Voting Securities"** of any Person means the outstanding securities of such Person entitling the holders thereof to vote generally in the election of directors of such Person.

**"Person"** shall have the same meaning ascribed to such term in Section 3(a)(9) of the Exchange Act, which definition shall include a "person" within the meaning of Section 13(d)(3) of the Exchange Act.

2. **Severance Payment.** If within twelve (12) months following a Change in Control, including in anticipation of a Change in Control, any member of the Group terminates Executive's employment without Cause or Executive terminates his employment for Good Reason, the Company will pay Executive a severance payment in an amount equal to the sum of (i) twelve (12) months of Executive's base salary that is in effect at the time immediately preceding the termination of Executive's employment without Cause or for Good Reason and (ii) the amount of the bonus paid to Executive by the Group for the preceding calendar year. Subject to the provisions of Section 3, such severance payment shall be paid in a lump sum to Executive within ten (10) days of the termination of Executive's employment; provided, however that the severance payment may be subject to the reduction set forth below:

(i) Notwithstanding anything in this Agreement to the contrary, in the event it shall be determined that any payment, award, benefit or distribution (or any acceleration of any payment, award, benefit or distribution) by the Group or any entity which effectuates a Change in Control (or any of its affiliated entities) to or for the benefit of Executive (whether pursuant to the terms of this Agreement or otherwise) (the **"Payments"**) would be subject to the excise tax (the **"Excise Tax"**) under Section 4999 of the Internal Revenue Code of 1986, as amended (the **"Code"**), then the amounts payable to Executive under this Agreement shall be reduced to the maximum amount as will result in no portion of the Payments being subject to such excise tax (the **"Safe Harbor Cap"**). For purposes of reducing the Payments to the Safe Harbor Cap, only amounts payable to Executive under this Agreement (and no other Payments) shall be reduced, unless consented to by Executive.

(ii) All determinations required to be made under this Agreement shall be made by the public accounting firm that is retained by the Company as of the date immediately prior to the Change in Control (the “**Accounting Firm**”) which shall provide detailed supporting calculations both to the Company and Executive within fifteen (15) business days of the receipt of notice from the Company or the Executive that there has been a Payment, or such earlier time as is requested by the Company. Notwithstanding the foregoing, in the event (i) the Board shall determine prior to the Change in Control that the Accounting Firm is precluded from performing such services under applicable auditor independence rules or (ii) the Audit Committee of the Board determines that it does not want the Accounting Firm to perform such services because of auditor independence concerns or (iii) the Accounting Firm is serving as accountant or auditor for the individual, entity or group effecting the Change in Control, the Board shall appoint another nationally recognized public accounting firm to make the determinations required hereunder (which accounting firm shall then be referred to as the Accounting Firm hereunder). If payments are reduced to the Safe Harbor Cap, the Accounting Firm shall provide a reasonable opinion to Executive that he is not required to report any Excise Tax on his federal income tax return. All fees, costs and expenses (including, but not limited to, the costs of retaining experts) of the Accounting Firm shall be borne by the Company. If the Accounting Firm determines that no Excise Tax is payable by Executive, it shall furnish Executive with a written opinion to such effect, and to the effect that failure to report the Excise Tax, if any, on Executive’s applicable federal income tax return will not result in the imposition of a negligence or similar penalty. In the event the Accounting Firm determines that the Payments shall be reduced to the Safe Harbor Cap, it shall furnish Executive with a written opinion to such effect. The determination by the Accounting Firm shall be binding upon the Company and Executive.

3. *Delay of Payments.* If the Company determines that Executive is a “specified employee” within the meaning of Section 409A of the Internal Revenue Code of 1986, as amended, and that, as a result of such status, any portion of the severance payment under this Agreement would be subject to additional taxation, the Company will delay paying any portion of such severance payment until the earliest permissible date on which payments may commence without triggering such additional taxation (with such delay not to exceed six (6) months).

