UNITED SECURITY BANCSHARES
Form 10-K
March 04, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

x	ANNUALREPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2015.
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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer o Small reporting company x

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

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, 2015: $56,416,013
Shares outstanding as of February 29, 2016: 16,051,406
DOCUMENTS INCORPORATED BY REFERENCE
Certain portions of the Definitive Proxy Statement for the 2016 Meeting of Part III, Items 10, 11, 12, 13 and 14 Shareholders is incorporated by reference into Part III.

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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 (the “Company”) is a California corporation incorporated during March of 2001 and is registered with the Board of Governors of the Federal Reserve System as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company’s stock is listed on NASDAQ under the symbol “UBFO”. United Security Bank (the “Bank”) is a wholly-owned bank subsidiary of the Company and was formed in 1987. United Security Bancshares Capital Trust I (the “Trust”) was formed during June of 2001 as a Delaware business trust for the sole purpose of issuing Trust Preferred securities. The Trust was originally formed as a subsidiary of the Company, but was deconsolidated during 2004 pursuant to the adoption of ASC 810 (as revised), “Consolidation of Variable Interest Entities." During July 2007, the Trust Preferred Securities issued under USB Capital Trust I were redeemed, and upon retirement, the USB Capital Trust I was dissolved. During July 2007, the Company formed United Security Bancshares Capital Trust II and issued $15.0 million in Trust Preferred Securities with terms similar to those originally issued under USB Capital Trust I, except at a lower interest rate. During 2015, $3.0 million in Trust Preferred Securities were redeemed. At present, the Company does not engage in any material business activities other than ownership of the Bank.

United Security Bank

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 Company stock on a one-to-one basis.

The Bank is a California state-chartered bank headquartered in Fresno, California. It is also a member of the Federal Reserve System (“Fed member”). The Bank originally commenced business on December 21, 1987, as a national bank and, during the fourth quarter of 1998, filed an application with the California Department of Financial Institutions and other regulatory authorities to become a state-chartered bank. The shareholders approved the conversion in January of 1999, and the Bank was granted approval to operate as a state-chartered bank on February 3, 1999. The Bank’s operations are currently subject to federal and state laws applicable to state-chartered, Fed member banks, and its deposits are insured up to the applicable limits by the Federal Deposit Insurance Corporation (FDIC). The Bank is also subject to the Federal Deposit Insurance Act and regulatory reporting requirements of the FDIC. As a state-chartered bank and a member of the Federal Reserve System, the Bank is subject to supervision and regular

examinations by the Board of Governors of the Federal Reserve System (FRB) and the California Department of Business Oversight (DBO). In addition, the Bank is required to file reports with the FRB and provide such additional information as the FRB may require.

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. For further discussion of the REIT, refer to Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations – Income Taxes.

Effective April 23, 2004, the Company completed a merger with Taft National Bank headquartered in Taft, California. Taft National Bank (Taft) was merged into United Security Bank and Taft's two branches, one located in Taft and the other located

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in Bakersfield, California, operate as branches of United Security Bank. This transaction was accounted for using the purchase method of accounting, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Taft based on the fair value of those assets and liabilities, with resultant goodwill of $1.6 million and core deposits intangibles of $1.9 million. Goodwill is not amortized but is reviewed at least annually for impairment, while core deposit intangibles were amortized over a period of 7 years. At the time of the merger, the Company sought opportunities to expand its market area to the south with the expectation that the Bakersfield area would have significant growth given its strategic location just north of Los Angeles. The Company has recorded no impairment on either the goodwill or core deposit intangible related to the Taft merger.

On February 16, 2007, the Company completed its merger with Legacy Bank, N.A., located in Campbell, California, with the acquisition of 100 percent of Legacy's outstanding common shares. At the time of the merger, Legacy Bank's one branch was merged with and into United Security Bank, a subsidiary of the Company. The purchase of Legacy Bank provided the Company with an opportunity to expand its market area into Santa Clara County and to serve a growing small business niche and individual client base built by Legacy. The Company believes that as the economy continues to recover from the recent significant downturn, there will be increased opportunities to expand business within the greater Campbell area particularly in lending to small-to-medium sized businesses, The merger transaction was accounted for as a purchase transaction, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy Bank based on the fair value of those assets and liabilities, with resultant goodwill of $8.8 million and core deposits intangibles of $1.9 million. Goodwill is not amortized but is reviewed at least annually for impairment, while core deposit intangibles are being amortized over a period of approximately 7 years. The Company recognized no impairment charges related to goodwill or core deposit intangibles related to the Legacy merger.

At December 31, 2015, 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. In addition, the Company and Bank have administrative headquarters located at 2126 Inyo Street, Fresno, California, 93721. The Company operates as one operating segment.

At December 31, 2015 and 2014, the consolidated Company had total assets of approximately $725,644,000, and $663,169,000, respectively. For the year ended December 31, 2015, the Company reported net income of $6,810,000, as compared to $6,216,000 for the year ended December 31, 2014. At December 31, 2015, the consolidated Company had approximately $505,663,000 in net loans, $621,805,000 in deposits, and $89,635,000 in shareholders' equity.

The Company has increased loan growth over the last two years as the economy and real estate markets have improved. Total loans increased 16.35% between December 31, 2013 and December 31, 2014, and increased an additional 13.17% between December 31, 2014 and December 31, 2015. During the same periods, nonperforming assets increased and related loan losses decreased. Nonperforming assets declined from $32,048,000 at December 31, 2013, to $29,586,000 at December 31, 2014, but increased $2,508,000 to $32,094,000 at December 31, 2015. Negative loan loss provisions totaled $1,098,000 for the year ended December 31, 2013. Negative provisions were recorded for the years ended December 31, 2014, and December 31, 2015, of $845,000 and $41,000, respectively. Over the past few years, housing starts have increased and housing prices in the Company's market area have improved. Unemployment and other economic factors continue to strengthen. As a result, Management's focus over the past year, has been to concentrate its efforts on developing new business and growing the loan portfolio. Lending policies and procedures have been enhanced, and loan modifications, including rate and maturity concessions, and forbearance agreements, continue to be utilized in order to minimize loss exposure in the loan portfolio.

