UNITED SECURITY BANCSHARES
Form 10-K
March 02, 2018
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2017.

o 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	91-2112732
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2126 Inyo Street, Fresno, California	93721
(Address of principal executive offices)	(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 o No x
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 o No x
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 x No o
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 o No o
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. o
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 o	Accelerated filer x	Non-accelerated filer o
Small reporting company o		Emerging growth company o

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. o

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, 2017: $119,569,297

Shares outstanding as of February 28, 2018: 16,885,615

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Definitive Proxy Statement for the 2018 Meeting of Shareholders is incorporated by reference into Part III. Part III, Items 10, 11, 12, 13 and 14

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PART 1

Certain matters discussed or incorporated by reference in this Annual Report of Form 10-K 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 Securities Litigation Reform Act of 1995 that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, among others, (1) competitive pressure in the banking industry increasing significantly; (2) changes in the interest rate environment which may reduce margins and devalue assets; (3) general economic conditions, either nationally or regionally, are less favorable than expected, resulting in, among other things, a deterioration in credit quality; (4) changes in the regulatory environment; (5) changes in business conditions and inflation; (6) changes in securities markets; (7) asset/liability matching risks and liquidity risks; (8) potential impairment of goodwill and other intangible assets; (9) loss of key personnel; and (10) operational interruptions including data processing systems failure and fraud. 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 during March of 2001 and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended (the “BHCA”). The Company’s stock is listed on NASDAQ under the symbol “UBFO.” United Security Bank (the “Bank”) was formed in 1987 and, on June 12, 2001, the Bank became the wholly-owned subsidiary of United Security Bancshares through a tax-free holding company reorganization, accounted for on a basis similar to the pooling of interest method. In the transaction, each share of Bank stock was exchanged for a share of United Security Bancshares stock on a one-to-one basis. References to the “Company” are references to United Security Bancshares and United Security Bank, on a consolidated basis. References to the “Bank” are to United Security Bank. References to the "Holding Company" are to United Security Bancshares only.

At present, the Company does not engage in any material business activities other than ownership of the Bank.

United Security Bank

The Bank is a California state-chartered bank headquartered in Fresno, California. It is also a member of the Federal Reserve System. The Bank originally commenced business on December 21, 1987, as a national bank. On February 3, 1999, the Bank converted into a California state-chartered bank after receiving all necessary regulatory and shareholder approvals. The Bank’s operations are currently subject to federal and state laws applicable to state-chartered member banks, and its deposits are insured up to the applicable limits by the Federal Deposit Insurance Corporation (the “FDIC”). The Bank is also subject to the Federal Deposit Insurance Act (“FDIA”) and regulatory reporting requirements of the FDIC. As a state-chartered member bank, the Bank is subject to supervision and regular examinations by the Board of Governors of the Federal Reserve System (the “FRB”) and the California Department of Business Oversight (the “DBO”). In addition, the Bank is required to file reports with the FRB and provide such additional information as the FRB may require.

At December 31, 2017, the Bank operates three branches (including its main office), one construction lending office, and one financial services office in Fresno and one branch each, in Oakhurst, Caruthers, San Joaquin, Firebaugh, Coalinga, Bakersfield, Taft, and Campbell. The Bank has ATMs at all branch locations and off-site ATMs at eight different non-branch locations. In addition, the Company and 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 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 current accounting standards related to variable interest entities. 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. 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 of the Company. The 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 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. 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 at year-end 2015. The Company may redeem the junior subordinated debentures at any time at par.

The following discussion of the Company's services should be read in conjunction with "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS."

Bank Services

As a state-chartered commercial bank, United Security Bank offers 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.

The Bank offers a wide range 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 the Bank's 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 9.43% and 15.22% of total deposits at December 31, 2017 and 2016, respectively. A portion of those time deposits are brokered deposits which are considered wholesale funding sources generally from out of the Bank’s market area. Brokered deposits comprised 1.08% and 4.16% of total deposits at December 31, 2017 and 2016, respectively.

The Bank also engages in a full complement of lending activities, including real estate mortgage (50.93% of total loans at December 31, 2017), commercial and industrial (7.82% of total loans at December 31, 2017), real estate construction (20.45% of total loans at December 31, 2017), as well as agricultural (9.89% of total loans at December 31, 2017), and installment loans (10.91% of total loans at December 31, 2017). Approximately 71.30% of the Bank's loans are secured by real estate at December 31, 2017. 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, 2017, the Bank had loans (net of unearned fees) outstanding of $602,390,000, which represented approximately 87.60% of the Bank's total deposits and approximately 74.75% of its total assets.

Real estate mortgage loans are secured by deeds of trust primarily on commercial property. Repayment of real estate mortgage loans is generally from the cash flow of the borrower. Commercial and industrial loans have a high degree of industry diversification. Loans may be originated in the Company's market area, or participated with other financial institutions outside the Company's market area. A substantial portion of the Company's 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. 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. Repayment of real estate construction loans is generally from long-term mortgages with other lending institutions. 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.

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Although the Bank has a high concentration of commercial real estate loans, the Bank is not in the business of making residential mortgage loans to individuals. Residential mortgage loans totaled $84,804,000, or 14.10% of the portfolio at December 31, 2017. The residential mortgage loan portfolio is primarily comprised of purchased residential mortgage pools. The Bank does not originate, or have in its loans portfolio, any subprime, Alt-A, or option adjustable rate loans. The Bank does 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, the Bank has restructured certain loans to allow the borrower to continue to perform on the loan under a troubled debt restructuring plan.

The Bank purchases loan participations from, and sells 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. The Bank has reduced its level of loan participations over the past several years. Currently, the Bank holds no participation purchased loans. Loan participations sold comprised 1.3% and 0.7% of the total loan portfolio at December 31, 2017 and 2016, respectively. During the past year, participation lending activity has increased and currently the Company is participating in more participation sales.

In the normal course of business, the Bank makes various loan commitments and incurs certain contingent liabilities. Due to the nature of the business of the Bank's customers, there are no seasonal patterns or absolute predictability to the utilization of unused loan commitments; therefore, the Bank is unable to forecast the extent to which these commitments will be exercised within the current year. The Bank does 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, 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 online banking, mobile banking, safe deposit boxes, ATM services, payroll direct deposit, cashier's checks, and cash management services. In addition, the Bank offers a variety of specialized financial services, including wealth management, employee benefit, insurance and loan products, as well as consulting services for a variety of clients. 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. Most of the Bank's business originates within Fresno, Madera, Kern, and Santa Clara Counties. Neither the Bank’s business nor liquidity are seasonal, and there has been no material effect upon the Bank's capital expenditures, earnings or competitive position as a result of federal, state or local environmental regulation.

Competition and Market Share

The banking business in California generally, and in the market area served by the Company specifically, is highly competitive with respect to both loans and deposits. The Company competes 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 the Company. The Company competes for loans and deposits by offering competitive interest rate and by seeking to provide a higher level of personal 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 dealing 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 intensify the competitive environment. Many of the major commercial banks operating in the Company's market areas offer certain services such as trust and international banking services, which the Company does not offer directly. In addition, banks with larger capitalization have larger lending limits and are thereby able to serve larger customers.

The Company’s primary market area at December 31, 2017 was located in Fresno, Madera, and Kern Counties, 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, 2017, which is the most current information available.

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	Rank	Share
Fresno County	8th	3.81%
Madera County	8th	5.64%
Kern County	14th	0.81%
Total of Fresno, Madera, Kern Counties	11th	2.78%
Santa Clara County	42nd	0.02%

Supervision and Regulation

Introduction

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 it is subject to the listing standards and rules of NASDAQ.

Banking is a complex and highly regulated industry. The primary goals of banking rules and regulations are to maintain a safe and sound banking system, protect depositors and the FDIC's insurance fund, and facilitate the conduct of sound monetary policy. They are not intended for the benefit of shareholders of financial institutions. In furtherance of these goals, Congress and the states have created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies and the financial services industry. Consequently, the growth and earnings performance of the Holding Company can be affected not only by management decisions and general economic conditions, but also by the requirements of applicable state and federal statues, regulations and the policies of various governmental regulatory authorities.

From time to time, laws or regulations are enacted which have the effect of increasing the cost of doing business, limiting or expanding the scope of permissible activities, or changing the competitive balance between banks and other financial and non-financial institutions. Proposals to change the laws and regulations governing the operations of banks and bank holding companies are frequently made in Congress and by various bank and other regulatory agencies. Future changes in the laws, regulations or polices that impact the Holding Company and the Bank cannot necessarily be predicted, but they may have a material effect on the business and earnings of the Holding Company. 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

On July 21, 2010, the Dodd-Frank Act was signed into law to effect a fundamental restructuring of federal banking regulation. Among the provisions of the Dodd-Frank Act that affect the Holding Company are the following:

- Holding Company Capital Requirements. The Dodd-Frank Act required the FRB to apply consolidated capital requirements to depository institution holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities are excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than $15 billion in assets. The Dodd-Frank Act additionally requires capital requirements to be countercyclical so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

- Deposit Insurance. The Dodd-Frank Act broadened the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when

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the reserve ratio exceeds certain thresholds.

- Corporate Governance. The Dodd-Frank Act required publicly traded companies, such as the Holding Company, to give stockholders a non-binding vote on executive compensation at their first annual meeting taking place six months after the date of enactment and at least every three years thereafter and on so-called "golden parachute" payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders and requires that national securities exchanges prohibit brokers from voting on this proposal. The SEC has also adopted regulations under the Dodd-Frank Act that require public companies to include the nominees of significant, long-term shareholders in their proxy materials, alongside the nominees of management if such shareholder owned at least 3 percent of the company's shares continuously for at least the prior three years. Additionally, the Dodd-Frank Act directed the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1.0 billion, regardless of whether the Holding Company is publicly traded or not.

- Interstate Branching. The Dodd-Frank Act authorized national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted to branch.

- Limits on Derivatives. The Dodd-Frank Act prohibited state-chartered banks from engaging in derivatives transactions unless the loans to one borrower limits of the state in which the bank is chartered takes into consideration credit exposure to derivatives transactions. For this purpose, derivative transaction includes any contract, agreement, swap, warrant, note or option that is based in whole or in part on the value of any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities securities, currencies, interest or other rates, indices or other assets.