4. *Term and Termination.* This Agreement is effective as of the date first hereinabove written and shall terminate on October 22, 2023, unless automatically renewed. This Agreement shall automatically renew for additional periods of one (1) year each unless written notice is provided by Company to Executive of Company’s election not to renew this Agreement at least sixty (60) days prior to the end of the original or any extended term. Company agrees that its obligations under this Agreement shall survive the expiration or termination of this Agreement for a period of twelve (12) months following any Change in Control occurring prior to termination/non-renewal of this Agreement. For the avoidance of doubt, any Change in Control that occurs after termination or non-renewal of this Agreement shall not trigger any payments or obligations by Company to Executive under this Agreement.

5. *Golden Parachute Limitation.* Anything in this Agreement to the contrary notwithstanding, the Company shall not be obligated to make any payment hereunder that would be prohibited as a “golden parachute payment” or “indemnification payment” under Section 18(k) of the Federal Deposit Insurance Act.

6. *Payments on Executive’s Death.* If Executive dies and any amounts are or become payable under this Agreement, the Company will pay those amounts to Executive’s estate.

7. *Entire Agreement.* This Agreement contains the entire agreement of the parties and it supersedes any and all other agreements, either oral or in writing, between Executive and the Company or the Bank. Each party to this Agreement acknowledges that no representations, inducements, promises, or agreements, oral or otherwise, have been made by any party, or anyone acting on behalf of any party, which are not embodied herein, and that no other agreement, statement, or promise not contained in this Agreement shall be valid or binding. This Agreement may not be modified or amended by oral agreement, but only by an agreement in writing signed by the Company and Executive.

8. *Governing Law.* This Agreement shall be governed by and construed according to the laws of the State of California, except to the extent that the provisions of federal law supersede California law, and the parties hereto submit to the jurisdiction of the courts of competent jurisdiction of the County of Fresno, State of California.

9. *Unfunded Agreement for ERISA Purposes.* This Agreement shall be unfunded for tax purposes and for purposes of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended from time to time.

IN WITNESS WHEREOF, this Agreement has been executed as of the date first hereinabove written.

UNITED SECURITY BANCSHARES

-----  
By: Dennis R. Woods  
Its: President & Chief Executive Officer

EXECUTIVE

-----  
Robert Oberg  
Senior Vice President & Chief Risk Officer

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### **Section 3: EX-21.1 (EXHIBIT 21.1)**

Exhibit 21.1 – Subsidiaries of the Company (United Security Bancshares)

- 1) United Security Bank – incorporated in the State of California
- 2) USB Capital Trust II – incorporated in the State of Delaware

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### **Section 4: EX-23.1 (EXHIBIT 23.1)**

**Exhibit 23.1**



To the Board of Directors  
United Security Bancshares and Subsidiary

We consent to the incorporation by reference in Registration Statement No. 333-89362 dated May 30, 2002 on Form S-8, in Registration Statement No. 333-10078 dated September 25, 2002 on Form S-8, in Registration Statement No. 333-134125 dated May 12, 2006 on Form S-8, and in Registration Statement No. 333-203397 dated April 14, 2015 of United Security Bancshares and Subsidiary (United Security Bancshares) of our report dated March 1, 2019, with respect to the consolidated balance sheets of United Security Bancshares as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the years in the three year periods ended December 31, 2018, and the effectiveness of internal control over financial reporting as of December 31, 2018, which is included in this annual report on Form 10-K of United Security Bancshares for the year ended December 31, 2018.

/s/ Moss Adams LLP

Sacramento, California  
March 1, 2019

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## Section 5: EX-31.1 (EXHIBIT 31.1)

### 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: March 1, 2019

/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

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## Section 6: EX-31.2 (EXHIBIT 31.2)

### 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: March 1, 2019

/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

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## **Section 7: EX-32.1 (EXHIBIT 32.1)**

**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.

March 1, 2019

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 December 31, 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 December 31, 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

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## **Section 8: EX-32.2 (EXHIBIT 32.2)**

**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.

March 1, 2019

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

1. that this quarterly report on Form 10-Q for the quarter ended December 31, 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 December 31, 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

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