While loan growth prior to 2007 was funded to some degree by brokered deposits and other wholesale funding sources, the current state of the economy and the financial condition of the Company have made it increasingly important to continue to develop core deposits and reduce the Company's dependence on brokered and other wholesale

funding sources, including lines of credit with the Federal Reserve Bank and the FHLB. The Company increased its efforts early in 2009 to develop core deposit growth with employee training throughout the entire organization and a deposit-gathering program that incented employees to bring in new deposits from our local market area and establish more extensive relationships with our customers. As a result, the Bank has reduced its dependence on wholesale funding sources, including brokered deposits, to a level more in-line with peers.

The Company's percentage of brokered deposits are now in line with peers. Total brokered deposits decreased from $11,480,000 at December 31, 2014, to $8,546,000 at December 31, 2015, representing a decrease of $2,934,000. Despite additions to the loan portfolio and securities purchases, the Company has enhanced its liquidity positions with an increase in fed funds sold and other overnight investments of $82,229,000 at December 31, 2014 to $96,018,000 at December 31, 2015.

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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 11.12% and 13.82% of total deposits at December 31, 2015 and 2014, 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 1.37% and 2.03% of total deposits at December 31, 2015 and 2014, respectively.

The Bank also engages in a full complement of lending activities, including real estate mortgage (48.9% of total loans at December 31, 2015), commercial and industrial (10.8% of total loans at December 31, 2015), real estate construction (25.3% of total loans at December 31, 2015), as well as agricultural (10.1% of total loans at December 31, 2015), and installment loans (4.9% of total loans at December 31, 2015), with particular emphasis on short and medium-term obligations. Approximately 77% of the Bank's loans are secured by real estate at December 31, 2015. 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, 2015, the Bank had loans (net of unearned fees) outstanding of $515,376,000, which represented approximately 82.9% of the Bank's total deposits and approximately 71.0% 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.

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 $68,811,000 or 13.35% of the portfolio at December 31, 2015. The residential mortgage loan portfolio is 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 5.6% and 1.4% of the total loan portfolio at December 31, 2015 and 2014, 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. At December 31, 2015 and 2014, loan commitments of the Bank totaled $107,084,000 and $105,434,000, respectively, and letters of credit totaled $3,295,000 and $3,800,000, respectively. Of the $110,379,000 in total commitments outstanding at December 31, 2015, $15,989,000, or 14.5%, were for loans with maturities of one year or less. 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

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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, traveler's checks, money orders, and foreign drafts. 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.

Lending Policies

The following is a summary of the Bank’s loan policies.
Loan Documentation – All loan documentation is prepared by a centralized loan servicing department or by legal counsel based on the terms contained in the approved Credit Authorizations. The documentation, upon completion, is reviewed by a third party (Bank employee) in the loan servicing department prior to forwarding to the relationship managers, who then review the documents to ensure that they have been correctly prepared in accordance with the credit approval before execution by the borrowers.
Purchased Participations – The Bank independently underwrites, using the Bank’s same guidelines for direct originations, and reviews the loan documentation of participation loans originated by other lenders for acceptability.
Verification of Information – The Bank, principally a commercial business lender, has not and does not make any “No Doc” or “Stated Income” loans. In the underwriting of a commercial loan request, the Bank performs an enterprise analysis of the financial information for trends, verifies major assets and liabilities, and obtains Dun and Bradstreet Credit reports on the entities and credit bureau reports on the principals of the entity.
The Company is not dependent on any individual customer, entity, or group of related entities for deposits nor on any significant percentage of loans to borrowers.
Unsecured - Whether unsecured or secured, guarantees are usually obtained from the principals or from 3rd party guarantors if necessary for additional financial support. Unsecured loans totaled $35,626,000 and $46,982,000 at December 31, 2015 and 2014, respectively.
Historic policy on renewals - The renewal or extension of existing performing lines of credit or loans has not been changed; the credits are re-underwritten for the renewal period. The restructure or renewal of substandard loans is certified to the Board of Directors that the renewal is necessary to improve and protect the Bank’s ultimate interest in the collection of the credit or maximize its potential for collection, that the renewal reflects prudent underwriting based on reasonable repayment terms and is adequately secured, that the Bank has performed a comprehensive credit analysis indicating the borrower has the willingness and ability to repay the debt as per the terms of the restructure plan and that the Bank’s Loan Committee, designated by the Board, believes that the renewal will be repaid in accordance with the terms.
Additional Loans to nonaccrual borrowers. – The Bank as a general rule does not make additional loans to borrowers that are past due in principal or interest more than 90-days. However, in selected and limited instances as part of the workout or restructure of non-performing assets, to effect repayment, additional secured advances may be made.
Lending Limits – The Bank approves revolving lines of credit or loans for each borrower with terms and limits. Consideration is given for the aggregate direct borrowing exposure of the borrower, as well as, their indirect liability, plus the indirect liability of any guarantor. Overall, the Bank has established normal “House” lending limits at 50% of the Legal Lending Limit. The Legal Lending Limit is calculated for unsecured loans at 15% of total regulatory

capital, and for secured loans at 25% of total regulatory capital. The Board of Directors must approve any borrowing relationship that exceeds the House Lending Limit.

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

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and loan associations, finance companies, money market funds, credit unions and other financial institutions, including a number that are substantially larger than the Company. Deregulation of the banking industry, increased competition from non-bank entities for the cash balances of individuals and businesses, and continuing developments in the computer and communications industries have had, and most likely will continue to have, a significant impact on the Company's competitive position. With the enactment of interstate banking legislation in California, bank holding companies headquartered outside of California will continue to enter the California market and provide competition for the Company. Additionally, with the Gramm-Leach-Bliley Act of 1999, traditional competitive barriers between insurance companies, securities underwriters, and commercial banks have been eased, allowing a greater number of financial intermediaries to offer a wider assortment of financial services. 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, 2015 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, 2015, which is the most current information available.