- Transactions with Affiliates and Insiders. The Dodd-Frank Act expanded the definition of "affiliate" for purposes of quantitative and qualitative limitations of Section 23A of the Federal Reserve Act to include mutual funds advised by a depository institution or its affiliates. The Dodd-Frank Act will apply Section 23A and Section 22(h) of the Federal Reserve Act (governing transactions with insiders) to derivative transactions, repurchase agreements and securities lending and borrowing transaction that create credit exposure to an affiliate or an insider. Any such transactions with affiliates must be fully secured. The current exemption from Section 23A for transactions with financial subsidiaries will be eliminated. The Dodd-Frank Act also prohibits an insured depository institution from purchasing an asset from or selling an asset to an insider unless the transaction is on market terms and, if representing more than 10% of capital, is approved in advance by the disinterested directors.

- Consumer Financial Protection Bureau. The Dodd-Frank Act created an independent federal agency called the Consumer Financial Protection Bureau (the "CFPB"), which has been granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Practices Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB but are still examined and supervised by their federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act authorized the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, the Dodd-Frank Act allows borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage" as defined by the CFPB. The Dodd- Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

- Final Volcker Rule. In December 2013, the federal bank regulatory agencies adopted final rules that implement a part of the Dodd-Frank Act commonly referred to as the "Volcker Rule." Under these rules and subject to certain exceptions, banking entities, including the Holding Company and the Bank, will be restricted from engaging in activities that are considered proprietary trading and from sponsoring or investing in certain entities, including hedge or private equity funds that are considered "covered funds." These rules were originally scheduled to become effective on April 1, 2014; however certain provisions are subject to delayed effectiveness under rules promulgated by the FRB. At December 31, 2017, neither the Holding Company nor the Bank held any investment positions which were subject to the Volcker Rule. Therefore, while these new rules may require the Holding Company and/or the Bank to conduct certain internal analyses and reporting, we believe that the rules will not require any material changes in their

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respective operations or business.

The Dodd-Frank Act was enacted under the administration of former President Barack Obama and many of the rules and regulations implementing the provisions of the Dodd-Frank Act were enacted during that administration. The current administration under President Trump has sought to roll-back key pieces of the Dodd-Frank Act in an effort to loosen regulatory restrictions on financial institutions including, but not limited to, easing the “Volker Rule,” stress tests and other constraints on financial institutions. Federal banking regulators are currently seeking public input on revisions to key provisions of the Dodd-Frank Act and its implementing regulations in order to effectuate the current Administration’s initiatives of continued financial deregulation. In light the current Administration’s continuing efforts in this regard, the Holding Company cannot predict which provisions of the Dodd-Frank Act will be repealed, put in to effect, delayed or enforced under the current Administration and, therefore, cannot predict the effect, if any, that the Dodd-Frank Act will have on the Holding Company's future operations and financial condition.

The Holding Company

General. As a bank holding company, the Holding Company is subject to regulation by the FRB. According to FRB Policy, the Holding Company is expected to act as a source of financial strength for the Bank, to commit resources to support it in circumstances where the Holding Company might not otherwise do so. Under the BHCA, the Holding Company is subject to periodic examination by the FRB. The Holding Company is also required to file periodic reports of its operations and any additional information regarding its activities and those of its subsidiaries as may be required by the FRB.

Bank Holding Company Liquidity. The Holding Company is 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. The Holding Company 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. 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 is 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 amount of the proposed distribution, or
- Immediately after the distribution, the value of the Holding Company's assets would equal or exceed the sum of its total liabilities.

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. The Holding Company's common stock is registered with the SEC under the Exchange Act and, therefore, is 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. The Holding Company is required to file annual, quarterly and other current reports with the SEC. The SEC maintains an Internet site, http://www.sec.gov, at which the Holding Company's filings with the SEC may be accessed. the Holding Company's SEC filings are also available on its website at http://investors.unitedsecuritybank.com/Docs.

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The Holding Company’s common stock is listed on NASDAQ and trades under the symbol “UBFO.” As a company listed on NASDAQ, the Holding Company is 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 Federal Reserve, 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;

- 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, 2017, 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, 2017 are set forth

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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;

- "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";

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"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.

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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

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, 2017 the Bank owned 28,152 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, 2017, the Bank was in compliance with these requirements.

Effect of Governmental Policies and Recent Legislation

Impact of Monetary Policies

Banking has traditionally been a business that depends on rate differentials. In general, the difference between the interest earned on loans extended to the Company's customers and securities held in the Company's portfolio and the interest paid by the Company on its deposits and other borrowings comprise the major portion of the Company's earnings. The amounts of interest earned and paid are impacted by the volumes of interest-earning assets and interest-bearing liabilities and the interest rates, which rates are highly sensitive to many factors that are beyond the control of the Company. Accordingly, the earnings and growth of the Company are subject to the influence of domestic and foreign economic conditions, including, but not limited to, inflation, recession and unemployment.

The earnings and growth of the Company are also affected by the monetary and fiscal policies of the United States government and its agencies, particularly the FRB. The FRB implements national monetary policies (with objectives such as to curb inflation and combat recession) by its open market operations in United States Government securities, by adjusting the required level of reserves for financial institutions subject to reserve requirements, and by varying the discount rates applicable to borrowing by banks. The actions of the FRB in these areas influence the growth of bank loans, investments and deposits and also affect interest rates charged on loans and paid on deposits. The FRB's policies have had a significant effect on the operating results of commercial banks and are expected to continue to do so in the future. The nature and timing of any future changes in monetary policies are not predictable; however, the FRB has indicated its intention of slowing raising interest rates from their current historic lows.

In addition, adverse economic conditions could make a higher provision for loan losses a prudent course and could cause higher loan charge-offs, thus adversely affecting the Company's net income.

Consumer Protection Laws and Regulations

The banking regulatory agencies are focusing greater attention on compliance with consumer protection laws and their implementing regulations. Examination and enforcement have become more intense in nature, and insured institutions have been advised to monitor carefully compliance with such laws and regulations. The Company is subject to many federal and state consumer protection and privacy statutes and regulations, some of which are discussed below.

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The Community Reinvestment Act (the “CRA”) is intended to encourage insured depository institutions to help meet the credit needs of their communities. The CRA specifically directs the federal regulatory agencies, in examining insured depository institutions, to assess a bank’s record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution’s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations. The agencies use the CRA assessment factors in order to provide a rating to the financial institution. The ratings range from a high of “outstanding” to a low of “substantial noncompliance.” In its last examination for CRA compliance, as of March 2015, the Bank was rated “satisfactory.”

The Equal Credit Opportunity Act (the “ECOA”) generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The Truth in Lending Act (the “TILA”) is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things. As a result of Dodd Frank, Regulation Z promulgated under TILA includes new limits on loan originator compensation for all closed-end mortgages. These changes include, prohibiting certain payments to a mortgage broker or loan officer based on the transaction’s terms or conditions, prohibiting dual compensation, and prohibiting a mortgage broker or loan officer from ‘‘steering’’ consumers to transactions not in their interest, to increase mortgage broker or loan officer compensation.

The Fair Housing Act (the “FH Act”) regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered, illegal under the FH Act, including some that are not specifically mentioned in the FH Act itself.

The Home Mortgage Disclosure Act (the “HMDA”), in response to public concern over credit shortages in certain urban neighborhoods, requires public disclosure of information that shows whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a "fair lending" aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes.

The Right to Financial Privacy Act (the “RFPA”) imposes a new requirement for financial institutions to provide new privacy protections to consumers. Financial institutions must provide disclosures to consumers of its privacy policy, and state the rights of consumers to direct their financial institution not to share their nonpublic personal information with third parties.

Finally, the Real Estate Settlement Procedures Act (the “RESPA”) requires lenders to provide noncommercial borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts.

Penalties for noncompliance or violations under the above laws may include fines, reimbursement and other penalties. Due to heightened regulatory concern related to compliance with CRA, ECOA, TILA, FH Act, HMDA, RFPA and RESPA generally, the Company has incurred additional compliance costs and has expended additional funds for investments in its local communities.

Other Aspects of Banking Law

The Bank is also be 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, 2017, the Company employed 128 persons on a full-time equivalent basis. The Company believes its employee relations are excellent.

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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 1B. - Unresolved Staff Comments

The Company had no unresolved staff comments at December 31, 2017.

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.

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.

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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 leases its financial services facility located at 5260 N. Palm Ave., Suite 215, Fresno, CA. The lease commenced on September 1, 2017 and expires on August 31, 2022.

The Company also has eight remote ATM 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

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PART II

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

Trading History

The Company became a NASDAQ National Market listed company on May 31, 2001, then became a Global Select listed company during 2006, and trades under the symbol UBFO.

The Company currently has four market makers for its common stock. These include, Stone & Youngberg, LLC, Howe Barnes Hoeffer & Arnett, Sandler O'Neill & Partners, and Hill Thompson, Magid & Company. The Company is aware of two other securities dealers: Smith Barney and Dean Witter Reynolds Inc., which periodically act as brokers in the Company's stock.

On March 28, 2006, the Company announced a 2-for-1 stock split of the Company's no-par common stock payable May 1, 2006 effected in the form of a 100% stock dividend. Share information for all periods presented in this 10-K have been restated to reflect the effect of the stock split.

During the third quarter ended September 30, 2008 and the fourth quarter ended December 31, 2008, the Company declared 1% stock dividends. During each of the thirty-two consecutive quarters beginning March 31, 2009 through December 31, 2016, the Company again declared 1% stock dividends. Share information for all periods presented in this Form 10-K has been restated to reflect the effect of the 1% stock dividends.

The following table sets forth the high and low closing sales prices by quarter for the Company's common stock, for the years ended December 31, 2017 and 2016.

	Closing Prices		Volume
Quarter	High	Low	
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
4th Quarter 2016	$8.10	$6.10	752,732
3rd Quarter 2016	$6.54	$5.73	490,366
2nd Quarter 2016	$6.44	$4.92	1,031,090
1st Quarter 2016	$5.30	$4.65	756,080

At December 31, 2017, there were approximately 606 record holders of common stock of the Company. This does not reflect the number of persons or entities who hold their stock in nominee or street name through various brokerage firms.

Dividends

The Company's shareholders are entitled to dividends when and as declared by the Company's Board of Directors out of funds legally available therefore. Dividends paid to shareholders by the Company are subject to restrictions set forth in California General Corporation Law, which provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal the amount of the proposed distribution. As a bank holding company without significant assets other than its equity position in the Bank, the Company's ability to pay dividends to its shareholders depends primarily upon dividends it receives from the Bank. Such dividends paid by the Bank to the Company are subject to certain limitations. See "Management's Discussion and Analysis of Financial and Results of Operations – Regulatory Matters".

The Company distributed a 1% stock dividend to shareholders on April 7, 2017, 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 Company distributed a 1% stock dividend to shareholders on January 15, 2016, April 15, 2016, July 18, 2016, and October 21, 2016.

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The amount and payment of dividends by the Company to shareholders are set by the Company's Board of Directors with numerous factors involved including the Company's 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 for December 31, 2017.

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	651,389
Equity compensation plans not approved by security holders	N/A		N/A	N/A
Total	94,601		$ 7.87	651,389

(1) Under the United Security Bancshares 2015 Equity Incentive Award Plan (2015 Plan), the Company is authorized to issue restricted stock awards. Restricted stock awards are not included in the total in column (a). At December 31, 2017, there were 46,511 shares of restricted stock issued and outstanding.

A complete description of the above plans is included in Note 10 of the Company’s Financial Statements, in Item 8 of this Annual Report on Form 10K, and is hereby incorporated by reference.

Purchases of Equity Securities by Affiliates and Associated Purchasers

On May 16, 2007, the Company announced a stock repurchase plan to repurchase, as conditions warrant, up to 846,127 shares of the Company's common stock on the open market or in privately negotiated transactions. The repurchase plan represents approximately 5.00% of the Company's currently outstanding common stock. The duration of the program is open-ended and the timing of purchases will depend on market conditions.

As of December 31, 2017, there were 732,556 shares available for repurchase. The Company did not repurchase any common shares during the years ended December 31, 2017 and 2016.

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

Overview

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

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The Company

United Security Bancshares is a California corporation incorporated during March of 2001 and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended. United Security Bank is a wholly-owned bank subsidiary of the Company and was formed in 1987.

Current Trends Affecting Results of Operations and Financial Position

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

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

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 2017. 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 the Company's operations and increased the levels of nonperforming assets, increased expenses related to foreclosed properties, and decreased profit margins. As the Company continues its business development and expansion efforts throughout its market areas, it will also maintain its commitment to the reduction of nonperforming assets and provision of options for borrowers experiencing difficulties. Those options include combinations of rate and term concessions, as well as forbearance agreements with borrowers. Median sales prices and housing start numbers improved in the five county region from Merced to Kern beginning in 2013.

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

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

Application of Critical Accounting Policies and Estimates

The Company's consolidated financial statements are prepared in accordance with generally accepted accounting principles and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently may result in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When third-party information is not available, valuation adjustments are estimated using the Company's own assumptions in regard to the assumptions that market participants would use in pricing the asset or liability.

The most significant accounting policies followed by the Company are presented in Note 1 to the Company's 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

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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 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 the Company’s market area, or general economic trends, fluctuate.

Fair Value

Effective January 1, 2007, the Company adopted fair value option accounting standards choosing to apply the standards to its junior subordinated debt. The Company 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, 2017 and 2016, the Company recorded fair value adjustments related to its junior subordinated debt totaling losses of $882,000 and $518,000, respectively. (See Notes 8 and 13 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 the Company's 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 the Company’s 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 the Company’s income will be reduced. The Company recorded no valuation allowance against its deferred tax assets at December 31, 2017 and 2016.

On January 1, 2007, the Company 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-

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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, the Company will continue to re-evaluate existing tax positions, as well as new positions as they arise. If the Company determines in the future that its tax positions are not “more likely than not” to be sustained (as defined) by taxing authorities, the Company may need to recognize additional tax liabilities.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017, was signed into law, reducing the federal corporate tax rate to 21% from the existing maximum rate of 35%, effective January 1, 2018. As a result, The Company’s net deferred tax asset was revalued at the new lower tax rate as of December 31, 2017.

Impairment of Investment Securities

Investment securities are impaired when the amortized cost exceeds fair value. 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. 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, 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 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

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

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

Results of Operations

On a year-to-date basis, the Company reported net income of $8,640,000 or $0.51 per share ($0.51 diluted) for the year ended December 31, 2017, as compared to $7,385,000 or $0.44 per share ($0.44 diluted) for the same period in 2016. The increase of $1,255,000 between December 31, 2016 and December 31, 2017 is primarily the result of increases in interest-earning assets. Interest income increased by $3,457,000 between December 31, 2016 and December 31, 2017. Non-interest income decreased by $208,000.

The Company’s return on average assets was 1.07% for the year ended December 31, 2017, and 0.98%year ended December 31, 2016. The Company’s return on average equity was 8.63% for the year ended December 31, 2017, as compared to 7.86% for the year ended December 31, 2016.

As with variances in net income, changes in the return on average assets and average equity experienced by the Company during 2017 and 2016 were effected by increases in average loan balances and net interest income.

The following table sets forth certain selected financial data for the Bank for each of the years in the five-year periods ended December 31, 2017, and should be read in conjunction with the more detailed information and financial statements contained elsewhere herein (in thousands except per share data and ratios).

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(In thousands except per share data and ratios)	2017		2016		2015		2014		2013	
Selected Financial Ratios:										
Return on average assets	1.07	%	0.98	%	0.98	%	0.93	%	1.13	%
Return on average shareholders' equity	8.63	%	7.86	%	7.88	%	7.80	%	10.09	%
Average shareholders' equity to average assets	12.46	%	12.43	%	12.41	%	11.88	%	11.20	%
Dividend payout ratio	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 for credit losses totaled $31,200,000 for the year ended December 31, 2017, representing an increase of $3,136,000, or 11.17%, when compared to the $28,064,000 reported for the same period of the previous year. Although market rates of interest are at historically low levels, the Company’s disciplined deposit pricing efforts have helped maintain adequate margins. The Company’s net interest margin, as shown in Table 1, increased to 4.27% for the year ended December 31, 2017, when compared to 4.11% for the year ended December 31, 2016, and increased from 4.22% for the year ended December 31, 2015.

Table 1. – Distribution of Average Assets, Liabilities and Shareholders’ Equity:
Interest rates and interest differentials
Years ended December 31, 2017, 2016, and 2015

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	2017			2016			2015		
(Dollars in thousands)	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
Assets:									
Interest-earning assets:									
Loans and leases (1)	$569,079	$30,817	5.42 %	$540,777	$28,182	5.21 %	$493,375	26,469	5.36 %
Investment Securities – taxable	52,513	901	1.72 %	49,612	825	1.66 %	40,616	722	1.78 %
Interest-bearing deposits in other banks	644	5	0.78 %	1,517	8	0.53 %	1,525	6	0.39 %
Interest-bearing deposits in FRB	108,218	1,207	1.12 %	90,393	458	0.51 %	83,709	213	0.25 %
Total interest-earning assets	730,454	$32,930	4.51 %	682,299	$29,473	4.32 %	619,225	27,410	4.43 %
Allowance for credit losses	(9,067)			(9,311)			(11,357)		
Noninterest-earning assets:									
Cash and due from banks	22,225			21,886			22,279		
Premises and equipment, net	10,613			10,497			11,174		
Accrued interest receivable	4,594			2,568			1,601		
Other real estate owned	5,998			9,100			13,466		
Other assets	39,313			36,658			40,086		
Total average assets	$804,130			$753,697			$696,474		
Liabilities and Shareholders' Equity:									
Interest-bearing liabilities:									
NOW accounts	$87,867	$117	0.13 %	$85,357	$111	0.13 %	$79,977	108	0.14 %
Money market accounts	154,629	703	0.45 %	148,911	567	0.38 %	139,220	461	0.33 %
Savings accounts	79,202	183	0.23 %	67,590	145	0.21 %	62,163	159	0.26 %
Time deposits	76,856	423	0.55 %	73,680	344	0.47 %	74,193	328	0.44 %
Junior subordinated debentures	9,211	304	3.30 %	8,058	242	3.00 %	9,410	225	2.39 %
Total interest-bearing liabilities	407,765	$1,730	0.42 %	383,596	$1,409	0.37 %	364,963	$1,281	0.35 %
Noninterest-bearing liabilities:									
Noninterest-bearing checking	289,334			268,712			237,034		
Accrued interest payable	102			81			73		
Other liabilities	6,769			7,592			8,005		
Total average liabilities	703,970			659,981			610,075		
Total average shareholders' equity	100,160			93,716			86,399		
Total average liabilities and shareholders' equity	$804,130			$753,697			$696,474		
Interest income as a percentage of average earning assets			4.51 %			4.32 %			4.43 %
			0.24 %			0.21 %			0.21 %

Interest expense as a percentage of average earning assets			
Net interest margin	4.27 %	4.11 %	4.22 %

(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 $537 for the year ended December 31, 2017, loan costs of approximately $163 for the year ended December 31, 2016, and loan fees of $163 for the year ended December 31, 2015.

The prime rate rose from 3.75% to 4.50% during 2017 and is expected to see further increases during 2018. These increases will affect rates for both loans and customer deposits, both of which are likely to increase as the prime rate increases.

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Both the Company's net interest income and net interest margin are affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as "volume change." Both are also affected by changes in yields on interest-earning assets and rates paid on interest-bearing liabilities, referred to as "rate change." The following table sets forth the changes in interest income and interest expense for each major category of interest-earning asset and interest-bearing liability, and the amount of change attributable to volume and rate changes for the 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

	2017 compared to 2016			2016 compared to 2015		
(In thousands)	Total	Rate	Volume	Total	Rate	Volume
Increase (decrease) in interest income:						
Loans	$2,635	$1,216	1,419	$1,713	$(774)	2,487
Investment securities	76	30	46	103	(49)	152
Interest-bearing deposits in other banks	(3)	5	(8)	(205)	(205)	—
Interest-bearing deposits in FRB	749	535	214	452	418	34
Total interest income	3,457	1,786	1,671	2,063	(610)	2,673
Increase (decrease) in interest expense:						
Interest-bearing demand accounts	142	118	24	109	68	41
Savings accounts	38	12	26	(14)	(27)	13
Time deposits	79	64	15	16	18	(2)
Subordinated debentures	62	26	36	17	52	(35)
Total interest expense	321	220	101	128	111	17
Increase (decrease) in net interest income	$3,136	$1,566	1,570	$1,935	$(721)	2,656

The net interest margin rose in 2017 due to increase in loan portfolio yields, yields of overnight investments with the Federal Reserve Bank, and investment securities yields. The Company has successfully sought to mitigate the low interest rate environment with loan floors included in new and renewed loans when practical. Loans yielded 5.42% during the year ended December 31, 2017, as compared to 5.21% and 5.36% for the years ended December 31, 2016 and 2015, respectively. For the year ended December 31, 2017, total interest income increased approximately $3,457,000, or 11.73%, as compared to the year ended December 31, 2016, reflective of an increase of $2,635,000 in loan interest income. 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 increase in average earning assets between 2017 and 2016 consisted of increases of $28,302,000 in loans, increases of $17,825,000 in interest-bearing deposits held at the Federal Reserve Bank, and increases of $2,901,000 in investment securities. Average interest-earning assets increased approximately $63,074,000 between 2016 and 2015 and the rate on interest earning assets decreased 11 basis points during the two periods. The average rates on loans decreased 15 basis points between the two periods, and the average rate on investment securities decreased approximately 12 basis points during the year ended December 31, 2016, as compared to the same period of 2015. The rate on interest earning assets decreased during the year ended December 31, 2016 due to decreases in loan and overnight deposit yields.