	Rank	Share
Fresno County	9th	3.44%
Madera County	10th	4.31%
Kern County	14th	0.96%
Total of Fresno, Madera, Kern Counties	12th	2.58%
Santa Clara County	42nd	0.02%

Supervision and Regulation

General

The Company and the Bank are subject to significant regulation and restrictions by federal and state laws and regulatory agencies. This regulation is intended primarily for the protection of depositors and the deposit insurance fund, and secondarily for the stability of the U.S. banking system. It is not intended for the benefit of shareholders of financial institutions. 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.

The Company

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended (the “BHC Act”), and is registered as such with the FRB. A bank holding company is required to file annual reports with the FRB regarding its business operations and those of its subsidiaries. The Company is also subject to examination by the FRB.

The BHC Act requires, among other things, prior approval before acquiring, directly or indirectly, ownership or control of any voting shares of any bank, if after such acquisition it would directly or indirectly own or control more than 5% of the voting stock of that bank, unless it already owns a majority of the voting stock of that bank. The BHC Act also provides that the FRB shall not approve any acquisition that would result in or further the creation of a monopoly, or the effect of which may be substantially to lessen competition, unless the anticompetitive effects of the proposed transaction are clearly outweighed by the probable effect in meeting the convenience and needs of the

community served.

Furthermore, under the BHC Act, a bank holding company is, with limited exceptions, prohibited from (i) acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or (ii) engaging in any activity other than managing or controlling banks. With the prior approval of the FRB, however, a bank holding company may own shares of a company engaged in activities which the FRB has determined to be so closely related to banking or managing or controlling banks as to be proper incident thereto. Amendments to the BHC Act expand the circumstances under which a bank holding company may acquire control of all or substantially all of the assets of a bank located outside the State of California.

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The Company is a legal entity, separate and distinct from the Bank. The Company has the ability to raise capital on its own behalf or borrow from external sources. The Company may also obtain additional funds from dividends paid by, and fees charged for services provided to, the Bank. Those dividends may come from funds legally available for those dividends, as specified and limited by the California Financial Code. If the Bank's regulatory authorities determine that the Bank's capital is not adequate or that the payment of the dividend would be unsafe or unsound, the regulatory authorities may order the Bank not to pay or reduce the amount of the dividend.
Moreover, the BHC Act requires a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. It is the FRB's policy that a bank holding company should stand ready to use available resources to provide adequate capital funds to subsidiary banks during periods of financial stress and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting a subsidiary bank. Under certain conditions, the FRB may conclude that certain actions of a bank holding company, such as payment of cash dividends to its shareholders, or the receipt of dividends from its subsidiary bank, would constitute unsafe and unsound banking practices because they violate the FRB's "source of strength" doctrine.

A bank holding company and its subsidiaries are prohibited from certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with certain exceptions, a bank may not condition an extension of credit on a promise by its customer to obtain other services by it, its holding company or other subsidiaries, or on a promise by its customer not to obtain services from a competitor. In addition, federal law imposes certain restrictions between the Company and its subsidiaries, including the Bank. As an affiliate of the Bank, the Company is subject, with certain exceptions, to provisions of federal law imposing limitations on, and requiring collateral for, extensions of credit by the Bank to its affiliates.

As a public company, United Security Bancshares is subject to the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act amends the Securities and Exchange Act of 1934, and is intended to protect investors by, among other things, improving the reliability of financial reporting, increasing management accountability, and increasing the independence of Directors and the Company's external accountants.

The Company is subject to the periodic reporting requirements of the Securities Exchange Act of 1934, as amended, which include but are not limited to the filing of annual, quarterly and other current reports with the SEC.

The Bank

The Bank as a state-chartered bank and a member of the Federal Reserve, is subject to regulation, supervision and regular examination by the FRB, the California Department of Business Oversight (the "DBO") and the Consumer Financial Protection Bureau (the "CFPB"). 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 the applicable provisions of the Federal Deposit Insurance Act 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

The Company is subject to consolidated regulatory capital requirements administered by the FRB and the Bank is subject to similar capital requirements also administered by the FRB. The Dodd Frank Act applied the same leverage and risk based capital requirements that apply to insured depository institutions to bank holding companies, such as the Company. The guidelines of the FRB and the other federal banking agencies are intended to ensure that banking organizations have adequate capital given the risk levels of assets and off balance sheet financial instruments.

General Risk Based Capital Rules

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Prior to January 1, 2015, the FRB risk-based capital guidelines were based upon the 1988 Capital Accord ("Basel I") of the Basel Committee on Banking Supervision (the "Basel Committee"). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines that each country's supervisors can use to determine the supervisory policies that apply.

Under the general risk-based capital rules, applicable through December 31, 2014, banking organizations were required to maintain minimum ratios of Tier 1 capital and total capital to total risk weighted assets (including certain off balance sheet items, such as letters of credit). For purposes of calculating the ratios, a banking organization's assets and some of its specified off balance sheet commitments and obligations are assigned to various risk categories. A depository institution's or holding company's capital, in turn, is classified in one of two tiers relevant to us, depending on type:

Core Capital (Tier 1). Tier 1 capital includes common equity, retained earnings, qualifying non cumulative perpetual preferred stock, a limited amount of qualifying cumulative perpetual stock at the holding company level, minority interests in equity accounts of consolidated subsidiaries, and qualifying trust preferred securities (subject to phase out as described under "-Basel III Capital Rules" below) minus goodwill, most intangible assets and certain other assets.

Supplementary Capital (Tier 2). Tier 2 capital includes, among other things, perpetual preferred stock and trust preferred securities not meeting the Tier 1 definition, qualifying mandatory convertible debt securities, qualifying subordinated debt, and allowances for possible credit losses, subject to limitations.

As a bank holding company, the Company currently was required to maintain Tier 1 capital and total capital equal to at least 4.0% and 8.0%, respectively, of its total risk weighted assets (including various off balance sheet items, such as letters of credit). The Bank was required to maintain equivalent capital levels under the FDIC's capital adequacy guidelines. In addition, as a depository institution, the Bank is subject to minimum capital ratios under the regulatory framework for prompt corrective action discussed under "-Prompt Corrective Action."

The Company and the Bank are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization's Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). Bank holding companies and FRB supervised banks, such as the Company and the Bank, are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. In addition, for a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%.

Regulatory capital requirements limit the amount of deferred tax assets that may be included when determining the amount of regulatory capital. Deferred tax asset amounts in excess of the calculated limit are deducted from regulatory capital.

The Company issued subordinated debentures to trusts that were established by us which, in turn, issued trust preferred securities. The Company includes in Tier 1 capital an amount of trust preferred securities equal to no more than 25% of the sum of all core capital elements, which is generally defined as shareholders' equity less goodwill, net of any related deferred income tax liability. At December 31, 2015, the amount of trust preferred securities included in Tier I capital was $7,836,000.

Basel III Capital Rules

In July 2013, the FRB and the other federal banking regulators approved final rules (the "New Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations. The New Capital Rules

generally implement the Basel Committee's December 2010 final capital framework referred to as "Basel III" for strengthening international capital standards. The New Capital Rules substantially revise the risk based capital requirements applicable to bank holding companies and their depository institution subsidiaries, including the Company and the Bank, as compared to the current U.S. general risk based capital rules. The New Capital Rules revise the definitions and the components of regulatory capital, as well as address other issues affecting the numerator in banking institutions' regulatory capital ratio calculations. The New Capital Rules also address asset risk weights and other matters affecting the denominator in banking institutions' regulatory capital ratio calculations and replace the existing general risk weighting approach, which was derived from the Basel Committee's 1988 "Basel I" capital accords, with a more risk sensitive approach based, in part, on the "standardized approach" in the Basel Committee's 2004 "Basel II" capital accords. The New Capital Rules also implement the requirements of Section 939A of the Dodd Frank Act to remove references to credit ratings from the federal regulators' rules. The New Capital Rules were effective for the Company and the Bank as of January 1, 2015, subject to phase in periods for certain of their components and other provisions.

The New Capital Rules, among other things: (i) introduce a new capital measure called Common Equity Tier 1 ("CET1") and related regulatory capital ratio of CET1 to risk weighted assets; (ii) specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting certain revised requirements; (iii) mandate that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital; and (iv) expand the scope of the deductions from and adjustments to capital as compared to existing regulations. Under the New Capital Rules, for most banking organizations the most common form of Additional Tier 1 capital is non cumulative perpetual preferred stock and the most common form of Tier 2 capital is subordinated notes and a portion of the allowance for loan and lease losses, in each case, subject to the New Capital Rules' specific requirements.

Pursuant to the New Capital Rules, the minimum capital ratios as of January 1, 2015 are as follows:

4.5% CET1 to risk weighted assets;

6.0% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk weighted assets;

8.0% Total capital (that is, Tier 1 capital plus Tier 2 capital) to risk weighted assets; and

4% Tier 1 capital to average consolidated assets as reported on regulatory financial statements (known as the "leverage ratio").

The New Capital Rules also introduce a new "capital conservation buffer," composed entirely of CET1, on top of these minimum risk weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer began on January 1, 2016 at a 0.625% level and increase by 0.625% on each subsequent January 1st, until it reaches 2.5% on January 1, 2019. When fully phased in, the Company and the Bank will be required to maintain such additional capital conservation buffer of 2.5% of CET1, effectively resulting in minimum ratios of: (i) CET1 to risk weighted assets of at least 7%; (ii) Tier 1 capital to risk weighted assets of at least 8.5%; and (iii) Total capital to risk weighted assets of at least 10.5%.

The New Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks and significant investments in non consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such items, in the aggregate, exceed 15% of CET1.

In addition, under the current general risk based capital rules, the effects of accumulated other comprehensive income or loss ("AOCI") items included in shareholders' equity (for example, unrealized gains and losses of securities held in the available-for-sale portfolio) under U.S. GAAP are reversed for the purposes of determining regulatory capital ratios. Pursuant to the New Capital Rules, the effects of certain AOCI items are not excluded; however, non advanced approaches banking organizations, including the Company and the Bank, were able to make a one time permanent election to continue to exclude these items in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of our securities portfolio.

Implementation of the deductions and other adjustments to CET1 commenced on January 1, 2015 and will be phased in over a 4 year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter).

The New Capital Rules prescribe a new standardized approach for risk weightings that expand the risk weighting categories from the previous four Basel I derived categories (0%, 20%, 50% and 100%) to a larger and more

risk sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, resulting in higher risk weights for a variety of asset classes.

We are continuing to evaluate the impact of the New Capital Rules on our capital ratios and related calculations and believe that, as of December 31, 2015, the Company and the Bank were "well-capitalized" under the New Capital Rules. The regulatory capital guidelines as well as the actual capitalization for the Bank and the Company as of December 31, 2015 are as follows:

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	Requirement to be:		December 31, 2015	
	Adequately Capitalized	Well Capitalized	Company	Bank
Tier 1 leverage capital ratio	4.0%	5.0%	12.95%	12.94%
Common equity tier 1 capital ratio	4.5%	6.5%	14.10%	15.43%
Tier 1 risk-based capital ratio	6.0%	8.0%	15.40%	15.43%
Total risk-based capital ratio	8.0%	10.0%	16.65%	16.69%

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. The federal banking agencies have not yet proposed rules to implement the NSFR.

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: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. 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.