For the year ended December 31, 2017, total interest expense increased approximately $321,000, or 22.78%, as compared to the year ended December 31, 2016. Between those two periods, average interest-bearing liabilities increased by $24,169,000, and the average rates paid on these liabilities increased by 5 basis points. CDARs reciprocal deposits, which are preferred by some depositors, have decreased from $10.8 million to $7.4 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 12/31/17	YTD Average 12/31/16	YTD Average 12/31/15
Loans	77.91 %	79.26 %	79.68 %
Investment securities available for sale	7.18 %	7.27 %	6.56 %
Interest-bearing deposits in other banks	0.09 %	0.22 %	0.25 %
Interest-bearing deposits in FRB	14.82 %	13.25 %	13.51 %
Total earning assets	100.00 %	100.00 %	100.00 %
NOW accounts	21.55 %	22.25 %	21.91 %
Money market accounts	37.92 %	38.82 %	38.15 %
Savings accounts	19.42 %	17.62 %	17.03 %
Time deposits	18.85 %	19.21 %	20.33 %
Subordinated debentures	2.26 %	2.10 %	2.58 %
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 sufficient to cover risk elements in the loan portfolio.
For the year ended December 31, 2017, the provision to the allowance for credit losses totaled $24,000. The recovery of provision for the year ended December 31, 2016 totaled $21,000. The recovery of provision for the year ended December 31, 2015 totaled $41,000.

The allowance for credit losses decreased to 1.54% of total loans during the year ended December 31, 2017, as compared to 1.56% at December 31, 2016, and 1.88% at December 31, 2015. The negative loan loss provisions recorded during 2015 and 2016, and the provision of $24,000 recorded during 2017, are a result of continuing improvements in the overall credit quality of the loan portfolio, overall improvements in economic conditions over the recent years, and improvements in loans 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)	2017	% of Total	2016	% of Total	2015	% of Total
Customer service fees	$3,851	89.43 %	$3,792	84.01 %	$3,620	76.45 %
Increase in cash surrender value of BOLI/COLI	534	12.40 %	530	11.74 %	$519	10.96 %
Loss on fair value option of financial liabilities	(882)	(20.48)%	(518)	(11.48)%	$(73)	(1.54)%
Gain on sale of other assets	73	1.70 %	—	0.00 %	$10	0.21 %
Gain on redemption of junior subordinated debenture	—	0.00 %	—	0.00 %	$78	1.65 %
Gain (loss) on other investments	3	0.07 %	—	0.00 %	$(23)	(0.49)%
Other	727	16.88 %	710	15.73 %	$604	12.76 %

Total	$4,306	100.00 %	$4,514	100.00 %	$4,735	100.00 %

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

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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, the primary component of noninterest income, increased $59,000 or 1.56% between the two periods presented. The decrease in noninterest income of $208,000 between the two periods is the result of a loss on the fair value of a liability of $882,000 during 2017 as compared to a loss of $518,000 during 2016, partially offset by the increase in customer services fees. The change in the fair value of financial liability was primarily caused by fluctuations in the LIBOR yield curve. The cost of the Company's subordinated debentures issued by USB Capital Trust II has remained low 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 3.20% and 2.29% at December 31, 2017 and 2016, respectively.

Noninterest income for the year ended December 31, 2016, decreased $221,000 or 4.67% when compared to the same period of 2015. Customer service fees increased $172,000 or 4.75% between the two periods. The decrease in noninterest income of $221,000 is the result of a loss on the fair value of a liability of $518,000 during 2016 as compared to a loss of $73,000 during 2015, 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, 2017, 2016, and 2015:

(Dollars in thousands)	2017 Amount	2017 % of Average Earning Assets	2016 Amount	2016 % of Average Earning Assets	2015 Amount	2015 % of Average Earning Assets
Salaries and employee benefits	$10,821	1.48 %	$10,628	1.56 %	$9,921	1.60 %
Occupancy expense	4,254	0.58 %	4,222	0.62 %	4,042	0.65 %
Data processing	119	0.02 %	148	0.02 %	126	0.02 %
Professional fees	1,433	0.20 %	1,493	0.22 %	1,137	0.18 %
FDIC/DFI assessments	391	0.05 %	767	0.11 %	959	0.15 %
Directors fees	289	0.04 %	284	0.04 %	277	0.04 %
Correspondent bank service charges	—	— %	—	— %	—	— %
Loss on CA Tax Credit Partnership	109	0.01 %	158	0.02 %	73	0.01 %
Net (gain) cost on operation and sale of OREO	(150)	(0.02)%	263	0.04 %	619	0.10 %
Other	2,537	0.35 %	2,382	0.35 %	2,444	0.39 %
Total	$19,803	2.71 %	$20,345	2.98 %	$19,598	3.14 %

Noninterest expense decreased $542,000 or 2.66% between the years ended December 31, 2017 and 2016. The net decrease in noninterest expense between the comparative periods is primarily the result of decreases in net cost on operation and sale of OREO and regulatory assessments, partially offset by increases in salaries. Noninterest expense increased $747,000 between the years ended December 31, 2016 and 2015, due to increases in salaries and employee benefits and occupancy expense, partially offset by a decreases in regulatory assessments and the net cost on operation and sale of OREO.

Included in net costs on operations of OREO for the years ended December 31, 2017 and 2016, are gains on the sale of OREO totaling $336,000 and $37,000, respectively, and OREO operating expenses totaling $186,000 and $300,000, respectively. There were no impairment losses on OREO recorded during the years ended 2016 and 2017.

During the years ended December 31, 2017 and 2016, the Company recognized stock-based compensation expense of $97,000 and $26,000 (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

The Company's income tax expense is impacted to some degree by permanent taxable differences between income reported for book purposes and income reported for tax purposes, as well as certain tax credits which are not reflected in the Company's

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pretax income or loss shown in the statements of operations and comprehensive income. As pretax income or loss amounts become smaller, the impact of these differences become more significant and are reflected as variances in the Company's effective tax rate for the periods presented. In general, the permanent differences and tax credits affecting tax expense have a positive impact and tend to reduce the effective tax rates shown in the Company's statements of operations and comprehensive income. As of December 31, 2017 the effective tax rate rose to 45%, from 40% as a result of the 2017 Tax Cuts and Jobs Act. As a result of this rate change the Company's net deferred tax asset was revalued resulting in a write-down of $986,000. The impact to earnings for the fourth quarter 2017 is $0.06 per share.

The Company reviews its 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.

The Company has reviewed all of its tax positions as of December 31, 2017, and has determined that there are no material amounts that should be recorded under the current income tax accounting guidelines.

Financial Condition

Total assets increased by $17,864,000 or 2.27% during the year from a balance of $787,972,000 at December 31, 2016 to $805,836,000 at December 31, 2017, and increased $80,192,000 or 11.05% from the balance of $725,644,000 at December 31, 2015. During the year ended December 31, 2017, increases of $31,191,000 were experienced in net loans. Overnight interest-bearing deposits in the Federal Reserve Bank and federal funds sold decreased a net $14,554,000, and 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 of $676,629,000 reported at December 31, 2016, and increased $65,888,000, or 10.60%, from the balance of $621,805,000 reported at December 31, 2015.

During the year ended December 31, 2016, increases of $56,269,000 were experienced in net loans. Overnight interest-bearing deposits in the Federal Reserve Bank and federal funds sold decreased a net $8,767,000, while investment securities increased by $26,598,000 during the year ended December 31, 2016. Total deposits of $676,629,000 at December 31, 2016 increased $54,824,000, or 8.82%, from the balance reported at December 31, 2015 of $621,805,000, and $111,256,000 or 19.68% from the balance of $563,287,000 reported at December 31, 2014.

Earning assets averaged approximately $730,454,000 during the year ended December 31, 2017, as compared to $682,299,000 for the year ended December 31, 2016. Average interest-bearing liabilities increased to $407,765,000 for the year ended December 31, 2017, as compared to $383,596,000 for the year ended December 31, 2016.

Loans

The Company's primary business is that of acquiring deposits and making loans, with the loan portfolio representing the largest and most important component of its earning assets. Loans totaled $601,351,000 at December 31, 2017, representing an increase of $31,592,000, or 5.54%, when compared to the balance of $569,759,000 at December 31, 2016. During 2017, average loans increased 5.23% when compared to the year ended December 31, 2016. Average loans totaled $569,079,000, $540,777,000, and $493,375,000 for the years ended December 31, 2017, 2016 and 2015, 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:

(In thousands)	2017 Dollar Amount	% of Loans	2016 Dollar Amount	% of Loans	2015 Dollar Amount	% of Loans	2014 Dollar Amount	% of Loans	2013 Dollar Amount	% of Loans
Commercial and Industrial	$47,026	7.8 %	$49,005	8.6 %	$55,826	10.8 %	$62,369	13.6 %	$70,686	17.9 %
Real estate mortgage	306,293	50.9 %	288,200	50.6 %	252,232	48.9 %	214,877	46.9 %	197,365	49.9 %
RE construction & development	122,970	20.4 %	130,687	22.9 %	130,596	25.3 %	137,158	30.0 %	87,004	22.0 %
Agricultural	59,481	9.9 %	56,918	10.0 %	52,137	10.1 %	31,713	6.9 %	30,932	7.8 %
Installment/other	65,581	10.9 %	44,949	7.9 %	24,527	4.9 %	11,802	2.6 %	9,330	2.4 %
Total Loans	$601,351	100.0%	$569,759	100.0%	$515,318	100.0%	$457,919	100.0%	$395,317	100.0%

Loan volume continues to be highest in what has historically been the Bank's primary lending emphasis: commercial, real estate mortgage, and construction lending. Total loans increased $31,592,000 during 2017. There were increases of $18,093,000, or 6.28%, in real estate mortgage loans, $20,632,000, or 45.9%, in installment loans, and $2,563,000, or 4.5%, in agriculture loans when compared to the previous year. Real estate construction and development loans decreased $7,717,000, or 5.90%, and commercial and industrial loans decreased $1,979,000, or 4.04%.

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 36.76% and 35.14%, of the total loan portfolio at December 31, 2017 and December 31, 2016, respectively. Commercial real estate loans increased $20,819,000 during 2017. Residential mortgage loans are not generally a large part of the Company's loan portfolio, but some residential mortgage loans have been made over the past few years to facilitate take-out loans for construction borrowers who were unable to obtain permanent financing elsewhere. Additionally, the Company purchases residential mortgage pools. Residential mortgage loans are generally 30-year amortizing loans with maturities of between three and five years. These loans totaled $84,804,000 or 14.10% of the portfolio at December 31, 2017, and $87,388,000, or 15.34% of the portfolio at December 31, 2016. The Bank held no purchased loan participations at December 31, 2017 or December 31, 2016. Loan participations sold increased from $3,760,000 or 0.7% of the portfolio at December 31, 2016, to $7,535,000, or 1.3%, at December 31, 2017.

During 2016, the Company experienced an increase of $35,968,000, or 14.3%, in real estate mortgage loans, an increase of $20,422,000, or 83.3%, in installment loans, an increase of $4,781,000, or 9.2%, in agricultural loans, and an increase of $91,000, or 0.1%, in construction loans.

At December 31, 2017, approximately 56.1% 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. Residential housing markets continued to strengthen during 2017, and, as a result, real estate mortgage loans increased $18,093,000. Real estate construction loans decreased $7,717,000, or 5.9%, during 2017, as compared to an increase in real estate construction loans of $91,000, or 0.1%, during 2016. 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 $2,563,000, or 4.5%, between December 31, 2016 and December 31, 2017. Commercial loans, consisting primarily of loans for non real estate business operations, decreased $1,979,000, or 4.04%.

The real estate mortgage loan portfolio totaling $306,293,000 at December 31, 2017, consists of commercial real estate, residential mortgages, and home equity loans. Commercial real estate is the predominate segment of the portfolio, with balances of $221,032,000, and $200,213,000 at December 31, 2017 and 2016, 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 had balances of $84,804,000 and $87,388,000 at December 31, 2017 and 2016, respectively. The Company's home equity loan portfolio totaled $457,000 at December 31, 2017, and $599,000 at December 31, 2016.

Included within the installment loan portfolio are $60,595,000 in student loans as of December 31, 2017, as compared to $38,514,000 at December 31, 2016. The student loan portfolio consists of unsecured loans to medical and pharmacy students

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currently enrolled in medical and pharmacy schools in the US and the Caribbean. Loan interest rates range from 3.875% to 8.875%. These loans are typically insured through a Surety Bond issued by ReliaMax Surety Company. At December 31, 2017, $6,473,000 in loans were in repayment compared to $3,759,000 as of December 31, 2016. Accrued interest on student loans was $4,261,000 and $1,850,000 as of December 31, 2017 and 2016, respectively.

The following table sets forth the maturities of the Bank's loan portfolio at December 31, 2017. Amounts presented are shown by maturity dates rather than repricing periods:

(In thousands)	Due in one year or less	Due after one year through five years	Due after five years	Total
Commercial and agricultural	$41,288	$30,683	$34,537	$106,508
Real estate construction & development	73,686	46,944	2,340	122,970
Real estate – mortgage	38,290	111,910	156,093	306,293
All other loans	2,917	1,721	60,942	65,580
Total Loans	$156,181	$191,258	$253,912	$601,351

For the year ended December 31, 2017 and 2016, the average yield on loans was 5.42% and 5.21%, respectively. The Company utilizes rate floors intended to mitigate interest rate risk if interest rates fall, as well as to compensate the Company for additional credit risk under current market conditions. The Bank’s 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, 2017 and 2016, approximately 52.0% and 45.3% of the Bank's 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, 2017. Amounts presented are shown by maturity dates rather than repricing periods, and do not consider renewals or prepayments of loans:

(In thousands)	Due in one year or less	Due after one Year through Five years	Due after Five years	Total
Accruing loans:				
Fixed rate loans	$75,383	$142,286	$43,865	$261,534
Floating rate loans	75,503	109,848	149,171	334,522
Total accruing loans	150,886	252,134	193,036	596,056
Nonaccrual loans:				
Fixed rate loans	5,102	—	—	5,102
Floating rate loans	194	—	—	194
Total nonaccrual loans	5,296	—	—	5,296
Total Loans	$156,182	$252,134	$193,036	$601,352

Securities

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

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(In thousands)	December 31, 2017 Amortized Cost	December 31, 2017 Fair Value (Carrying Amount)	December 31, 2016 Amortized Cost	December 31, 2016 Fair Value (Carrying Amount)	December 31, 2015 Amortized Cost	December 31, 2015 Fair Value (Carrying Amount)
Available-for-sale:						
U.S. Government agencies	$19,683	$ 19,954	$22,992	$ 23,203	$9,778	$ 10,123
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	22,391	22,031	30,867	30,572	16,835	16,958
Mutual Funds	4,000	3,737	4,000	3,716	4,000	3,812
Total available-for-sale	$46,074	$ 45,722	$57,859	$ 57,491	$30,613	$ 30,893

The contractual maturities of investment securities as well as yields based on amortized cost of those securities at December 31, 2017 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	One year or less Amount	Yield (1)	After one year to five years Amount	Yield (1)	After five years to ten years Amount	Yield (1)	After ten years Amount	Yield (1)	Total Amount	Yield (1)
Available-for-sale:										
U.S. Government agencies	$—	— %	$—	— %	$688	1.16%	$18,995	1.41%	$19,683	1.40%
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	94	2.14%	4,498	2.40%	6,996	2.41%	10,803	3.17%	22,391	2.77%
Mutual Funds	4,000	2.02%	—	— %	—	— %	—	— %	4,000	2.02%
Total amortized cost	$4,094	2.02%	$4,498	2.40%	$7,684	2.30%	$29,798	2.05%	$46,074	2.12%

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

At December 31, 2017 and 2016, available-for-sale securities with an amortized cost of approximately $34,780,746 and $19,653,625, respectively (fair value of $34,542,543 and $16,670,290, respectively) were pledged as collateral for public funds and FHLB borrowings.

Deposits

The 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 97.0% and 93.5% of the total deposit portfolio at December 31, 2017 and 2016, respectively. The Company continues to maintain a low reliance on brokered deposits while maintaining sufficient liquidity. Brokered deposits totaled $7,421,000 or 1.08% of total deposits at December 31, 2017, as compared to $28,132,000, or 4.16% at December 31, 2016.

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:

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	December 31,				
(In thousands)	2017	2016	2015	2014	2013
Noninterest-bearing deposits	$307,299	$262,697	$262,168	$215,439	$214,317
Interest-bearing deposits:					
NOW and money market accounts	234,154	235,873	226,886	211,290	198,928
Savings accounts	81,408	75,068	63,592	60,499	45,758
Time deposits:					
Under $250,000	51,687	87,419	58,122	65,844	28,825
$250,000 and over	13,145	15,572	11,037	12,301	54,661
Total interest-bearing deposits	380,394	413,932	359,637	349,934	328,172
Total deposits	$687,693	$676,629	$621,805	$565,373	$542,489

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

	December 31,				
	2017	2016	2015	2014	2013
Noninterest-bearing deposits	44.69 %	38.82 %	42.16 %	38.11 %	39.51 %
Interest-bearing deposits:					
NOW and money market accounts	34.05 %	34.86 %	36.49 %	37.37 %	36.67 %
Savings accounts	11.84 %	11.09 %	10.23 %	10.70 %	8.43 %
Time deposits:					
Under $250,000	7.52 %	12.92 %	9.35 %	11.65 %	5.31 %
$250,000 and over	1.91 %	2.30 %	1.77 %	2.18 %	10.08 %
Total interest-bearing deposits	55.31 %	61.18 %	57.84 %	61.89 %	60.49 %
Total deposits	100.00 %	100.00 %	100.00 %	100.00 %	100.00 %

The Company's 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, 2017, noninterest-bearing deposits increased $44,602,000, or 16.98%. Total time deposits decreased $38,159,000, or 37.05%, during the year ended December 31, 2017, and brokered deposits, a component of total time deposits, decreased by $20,711,000, or 73.62%, during the year. Savings accounts increased $6,340,000, or 8.45%, and NOW and money market decreased $1,719,000, or 0.73%, during the year ended December 31, 2017.

During the year ended December 31, 2016, increases were experienced across all categories. Total time deposits increased $33,832,000, or 48.92%, during the year ended December 31, 2016, and brokered deposits, a component of total time deposits, increased $19,586,000, or 4.16%, during the year. Increases in savings accounts and NOW and money market accounts of $11,476,000, or 18.05%, and $8,987,000, or 3.96%, respectively, were realized during the year ended December 31, 2016. Noninterest-bearing deposits increased $529,000 during the year.

On a year-to-date average basis, total deposits increased $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, the Company experienced increases in all deposit account categories between the years ended December 31, 2016 and December 31, 2017. On a year-to-date average basis, total deposits increased by $51,663,000, or 8.7%, between the years ended December 31, 2015 and December 31, 2016. Of that total, interest-bearing deposits increased by $19,985,000, or 5.60%, and noninterest-bearing deposits increased $31,678,000, or 13.36%, during 2016. On average, the Company experienced decreases in time deposits, while NOW accounts, money market and savings accounts increased between the years ended December 31, 2015 and December 31, 2016.

The following table sets forth the average deposits and average rates paid on those deposits for the years ended December 31, 2017, 2016, and 2015:

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(Dollars in thousands)	2017 Average Balance	Rate %	2016 Average Balance	Rate %	2015 Average Balance	Rate %
Interest-bearing deposits:						
Checking accounts	$242,496	0.34%	$234,268	0.29%	$219,197	0.26%
Savings	79,202	0.23%	67,590	0.21%	62,163	0.26%
Time deposits (1)	76,856	0.55%	73,680	0.47%	74,193	0.44%
Noninterest-bearing deposits	289,334		268,712		237,034	

(1) Included at December 31, 2017, are $13,145,000 in time certificates of deposit of $250,000 or more, of which $2,245,000 matures in three months or less, $5,868,000 matures in four to twelve months, and $3,980,000 matures in one to three years.