Under the prompt corrective action provisions of FDICIA ("PCA"), an insured depository institution generally will be classified as undercapitalized if its total risk based capital is less than 8% or its Tier 1 risk based capital or leverage ratio is less than 4%. The New Capital Rules revised the PCA regulations by: (i) introducing a CET1 ratio requirement at each PCA category (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum Tier 1 capital ratio for well capitalized status being 8% (as compared to the current 6%); and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be adequately capitalized (under the New Capital Rules a 5% leverage ratio is required for an institution to be

well capitalized and a 4% leverage ratio is required to be adequately capitalized). The New Capital Rules do not change the total risk based capital requirement for any PCA category. An institution that, based upon its capital levels, 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 hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions and prohibitions, including restrictions on growth, restrictions on interest rates paid on deposits, prohibitions on payment of dividends and restrictions on the acceptance of brokered deposits. Furthermore, if a bank is classified in one of the undercapitalized categories, it is required to submit a capital restoration plan to its federal bank regulator, and the holding company must guarantee the performance of that plan. The obligation of a controlling bank holding company to fund a capital restoration plan is limited to the lower of 5% of an undercapitalized subsidiary’s assets or the amount required to meet regulatory capital requirements.

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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. The initial base assessment rates range from five to 35 basis points. 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. The Bank's assessment rate for 2011 fell at the high end of this range. 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 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, 2015 the Bank owned 22,214 shares of the FHLB-SF capital stock.

Federal Reserve. 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, 2015, the Bank was in compliance with these requirements.

Regulatory Agreement with the Federal Reserve Bank of San Francisco

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On March 23, 2010, the Company and the Bank entered into a formal written agreement (the "Agreement") with the Federal Reserve Bank of San Francisco (the "Federal Reserve") as a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions (now the Department of Business Oversight, or "DBO") in June 2009. That examination found significant increases in nonperforming assets, both classified loans and OREO, during 2008 and 2009, and heightened concerns about the Bank's use of brokered and other wholesale funding sources to fund loan growth, which created increased risk to equity capital and potential volatility in earnings.

Under the terms of the Agreement, the Company and the Bank agreed, among other things: to maintain a sound process for determining, documenting, and recording an adequate allowance for loan and lease losses; to improve the management of the Bank's liquidity position and funds management policies; to maintain sufficient capital at the Company and Bank level; and to improve the Bank's earnings and overall condition. The Company and Bank also agreed not to increase or guarantee any debt, purchase or redeem any shares of stock, declare or pay any cash dividends, or pay interest on the Company's junior subordinated debt or trust preferred securities, without prior written approval from the Federal Reserve. The Company generates no revenue of its own and, as such, relies on dividends from the Bank to pay its operating expenses and interest payments on the Company's junior subordinated debt.

Effective November 19, 2014, the Federal Reserve terminated the Agreement with the Bank and the Company and replaced it with an informal supervisory agreement that requires, among other things, obtaining written approval from the Federal Reserve prior to the payment of dividends from the Bank to the Company or the payment of dividends by the Company or interest on the Company's junior subordinated debt. The inability of the Bank to pay cash dividends to the Company may hinder the Company's ability to meet its ongoing operating obligations.

Regulatory Order from the California Department of Business Oversight

On May 20, 2010, the DBO issued a formal written order (the "Order") pursuant to a consent agreement with the Bank as a result of the same June 2009 joint regulatory examination. The terms of the Order were essentially similar to the Federal Reserve's Agreement, except for a few additional requirements.

On September 24, 2013, the Bank entered into an informal Memorandum of Understanding (the "MOU") with the DBO and on October 15, 2013, the Order was terminated. The Order and the MOU require the Bank to maintain a ratio of tangible shareholder's equity to total tangible assets equal to or greater than 9.0% and also requires the DBO's approval for the Bank to pay a dividend to the Company.

Accordingly, reflecting the Company's and the Bank's improved financial condition and performance, as of November 19, 2014, the Bank and the Company have been relieved of all formal regulatory agreements. Some of the governance and procedures established by the Agreement and the Order remain in place, including submission of certain plans and reports to the Federal Reserve and DBO, the Bank's obligation to maintain a 9.0% tangible shareholder's equity ratio, and the requirement to seek approvals from the Federal Reserve and the DBO for either the Bank or the Company to pay dividends and for the Company to pay interest on its outstanding junior subordinated debt. While no assurances can be given as to future regulatory approvals, over the last two years the DBO and the Federal Reserve have been approving the Bank's quarterly payment of dividends to the Company to cover the Company's operating expenses, tax obligations and interest payments on the junior subordinated debt and the Company's payment of quarterly interest on the junior subordinated debt.

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

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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.

Extensions of Credit to Insiders

The Federal Reserve Act and the FRB's Regulation O place limitations and conditions on loans or extensions of credit to:

a bank's or bank holding company's executive officers, directors and principal shareholders (i.e., in most cases, those persons who own, control or have power to vote more than 10% of any class of voting securities),

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.

Loans and leases extended to any of the above persons 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 terms (including interest rates and collateral) as, and follow credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions with non-insiders, and must not involve more than the normal risk of repayment or present other unfavorable features. In addition, Regulation O provides that the aggregate limit on extensions of credit to all insiders of a bank as a group cannot exceed the bank's unimpaired capital and unimpaired surplus. Regulation O also prohibits a bank from paying an overdraft on an account of an executive officer or director, except pursuant to a written pre-authorized interest-bearing extension of credit plan that specifies a method of repayment or a written pre-authorized transfer of funds from another account of the officer or director at the bank.

Transactions with Affiliates

Sections 23A and 232B of the Federal Reserve Act and the FRB's Regulation W impose quantitative and qualitative limitations on the ability of a bank to make loans to or enter into certain types of transactions with its holding company and other subsidiaries of the holding company ("affiliates"). Under Sections 23A and 23B and Regulation W, loans by the Bank to affiliates, investments by the Bank in affiliates' stock, and taking affiliates' stock as collateral for loans to any borrower are limited to 10% of the Bank's capital, in the case of any one affiliate, and are 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.

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.

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 October 2012, the Bank was rated "satisfactory."

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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.