Short-term Borrowings

The Company has 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. The Company has 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. The Company may continue to borrow funds in the future as part of its asset/liability strategy, and may use these funds to acquire certain other assets as deemed appropriate by 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 the Company’s asset/liability management strategy. FHLB advances are collateralized by the Company’s investment in FHLB stock, securities, and certain qualifying mortgage loans. In addition, the Company has the ability to obtain borrowings from the Federal Reserve Bank of San Francisco ("FRB"), collateralized by certain pledged loans in the Company’s 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 the Company’s financial position.

The Company had collateralized lines of credit with the FRB of $305,236,000 and $323,162,000, as well as FHLB lines of credit totaling $13,363,000 and $2,037,000 at December 31, 2017 and 2016, 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, 2017, the Company 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 the Company's principal business activity, and ensuring appropriate evaluation, diversification, and control of credit risks is a primary management responsibility. Losses are implicit in lending activities and the amount of such losses will vary, depending on the risk characteristics of the loan portfolio as affected by local economic conditions and the financial experience of borrowers.

The allowance for credit losses is maintained at a level deemed appropriate by management to provide for known and inherent risks in existing loans and commitments to extend credit. The adequacy of the allowance for credit losses is based upon management's continuing assessment of various factors affecting the collectability of loans and commitments to extend credit; including current economic conditions, past credit experience, collateral, and concentrations of credit. There is no precise method of predicting specific losses or amounts which may ultimately be charged off on particular segments of the loan portfolio. The conclusion that a loan may become uncollectible, either in part or in whole is 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, the Company follows, in accordance with GAAP, the guidelines set forth in the Revised Interagency Policy Statement on the Allowance for Loan and Lease Losses ("Statement") issued by banking regulators in December 2006. The Statement is a revision of the previous guidance released in July 2001, and outlines characteristics that should be used in segmentation of the loan portfolio for purposes of the analysis including risk classification, past due status, type of loan, industry or collateral. It also outlines factors to consider when adjusting the loss factors for various segments of the loan portfolio, and updates previous guidance that describes the responsibilities of the board of directors, management, and bank examiners regarding the allowance for credit losses. Securities and Exchange Commission Staff Accounting Bulletin No.

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102 was released during July 2001, and represents the SEC staff's view relating to methodologies and supporting documentation for the Allowance for Loan and Lease Losses that should be observed by all public companies in complying with the federal securities laws and the Commission's interpretations. It is also generally consistent with the guidance published by the banking regulators.

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

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

Loan Segments for Loan Loss Reserve Analysis	Loan Balances at December 31,				
(Dollars in thousands)	2017	2016	2015	2014	2013
Commercial and Business Loans	$46,065	$47,464	$54,503	$60,422	$68,460
Government Program Loans	961	1,541	1,323	1,947	2,226
Total Commercial and Industrial	47,026	49,005	55,826	62,369	70,686
Commercial Real Estate Term Loans	221,032	200,213	182,554	154,672	143,919
Single Family Residential Loans	84,804	87,388	68,811	59,095	52,036
Home Improvement/Home Equity Loans	457	599	867	1,110	1,410
Total Real Estate Mortgage	306,293	288,200	252,232	214,877	197,365
RE Construction and Development Loans	122,970	130,687	130,596	137,158	87,004
Agricultural Loans	59,481	56,918	52,137	31,713	30,932
Installment/other (1)	65,581	44,949	24,527	11,802	9,330
Total Loans	$601,351	$569,759	$515,318	$457,919	$395,317

(1) Consumer Loans

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
- and the unallocated allowance.

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

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

Management determines the loss factors for problem graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates loan losses over the previous quarters as determined by management (time horizons adjusted as business cycles or environment changes) and loss factors are adjusted to recognize and quantify the loss exposure from changes in market conditions and trends in the Company's loan portfolio. For purposes of this analysis, loans are grouped by internal risk classifications and categorized as pass, special mention, substandard, doubtful, or loss. Certain loans are homogeneous in nature and are therefore pooled by risk grade. These homogeneous loans include consumer installment and home equity loans. Special mention loans are currently performing but

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are potentially weak, as the borrower has begun to exhibit deteriorating trends which, if not corrected, could jeopardize repayment of the loan and result in further downgrades. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as doubtful has critical weaknesses that make full collection of the obligation improbable. Classified loans, as defined by the Company, include impaired loans and loans categorized as substandard, doubtful, and loss which are not considered impaired. At December 31, 2017, impaired and classified loans totaled $27,311,000, or 4.54%, of gross loans as compared to $29,838,000, or 5.24%, of gross loans at December 31, 2016.

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

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 the Company's historical loss experience and other loss factors, rather than specific loss contingencies. At December 31, 2017 and 2016, the formula reserve allocated to undisbursed commitments totaled $329,000 and $337,000, 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 the key lending areas of the Company, 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, 2017, 2016 and 2015.

(In thousands)	December 31, 2017	December 31, 2016	December 31, 2015
Specific allowance – impaired loans	$ 1,888	$ 1,360	$ 3,097
Formula allowance – classified loans not impaired	1,136	1,226	1,385
Formula allowance – special mention loans	181	248	75
Total allowance for special mention and classified loans	3,205	2,834	4,557
Formula allowance for pass loans	4,806	5,371	5,086
Unallocated allowance	1,256	697	70
Total allowance	9,267	8,902	9,713
Impaired loans	14,790	16,179	23,612
Classified loans not considered impaired	12,521	13,659	15,900
Total classified and impaired loans	27,311	29,838	39,512

Special mention loans not considered impaired	10,201	5,965	2,562

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

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(Dollars in thousands)	December 31, 2017	December 31, 2016	December 31, 2015
Allowance for loan losses - period end	$9,267	$8,902	$9,713
Net loans (recovered) charged off during period	(341)	(790)	1,017
Provision (recovery of provision) for credit loss	24	(21)	(41)
Loans outstanding at period-end	601,351	569,759	515,381
ALLL as % of loans at period-end	1.54 %	1.56 %	1.88 %
Nonaccrual loans	5,296	7,264	8,193
Accruing restructured loans	6,084	5,146	11,028
Loans, past due 90 days or more, still accruing	485	1,250	—
Total non-performing loans	11,865	13,660	19,221
ALLL as % of nonperforming loans	78.10 %	65.17 %	50.53 %
Impaired loans	14,790	16,179	23,612
Classified loans not considered impaired	12,521	13,659	15,900
Total classified and impaired loans	$27,311	$29,838	$39,512
ALLL as % of classified loans	33.93 %	29.83 %	24.58 %

Impaired loans decreased $1,389,000 between December 31, 2016 and December 31, 2017 though the specific allowance related to those impaired loans increased $528,000 between December 31, 2016 and December 31, 2017 which was a result of payoffs throughout the year and the addition of newly identified impaired loans requiring specific reserves. The formula allowance related to criticized loans that are not impaired (including special mention and substandard) decreased by $157,000 between December 31, 2016 and December 31, 2017 through overall credit quality improvements. The level of “pass” loans increased approximately $29,907,000 between December 31, 2016 and December 31, 2017, while the related formula allowance decreased $565,000 during the same period. The formula allowance for "pass loans" is derived from loss factors using migration analysis and management's consideration of qualitative factors. The formula allowance for "pass loans" declined due to net recoveries in recent years resulting in lower loss factors as compared to prior years. The unallocated reserve totaled $1,256,000, or 13.6%, of the total ALLL at December 31, 2017. The increase in the unallocated reserve was a function of management's consideration of the inherent risks impacting the loan portfolio not reflected in the loss factors or qualitative factors. In evaluating the level of the unallocated reserve, management considered the Company's loan relationship and C&LD concentrations and its loss history relative to peers.

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

The general reserve requirements (ASC 450-70) decreased with the continued strengthening of local, state, and national economies and their impact on our local lending base, which has resulted in a lower qualitative component for the general reserve calculation. These positive factors were partially offset by the Company including OREO financial results in loss history and extending the look back period used to capture the loss history for the quantitative portion of the ALLL. In the third quarter of 2013, the look back period was changed from 4 years to stake-in-the-ground (December 31, 2005), in an effort to include higher losses experienced during the credit crisis. Changes in the mix of historical losses in the look back period resulted in a reallocation of the general reserve component of the allowance amount within the various loan segments as compared to December 31, 2017, as loss experience by segment has fluctuated over time. The stake-in-the-ground methodology requires the Company to use December 31, 2005 as the starting point of the look back period to capture loss history. Time horizons are subject to Management's assessment of the current period, taking into consideration changes in business cycles and environment changes.

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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.

The Company considers a loan to be impaired when, based upon current information and events, it believes it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include nonaccrual loans, troubled debt restructures, and performing loans in which full payment of principal or interest is not expected. Management bases the measurement of these impaired loans either on the fair value of the loan's collateral or the expected cash flows on the 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, 2017 and 2016, the Company's recorded investment in loans for which impairment has been recognized totaled $14,790,000 and $16,179,000, respectively. Included in total impaired loans at December 31, 2017, are $7,187,000 of impaired loans for which the related specific allowance is $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. Total impaired loans at December 31, 2016 included $7,563,000 of impaired loans for which the related specific allowance was $1,360,000, as well as $8,616,000 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 $15,973,000 and $19,566,000 during the years ended December 31, 2017 and 2016, 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, 2017 was real estate construction and development loans, comprising of 40.38% of total impaired loans. Impaired construction loans decreased $302,000, impaired commercial and industrial loans decreased $1,691,000, impaired real estate mortgage loans increased $365,000, and impaired agricultural loans increased $1,204,000 during the year ended December 31, 2017. 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 $10,791,000, or 70.9%, are secured by real estate at December 31, 2017, as compared to $11,770,000, or 72.8%, of total impaired loans at December 31, 2016.

The following table summarizes the components of impaired loans and their related specific allowance at December 31, 2017, 2016 and 2015.

(In thousands)	Balance December 31, 2017	Allowance December 31, 2017	Balance December 31, 2016	Allowance December 31, 2016	Balance December 31, 2015	Allowance December 31, 2015
Commercial and industrial	$ 3,318	$ 534	$ 5,009	$ 757	$ 5,201	$ 530
Real estate – mortgage	4,296	488	3,931	603	5,293	635
Real estate construction and development	5,972	—	6,274	—	12,519	1,282
Agricultural	1,204	866	—	—	16	—
Installment/other	—	—	965	—	650	650
Total impaired loans	$ 14,790	$ 1,888	$ 16,179	$ 1,360	$ 23,679	$ 3,097

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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, 2017, residential mortgages comprised $2,542,000 of the $11,362,000 in TDRs and commercial real estate loans comprised $5,951,000 of total TDRs.