Recent Legislation and Other Changes

From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial institutions. Proposals to change the laws and regulations governing the operations and taxation of banks and other financial institutions are frequently made in Congress, in the California legislature and before various bank regulatory agencies. The likelihood of any major change and the impact such change may have on the Company is impossible to predict. Certain of the potentially significant changes which have been enacted in the last several years recently and other which are currently under consideration by Congress or various regulatory agencies or professional agencies are

discussed below.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act has significantly changed the bank regulatory structure and has impacted the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act created a new interagency council, the Financial System Oversight Council that is charged with identifying and monitoring the systemic risk to the U.S. economy posed by systemically significant, large financial companies, including bank holding companies and non-bank financial companies. The Office of Thrift Supervision was eliminated and its powers distributed among the Office of the Comptroller of the Currency, the Federal Reserve Board and the FDIC. The legislation also established a floor for capital of insured depository institutions that cannot be lower than the standards then in effect, and directed the federal banking regulators

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to implement new leverage and capital requirements that take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives.

The Dodd-Frank Act additionally created a new independent federal regulator to administer federal consumer protection laws. Among the provisions of the Dodd-Frank Act are the following:

Deposit Insurance. The Dodd-Frank Act permanently increased the maximum deposit insurance amount for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2009. The Dodd-Frank Act also broadened the base for FDIC insurance assessments. Assessments are 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 eliminated the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. The Dodd-Frank Act eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

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. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks will be able to enter new markets more freely, potentially increasing competition.

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 take into consideration credit exposure to derivatives transactions. For this purpose, derivative transactions include 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.

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 are 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 became effective April 1, 2014, although certain provisions are subject to delayed effectiveness under rules promulgated by the FRB. The Company and the Bank held no investment positions at December 31, 2015 which were subject to the final rule. Therefore, while these new rules may require us to conduct certain internal analysis and reporting, we believe that they will not require any material changes in our operations or business.

Transactions with Affiliates and Insiders. The Dodd-Frank Act expanded the definition of "affiliate" for purposes of the 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 applied 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 transactions that create credit exposure to an affiliate or an insider. Any such transactions with affiliates must be fully secured. 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 disinterested directors.

Debit Card Interchange Fees. The Dodd-Frank Act requires that the amount of any interchange fee charged by a debit card issuer with respect to a debit card transaction must be reasonable and proportional to the cost incurred by the issuer. The FRB has established standards for reasonable and proportional fees which take into account the costs of

preventing fraud. The restrictions on interchange fees, however, do not apply to banks that, together with their affiliates, have assets of less than $10 billion, such as the Bank.

Consumer Financial Protection Bureau. The Dodd-Frank Act created a new, independent federal agency called the Consumer Financial Protection Bureau ("CFPB"), which was granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the ECOA, the TILA, the RESPA, the Fair Credit Reporting Act, the Fair Debt Collection 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 will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by the other 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

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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.

The Electronic Funds Transfer Act

The Electronic Funds Transfer Act (the “EFTA”) provides a basic framework for establishing the rights, liabilities, and responsibilities of consumers who use electronic funds transfer (“EFT”) systems. The EFTA is implemented by the FRB's Regulation E, which governs transfers initiated through ATMs, point-of-sale terminals, payroll cards, automated clearinghouse (“ACH”) transactions, telephone bill-payment plans, or remote banking services. Regulation E was amended in January 2010 to require consumers to opt in (affirmatively consent) to participation in the Bank’s overdraft service program for ATM and one-time debit card transactions before overdraft fees may be assessed on the consumer’s account. Notice of the opt-in right must be provided to all existing and new customers who are consumers, and the customer’s affirmative consent must be obtained, before charges may be assessed on the consumer’s account for paying such overdrafts.

Regulation E provides bank customers with an ongoing right to revoke consent to participation in an overdraft service program for ATM and one-time debit card transactions, as opposed to being automatically enrolled in such a program. Regulation E also prohibits banks from conditioning the payment of overdrafts for checks, ACH transactions, or other types of transactions that overdraw the consumer’s account on the consumer’s opting into an overdraft service for ATM and one-time debit card transactions. For customers who do not affirmatively consent to overdraft service for ATM and one-time debit card transactions, a bank must provide those customers with the same account terms, conditions, and features that it provides to consumers who do affirmatively consent, except for the overdraft service for ATM and one-time debit card transactions.

Incentive Compensation

On June 21, 2010, the federal banking agencies issued final guidance on incentive compensation which applies to all banks. Except for the largest banking organizations, enforcement of this guidance is handled through the agencies’ regular risk-focused examination process. The employees covered by the final guidance are senior executives and others who are responsible for oversight of the organization’s firm-wide activities or material business lines; individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk. The guidance provides for three principles for safe and sound incentive compensation arrangements:

Balanced Risk-Taking: Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks;

Compatibility with Effective Controls and Risk-Management: A banking organization’s risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements; and

Strong Corporate Governance: Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

Helping Families Save Their Homes Act

In May 2009 the Helping Families Save Their Homes Act of 2009 was enacted to help consumers avoid mortgage foreclosures on their homes through certain loss mitigation actions including special forbearance, loan modification, pre-foreclosure sale, deed in lieu of foreclosure, support for borrower housing counseling, subordinate lien resolution, and borrower relocation. This law permits the Secretary of Housing and Urban Development ("HUD"), for mortgages either in default or facing imminent default, to: (1) authorize the modification of such mortgages; and (2) establish a program for payment of a partial claim to a mortgagee who agrees to apply the claim amount to payment of a mortgage on a 1- to 4-family residence. In implementing the law, the Secretary of HUD is authorized to (1) provide compensation to the mortgagee for lost income on monthly mortgage payments due to interest rate reduction; (2) reimburse the mortgagee from a guaranty fund in connection with activities that the mortgagee is required to undertake concerning repayment by the mortgagor of the amount owed to HUD; (3) make payments to the mortgagee on behalf of the borrower, under terms defined by HUD; and (4) make mortgage modification with terms

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extended up to 40 years from the modification date. The new law also authorizes the Secretary of HUD to: (1) reassign the mortgage to the mortgagee; (2) act as a Government National Mortgage Association (“GNMA” or “Ginnie Mae”) issuer, or contract with an entity for such purpose, in order to pool the mortgage into a Ginnie Mae security; or (3) resell the mortgage in accordance with any program established for purchase by the federal government of insured mortgages. The law also amended the Foreclosure Prevention Act of 2008, with respect to emergency assistance for the redevelopment of abandoned and foreclosed homes (neighborhood stabilization), to authorize each state that has received certain minimum allocations and has fulfilled certain requirements, to distribute any remaining amounts to areas with homeowners at risk of foreclosure or in foreclosure without regard to the percentage of home foreclosures in such areas.

Credit Card Act of 2009

Also in May 2009, the Credit Card Act of 2009 was enacted to help consumers and ban certain practices of credit card issuers. This law allows interest rate hikes on existing balances only under limited conditions, such as when a promotional rate ends, there is a variable rate or if the cardholder makes a late payment. Interest rates on new transactions can increase only after the first year. Significant changes in terms on accounts cannot occur without 45 days' advance notice of the change. The law bans raising interest rates on customers based on their payment records with other unrelated credit issuers (such as utility companies and other creditors) for existing credit card balances, though card issuers would still be allowed to use universal default on future credit card balances if they give at least 45 days' advance notice of the change. The law allows consumers to opt out of certain significant changes in terms on their accounts. Opting out means cardholders agree to close their accounts and pay off the balance under the old terms. They have at least five years to pay the balance. Credit card issuers will be banned from issuing credit cards to anyone under 21, unless they have adult co-signers on the accounts or can show proof they have enough income to repay the card debt.

The law requires card issuers to give card account holders "a reasonable amount of time" to make payments on monthly bills. That means payments would be due at least 21 days after they are mailed or delivered. Credit card issuers would no longer be able to set early morning or other arbitrary deadlines for payments. When consumers have accounts that carry different interest rates for different types of purchases payments in excess of the minimum amount due must go to balances with higher interest rates first. Consumers must "opt in" to over-limit fees. Those who opt out would have their transactions rejected if they exceed their credit limits, thus avoiding over-limit fees. Fees charged for going over the limit must be reasonable. Finance charges on outstanding credit card balances would be computed based on purchases made in the current cycle rather than going back to the previous billing cycle to calculate interest charges. Fees on credit cards cannot exceed 25 percent of the available credit limit in the first year of the card.

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.

Conclusion

Future legislation is also likely to impact the Company’s business; however, it is impossible to predict what legislation might be enacted or what regulations might be adopted on the state or federal level or the effects thereof.

The foregoing summary of the laws, regulations and rules governing the Bank and the Company is not a complete summary of all applicable laws, regulations and rules.

Employees

At December 31, 2015, the Company employed 129 persons on a full-time equivalent basis. The Company believes its employee relations are excellent.

Available Information

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

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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, 2015.

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, and 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 branch was previously located at 1041 E. Shaw Avenue, Fresno, California, under a lease extension expiring February 28, 2005. The 7088 N. First location provides space for the relocated branch as well as the Real Estate Construction Department and the Indirect Consumer Lending Department.

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 with a lease term of 5 years ending April 2019, and has a five-year option to extend the lease term after that date.

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 branch facilities 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 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 branch office premises located at 523 Cascade Place, Taft, California. The branch facilities consist of approximately 9,200 square feet of office space.

The Company owns the branch facilities 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 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, 2021.

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 of approximately seven years.

The Company leases its financial services facility located at 9 River Park Place, Suite 420, Fresno, CA. The lease commenced on October 1, 2013 and expires on September 30, 2016.

Item 3 - Legal Proceedings

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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 twenty-eight consecutive quarters beginning March 31, 2009 through December 31, 2015, 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, 2015 and 2014.

	Closing Prices		Volume
Quarter	High	Low	
4th Quarter 2015	$5.39	$5.18	454,200
3rd Quarter 2015	$5.32	$5.02	439,400
2nd Quarter 2015	$5.37	$4.90	375,700
1st Quarter 2015	$5.49	$4.97	439,500
4th Quarter 2014	$5.70	$5.28	294,300
3rd Quarter 2014	$5.94	$5.41	502,400
2nd Quarter 2014	$5.73	$5.07	491,800
1st Quarter 2014	$5.74	$4.56	423,700

At December 31, 2015, there were approximately 693 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 January 21, 2015, April 17, 2015, July 17, 2015, and October 16, 2015. The Company distributed a 1% stock dividend to shareholders on January 22, 2014, April 23, 2014, July 23, 2014, and October 22, 2014.

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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, 2015.

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	115,927	$9.39	706,921
Equity compensation plans not approved by security holders	N/A	N/A	N/A
Total	115,927	$9.39	706,921

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 813,111 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, 2015, there were 703,972 shares available for repurchase. The Company did not repurchase any common shares during the years ended December 31, 2015 and 2014.

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, and, viii) potential impairment of goodwill and other intangible assets. Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company.

The Company

On June 12, 2001, the United Security Bank (the "Bank") became the wholly owned subsidiary of United Security Bancshares (the "Company") 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 Company stock on a one-to-one basis. No

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additional equity was issued as part of this transaction. In the following discussion, references to the Bank are references to United Security Bank. References to the Company are references to United Security Bancshares (including the Bank).

On June 28, 2001, United Security Bancshares Capital Trust I (the "Trust") was formed as a Delaware business trust for the sole purpose of issuing Trust Preferred securities. On July 16, 2001, the Trust completed the issuance of $15 million in Trust Preferred securities, and concurrently, the Trust used the proceeds from that offering to purchase Junior Subordinated Debentures of the Company. The Company contributed $13.7 million of the $14.5 million in net proceeds received from the Trust to the Bank to increase its regulatory capital and used the rest for the Company's business. Effective January 1, 2007, the Company adopted the fair value option for its junior subordinated debt issued by the Trust. As a result of the adoption of the accounting standards related to the fair value option, the Company recorded a fair value adjustment of $1.3 million, reflected as an adjustment to beginning retained earnings. On July 25, 2007, the Company redeemed the $15.0 million in subordinated debentures plus accrued interest of $690,000 and a 6.15% prepayment penalty totaling $922,500. Concurrently, the Trust Preferred securities issued by Capital Trust I were redeemed. The prepayment penalty of $922,500 had previously been a component of the fair value adjustment for the junior subordinated debt at the initial adoption of the fair value option.