Total TDRs decreased by 8.44% at December 31, 2017, as compared to December 31, 2016. Nonaccrual TDRs decreased by 27.34% and accruing TDRs increased by 18.23% over the same period. All TDR categories decreased, except accruing commercial real estate and agricultural, when compared on a year-over-year basis. Many of these credits are related to real estate projects that slowed significantly or stalled during the recession, leading the Company to pursue restructuring of the qualified credits allowing the real estate market time to recover and developers opportunity to finish projects at a slower pace. Concessions granted in these circumstances include lengthened maturities and/or rate reductions that enabled the borrower to finish the projects and may be entirely successful. In large part, current successes are related to a recovering real estate market.

The following tables summarizes TDRs by type, classified separately as nonaccrual or accrual, which are included in impaired loans at December 31, 2017 and December 31, 2016.

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

	Total TDRs	Nonaccrual TDRs	Accruing TDRs
(In thousands)	December 31, 2016	December 31, 2016	December 31, 2016
Commercial and industrial	$ 1,356	$ 565	$ 791
Real estate - mortgage:			
Commercial real estate	1,454	1,126	328
Residential mortgages	2,368	—	2,368
Total real estate mortgage	3,822	1,126	2,696
Real estate construction and development	6,267	4,608	1,659
Agricultural	—	—	—
Installment/other	965	965	—
Total Troubled Debt Restructurings	$ 12,410	$ 7,264	$ 5,146

Of the $11,362,000 in total TDRs at December 31, 2017, $5,278,000 were on nonaccrual status at period-end. Of the $12,410,000 in total TDRs at December 31, 2016, $7,264,000 were on nonaccrual status at period-end. As of December 31, 2017, the Company has no commercial real estate (CRE) workouts whereby an existing loan was restructured into multiple new loans (i.e., A Note/B Note structure).

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

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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, 2017 and December 31, 2016.

(In thousands)	December 31, 2017	December 31, 2016
Commercial and industrial	$ —	$ 4,416
Real estate - mortgage:		
Commercial real estate	8,487	621
Residential mortgages	643	—
Home equity loans	—	—
Total real estate mortgage	9,130	621
RE construction & development	720	928
Agricultural	994	—
Installment/other	—	—
Total Special Mention Loans	$ 10,844	$ 5,965

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 affects loan pricing. Low interest rates and a weaker economy continue to dominate, even though real estate prices show signs of stabilization and interest rates have begun to rise. 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 agreed to increasing its level of troubled debt restructurings, when doing so makes economic sense. While business and consumer spending show improvement in recent quarters, current GDP remains anemic. It is difficult to forecast what impact the Federal Reserve actions will have on the economy. Local unemployment rates in the San Joaquin Valley have improved, but remain elevated compared with other regions and historically are higher as a result of the area's agricultural dynamics. The Company believes that the Central San Joaquin Valley will continue to grow and diversify as property and housing costs remain low relative to other areas of the state. Management recognizes increased risk of loss due to the Company's exposure to local and worldwide economic conditions, as well as potentially volatile real estate markets, and takes these factors into consideration when analyzing the adequacy of the allowance for credit losses.

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

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	December 31,				
(Dollars in thousands)	2017	2016	2015	2014	2013
Total loans outstanding at end of period before deducting allowances for credit losses	$602,390	$570,834	$515,376	$459,575	$395,013
Average net loans outstanding during period	569,079	540,777	493,375	422,760	392,340
Balance of allowance at beginning of period	8,902	9,713	10,771	10,988	11,784
Loans charged off:					
Real estate	(23)	(29)	—	(200)	(635)
Commercial, Industrial & Agricultural	(122)	(870)	(1,397)	(318)	(678)
Installment and other	(18)	(24)	(489)	(16)	(273)
Total loans charged off	(163)	(923)	(1,886)	(534)	(1,586)
Recoveries of loans previously charged off:					
Real estate	95	55	225	728	1,538
Commercial and industrial & agricultural	201	60	630	330	279
Installment and other	208	18	14	104	71
Total loan recoveries	504	133	869	1,162	1,888
Net loans recovered (charged off)	341	(790)	(1,017)	628	302
Provision (recovery of provision) charged to operating expense	24	(21)	(41)	(845)	(1,098)
Balance of allowance for credit losses at end of period	$9,267	$8,902	$9,713	$10,771	$10,988
Net loan recoveries (charge-offs) to total average loans	0.06%	(0.15)%	(0.21)%	0.15%	0.08%
Net loan recoveries (charge-offs) to loans at end of period	0.06%	(0.14)%	(0.20)%	0.14%	0.08%
Allowance for credit losses to total loans at end of period	1.54%	1.56%	1.88%	2.34%	2.78%
Net loan recoveries (charge-offs) to allowance for credit losses	3.68%	(8.87)%	(10.47)%	5.83%	2.75%
Net loan recoveries (charge-offs) to provision (recovery of provision) for credit losses	1,420.83%	3,761.90%	2,480.49%	(74.32)%	(27.50)%

Loan charge-offs decreased $760,000 during the year ended December 31, 2017, when compared to the year ended December 31, 2016. Loan recoveries increased $371,000 during the same period. There were three loan charge-offs totaling $40,000 during the fourth quarter and an addition to the overdraft reserve of $6,000.

The following is a summary of the quarterly activity in the allowance for loan losses for the year ended December 31, 2017 (in thousands).

Description	Loss	Recoveries	Provision	Balance
Balance Forward				$8,902
1st quarter - 2017	$11	$ 36	$ 21	8,948
2nd quarter- 2017	104	214	(52)	9,006
3rd quarter - 2017	2	147	7	9,158
4th quarter - 2017	46	107	48	9,267
Total YTD - 2017	$163	$ 504	$ 24	$9,267

At December 31, 2017 and 2016, $329,000 and $337,000, respectively, of the formula allowance is allocated to unfunded loan commitments and is, therefore, carried separately in accounts payable and other liabilities on the consolidated balance sheets.

Management believes that the 1.54% credit loss allowance to total loans at December 31, 2017 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

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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.

(Dollars in thousands)	2017 Allowance for Credit Losses	2017 % of Loans	2016 Allowance for Credit Losses	2016 % of Loans	2015 Allowance for Credit Losses	2015 % of Loans	2014 Allowance for Credit Losses	2014 % of Loans	2013 Allowance for Credit Losses	2013 % of Loans
Commercial and industrial	$1,408	0.23%	$1,843	0.32%	$1,652	0.32%	$1,218	0.27%	$2,340	0.59%
Real estate – mortgage	1,182	0.20%	1,430	0.25%	1,449	0.28%	1,653	0.36%	1,862	0.47%
RE construction and development	2,903	0.48%	3,378	0.59%	4,629	0.90%	6,278	1.37%	5,533	1.40%
Agricultural	1,631	0.27%	666	0.12%	655	0.13%	482	0.11%	583	0.15%
Installment/other	887	0.15%	888	0.16%	1,258	0.24%	293	0.06%	275	0.07%
Not allocated	1,256	0.21%	697	0.12%	70	0.01%	847	0.18%	395	0.10%
	$9,267	1.54%	$8,902	1.56%	$9,713	1.88%	$10,771	2.35%	$10,988	2.78%

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.

During 2015, reserve allocations as a percentage of loans decreased for real estate mortgage and real estate construction and development 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 commercial and industrial, agricultural, and installment and other 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.

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

	December 31,				
(In thousands)	2017	2016	2015	2014	2013
Formula allowance	$6,123	$6,845	$6,546	$9,209	$9,831
Specific allowance	1,888	1,360	3,097	715	762
Unallocated allowance	1,256	697	70	847	395
Total allowance	$9,267	$8,902	$9,713	$10,771	$10,988

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.

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No loans were classified as doubtful at December 31, 2017. There was one real estate-collateralized installment loan with a recorded investment of $965,000 classified as doubtful at December 31, 2016.

Although in some instances, the downgrading of a loan resulting from the factors used by the Company in its allowance analysis has been reflected in the formula allowance, management believes that in some instances, the impact of future material events and trends are not reflected in the level of nonperforming loans or the internal risk grading process regarding these loans. Accordingly, the Company's evaluation of probable losses related to these factors may be reflected in the unallocated allowance. The evaluation of the inherent losses concerning these factors involves a higher degree of uncertainty because they are not identified with specific problem credits, and therefore the Company does not allocate the unallocated allowance among segments of the portfolio. At December 31, 2017 and December 31, 2016, the Company had unallocated allowances of $1,256,000 and $697,000. Management's estimate of the unallocated allowance are 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 the Company's lending limit, which, if any one were not to perform to contractual terms, would have a material impact on the allowance.

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

It is the Company's 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. Management may grant exceptions to this policy if the loans are well secured and in the process of collection.

The following table sets forth the Company's nonperforming assets as of the dates indicated:

	December 31,				
(Dollars in thousands)	2017	2016	2015	2014	2013
Nonaccrual loans (1)	$5,296	$7,264	$8,193	$9,935	$12,341
Accruing restructured loans	6,084	5,146	11,028	5,641	5,761
Loans, past due 90 days or more, still accruing	485	1,250	—	—	—
Total non-performing loans	11,865	13,660	19,221	15,576	18,102
Other real estate owned	5,745	6,471	12,873	14,010	13,946
Total non-performing assets	$17,610	$20,131	$32,094	$29,586	$32,048
Non-performing loans to total gross loans	1.95 %	2.40 %	3.73 %	3.40 %	4.58 %
Non-performing assets to total gross loans	2.90 %	3.53 %	6.23 %	6.47 %	8.11 %
Allowance for loan losses to nonperforming loans	78.94 %	65.17 %	50.53 %	69.15 %	60.70 %

(1) Included in nonaccrual loans at December 31, 2017 and 2016 are restructured loans totaling $5,278 and $7,264, respectively.

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

Non-performing assets decreased $11.963,000 between December 31, 2015 and December 31, 2016, 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.

Non-performing assets increased $2,508,000 between December 31, 2014 and December 31, 2015, due to an increase of $5,882,000 in accruing restructured loans, partially offset by decrease of $1,742,000 in nonaccrual loans and $1,137,000 in other real estate owned.

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Non-performing assets decreased $2,462,000 between December 31, 2013 and December 31, 2014, due to a decrease in nonaccrual loans of $2,406,000, partially offset by an increase in other real estate owned of $64,000. There were no write-downs to other real estate owned during the year ended December 31, 2014.

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

(In thousands)	December 31, 2017		December 31, 2016		December 31, 2015	
Recovery of provision for credit losses during period	$ 24		(21	)	$ (41	)
Allowance as % of nonperforming loans	78.94	%	65.17	%	50.53	%
Nonperforming loans as % total loans	1.95	%	2.40	%	3.73	%
Restructured loans as % total loans	1.89	%	2.18	%	3.59	%

Nonperforming assets, which are primarily related to the real estate loans and other real estate owned portfolio, decreased $2,646,000 from a balance of $20,131,000 at December 31, 2016 to a balance of $17,485,000 at December 31, 2017. Nonaccrual loans totaling $5,296,000 at December 31, 2017, decreased $1,968,000 from the balance of $7,264,000 reported at December 31, 2016. 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 decreased $1,389,000 during the year ended December 31, 2017 to a balance of $14,790,000 at December 31, 2017 due to a combination of loan payoffs and improved credit quality. Other real estate owned through a sale of property decreased $726,000 between December 31, 2016 and December 31, 2017. As a result of these events, nonperforming assets as a percentage of total assets decreased from 2.55% at December 31, 2016 to 2.17% at December 31, 2017.

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, 2017 totaled $341,000, as compared to charge offs of $790,000 for the year ended December 31, 2016. The Company charged-off approximately 6 loans during the year ended December 31, 2017, compared to 13 loans during the year ended December 31, 2016. Net loan recoveries totaling $341,000 during the year ended December 31, 2017, included $25,000 in net recoveries during the quarter ended March 31, 2017, $110,000 in net recoveries during the quarter ended June 30, 2017, $145,000 in net recoveries during the quarter ended September 30, 2017, and $61,000 in net recoveries during the fourth quarter of 2017. The percentage of net recoveries to average loans was 0.06%, for the year ended December 31, 2017. The percentages for the years ended December 31, 2016 and 2015 reflected net charge-offs to average loans of 0.15% and net charge-offs of 0.21%, respectively.

The loan portfolio increased from $515,318,000 at December 31, 2015, to $569,759,000 at December 31, 2016, and increased to $601,351,000 at December 31, 2017. Nonperforming loans decreased to $11,740,000 at December 31, 2017, from $13,660,000 at December 31, 2016, and $19,221,000 at December 31, 2015. Nonaccrual loans and accruing restructured loans are included in nonperforming loans. During the same period, total impaired and classified loans decreased from $29,838,000 at December 31, 2016, to $27,311,000 at December 31, 2017.

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

(In thousands)	Balance December 31,	December 31, 2016	December 31, 2015	Change from December 31, 2016	December 31, 2015

	2017				
Commercial and industrial	$212	$ 565	$ 328	$(353)	$(116)
Real estate - mortgage	742	1,126	1,635	(384)	(893)
Real estate - construction	4,342	4,608	5,580	(266)	(1,238)
Agricultural	—	—	—	—	—
Installment/other	—	965	650	(965)	(650)
Total Nonaccrual Loans	$5,296	$ 7,264	$ 8,193	$(1,968)	$(2,897)

Loans past due more than 30 days are receiving increased management attention and are monitored for increased risk. As of December 31, 2017 and 2016 past due loans more than 30 days totaled $1,445,000 and $3,103,000, respectively. The Company continues to move past due loans to nonaccrual status in its ongoing effort to recognize loan problems at an earlier point in time when they may be dealt with more effectively. As impaired loans, nonaccrual and restructured loans are reviewed for specific reserve allocations and the allowance for credit losses is adjusted accordingly.

Except for the loans included in the above tables, there were no loans at December 31, 2017, where the known credit problems of a borrower caused the Company to have serious doubts as to the ability of such borrower to comply with the present loan repayment terms and which would result in such loan being included as a nonaccrual, past due or restructured loan at some future date.

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, 2017, 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 $358,599,000.

Cash and cash equivalents have fluctuated during the three years ended December 31, 2017, 2016, and 2015, with period-end balances as follows (from Consolidated Statements of Cash Flows – in 000’s):

	Balance
December 31, 2017	$107,934
December 31, 2016	$113,032
December 31, 2015	$125,751

Cash and cash equivalents decreased $5,098,000 during the year ended December 31, 2017, and increased $12,719,000 during the year ended December 31, 2016.

The Company had a net cash inflow from operations of $7,555,000 for the year ended December 31, 2017, and a positive cash inflow from operations totaling $9,458,000 for the period ended December 31, 2016. The Company experienced net cash outflows from investing activities totaling $20,856,000 and net cash outflows of $77,007,000 during the years ended December 31, 2017 and December 31, 2016, respectively. For the year ended December 31, 2017, increases in loans outweighed principal payments on available for sale securities. For the year ended December 31, 2016, increases in loans outweighed proceeds from sales of OREO and maturities and principal payments on available for sale securities

During 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 deposit and savings accounts offset by decreases in time deposits. For the year ended December 31, 2016, the Company experienced net cash inflows of $54,830,000 primarily as the result of increases in demand deposits and savings accounts as well as 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 $358,599,000, 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 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, 2017, the Company had available credit of $305,236,000 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, 2017, the Bank had 74.75% of total assets in the loan portfolio and a loan to deposit ratio of 86.25%, as compared to 72.44% of total assets in the loan portfolio and a loan to deposit ratio of 83.05% at December 31, 2016. Liquid assets at December 31, 2017 include cash and cash equivalents totaling $107,934,000, as compared to $113,032,000 at December 31, 2016.

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Liabilities used to fund liquidity sources include core and non-core deposits as well as short-term borrowings capability. Core deposits, which comprise approximately 97.01% of total deposits at December 31, 2017, provide a significant and stable funding source for the Company. At December 31, 2017, 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 $358,599,000 are collateralized in part by certain qualifying loans in the Company’s loan portfolio. The carrying value of loans pledged on these used and unused borrowing lines totaled $473,364,000 at December 31, 2017. 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 year ended December 31, 2017, the Bank paid $4,291,000 in cash dividends to the parent company and paid $424,000 in cash dividends to the parent company during the year ended December 31, 2016. The Bank paid $2,416,000 in dividends to the parent company during the year ended December 31, 2015, and $1,519,000 in dividends during the year ended December 31, 2014.

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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 sets forth the Company’s and the Bank's actual capital positions at December 31, 2017 and 2016, as well as the minimum capital requirements and requirements to be well capitalized under prompt corrective action provisions (Bank required only) under the regulatory guidelines discussed above:

	Ratio at December 31, 2017	Ratio at December 31, 2016	Minimum for Capital Adequacy	Minimum requirement to be "Well Capitalized"
Total capital to risk weighted assets				
Company	17.54%	17.26%	8.00%	N/A
Bank	17.31%	17.19%	8.00%	10.00%
Tier 1 capital to risk-weighted assets				
Company	16.29%	16.01%	6.00%	N/A
Bank	16.06%	15.94%	6.00%	8.00%
Common equity tier 1 capital to risk-weighted assets				
Company	14.81%	14.68%	4.50%	N/A
Bank	16.06%	15.94%	4.50%	6.50%

Tier 1 capital to adjusted average assets (leverage)				
Company	13.01%	12.97%	4.00%	N/A
Bank	12.90%	12.99%	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 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.

As of December 31, 2017, the Company and the Bank meet all capital adequacy requirements to which they are subject.

Dividends

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

During the year ended December 31, 2017, the Bank paid cash dividends of $4,291,000 to the Company in order to fund the Company's operating costs, payments of interest on its junior subordinated debentures, estimated tax payments, and redemption of junior subordinated debentures. Additionally $2,870,000 in cash dividends were paid by the company 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, 2016 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, 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 was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At December 31, 2017, the Bank was not subject to a reserve requirement.

Item 8 - Financial Statements and Supplementary Data

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of United Security Bancshares and 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, 2017. 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, 2017 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 was effective as of
December 31, 2017.

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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, 2017 and 2016, 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, 2017, 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, 2017, 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, 2017 and 2016, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, 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, 2017, 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 2, 2018

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

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United Security Bancshares and Subsidiaries
Consolidated Balance Sheets
December 31, 2017 and 2016

(In thousands except shares)	December 31, 2017	December 31, 2016
Assets		
Cash and non-interest bearing deposits in other banks	$ 35,237	$ 25,781
Cash and due from Federal Reserve Bank	72,697	87,251
Cash and cash equivalents	107,934	113,032
Interest-bearing deposits in other banks	—	650
Investment securities available for sale (at fair value)	45,722	57,491
Loans	601,351	569,759
Unearned fees and unamortized loan origination costs, net	1,039	1,075
Allowance for credit losses	(9,267)	(8,902)
Net loans	593,123	561,932
Accrued interest receivable	6,526	3,895
Premises and equipment – net	10,165	10,445
Other real estate owned	5,745	6,471
Goodwill	4,488	4,488
Cash surrender value of life insurance	19,752	19,047
Investment in limited partnerships	1,601	757
Deferred tax assets - net	2,389	3,298
Other assets	8,391	6,466
Total assets	$ 805,836	$ 787,972
Liabilities & Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	$ 307,299	$ 262,697
Interest bearing	380,394	413,932
Total deposits	687,693	676,629
Accrued interest payable	44	76
Accounts payable and other liabilities	7,017	5,781
Junior subordinated debentures (at fair value)	9,730	8,832
Total liabilities	704,484	691,318
Shareholders' Equity		
Common stock, no par value 20,000,000 shares authorized, 16,885,615 issued and outstanding at December 31, 2017, and 16,705,594 at December 31, 2016	57,880	56,557
Retained earnings	44,182	40,701
Accumulated other comprehensive loss	(710)	(604)
Total shareholders' equity	101,352	96,654
Total liabilities and shareholders' equity	$ 805,836	$ 787,972

See notes to consolidated financial statements

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United Security Bancshares and Subsidiaries
Consolidated Statements of Income
Years Ended December 31, 2017, 2016, and 2015

(In thousands except shares and EPS)	December 31, 2017	December 31, 2016	December 31, 2015
Interest Income			
Loans, including fees	$ 30,817	$ 28,182	$ 26,469
Investment securities – AFS – taxable	901	825	722
Interest on deposits in FRB	1,207	458	213
Interest on deposits in other banks	5	8	6
Total interest income	32,930	29,473	27,410
Interest Expense			
Interest on deposits	1,426	1,167	1,056
Interest on other borrowings	304	242	225
Total interest expense	1,730	1,409	1,281
Net Interest Income Before Recovery of Provision for Credit Losses	31,200	28,064	26,129