Effective December 31, 2001, United Security Bank formed a subsidiary Real Estate Investment Trust ("REIT") through which preferred stock was offered to private investors, to raise capital for the bank in accordance with the laws and regulations in effect at the time. The principal business purpose of the REIT was to provide an efficient and economical means to raise capital. The REIT also provided state tax benefits beginning in 2002. On December 31, 2003, the California Franchise Tax Board (FTB) announced certain tax transactions related to real estate investment trusts (REITs) and regulated investment companies (RICs) will be disallowed pursuant to Senate Bill 614 and Assembly Bill 1601, which were signed into law in the 4th quarter of 2003 (For further discussion see Income Taxes section of Results of Operations contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations).

Effective April 23, 2004, the Company completed a merger with Taft National Bank headquartered in Taft, California. Taft National Bank ("Taft") was merged into United Security Bank and Taft's two branches, one located Taft and the other located in Bakersfield, California, began operating as branches of United Security Bank. The merger was accounted for using the purchase method of accounting, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Taft based on the fair value of those assets and liabilities, with resultant goodwill of $1.6 million and core deposits intangibles of $1.9 million. Goodwill is not amortized but is reviewed at least annually for impairment, while core deposit intangibles were amortized over a period of 7 years. The Company has recognized no impairment on either the goodwill or core deposit intangible related to the Taft merger.

On February 16, 2007, the Company completed its merger of Legacy Bank, N.A. with and into United Security Bank, a wholly owned subsidiary of the Company. Legacy Bank which began operations in 2003 operated one banking office in Campbell, California serving small business and retail banking clients. With its small business and retail banking focus, Legacy Bank provides a unique opportunity for United Security Bank to serve a loyal and growing small business niche and individual client base in the San Jose area. Upon completion of the merger, Legacy Bank's branch office began operating as a branch office of United Security Bank. The merger transaction was accounted for using the purchase accounting method, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy based on the fair value of those assets and liabilities. Fair value adjustments and intangible assets totaled approximately $12.9 million, including $8.8 million in goodwill. Goodwill is not amortized but is reviewed at least annually for impairment, while core deposit intangibles are being amortized over a period of 7 years. The Company has recognized no impairment on either the goodwill or core deposit intangibles related to the Legacy merger.

During July 2007, the Company formed USB Capital Trust II, a wholly-owned special purpose entity, for the purpose of issuing Trust Preferred Securities. Like USB Capital Trust I formed in July 2001, 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 is to pay interest on the junior subordinated debentures to USB Capital Trust II, which represents the sole source of dividend distributions to the holders of the Trust Preferred securities. 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

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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 anytime at par.

The Bank currently has eleven banking branches, one construction lending office, and one financial services office, which provide banking and financial services in Fresno, Madera, Kern, and Santa Clara counties. As a community-oriented bank holding company, the Company continues to seek ways to better meet its customers' needs for financial services, and to expand its business opportunities in today's ever-changing financial services environment. The Company's strategy is to be a better low-cost provider of services to its customer base while enlarging its market area and corresponding customer base to further its ability to provide those services.

On March 23, 2010, United Security Bancshares (the "Company") and its wholly owned subsidiary, United Security Bank (the "Bank"), entered into a formal written agreement (the “Agreement”) with the Federal Reserve Bank of San Francisco (the “Federal Reserve”) as a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions (the “DFI”) in June 2009. That examination found significant increases in nonperforming assets, both classified loans and OREO, during 2008 and 2009, and heightened concerns about the Bank’s use of brokered and other wholesale funding sources to fund loan growth, which created increased risk to equity capital and potential volatility in earnings. Under the terms of the Agreement, the Company and the Bank agreed, among other things: to maintain a sound process for determining, documenting, and recording an adequate allowance for loan and lease losses; to improve the management of the Bank's liquidity position and funds management policies; to maintain sufficient capital at the Company and Bank level; and to improve the Bank’s earnings and overall condition. The Company and Bank also agreed not to increase or guarantee any debt, purchase or redeem any shares of stock, declare or pay any cash dividends, or pay interest on the Company's junior subordinated debt or trust preferred securities, without prior written approval from the Federal Reserve. The Company generates no revenue of its own and, as such, relies on dividends from the Bank to pay its operating expenses and interest payments on the Company’s junior subordinated debt. Effective November 19, 2014, the Federal Reserve terminated the Agreement with the Bank and the Company and replaced it with an informal supervisory agreement that requires, among other things, obtaining written approval from the Federal Reserve prior to the payment of dividends from the Bank to the Company or the payment of dividends by the Company or interest on the Company’s junior subordinated debt. The inability of the Bank to pay cash dividends to the Company may hinder the Company’s ability to meet its ongoing operating obligations. (For more information on the Agreement see the “Regulatory Matters” section included in this Management’s Discussion and Analysis of Financial Condition and Results of Operations.)

On May 20, 2010, the DFI (now known as the Department of Business Oversight (the “DBO”)) issued a formal written order (the “Order”) pursuant to a consent agreement with the Bank as a result of the same June 2009 joint regulatory examination. The terms of the Order were essentially similar to the Federal Reserve’s Agreement, except for a few additional requirements. On September 24, 2013, the Bank entered into an informal Memorandum of Understanding (the “MOU”) with the DBO and on October 15, 2013, the Order was terminated. The Order and the MOU require the Bank to maintain a ratio of tangible shareholder’s equity to total tangible assets equal to or greater than 9.0% and also requires the DBO’s approval for the Bank to pay a dividend to the Company. Accordingly, reflecting the Company’s and the Bank’s improved financial condition and performance, as of November 19, 2014, the Bank and the Company have been relieved of all formal regulatory agreements. Some of the governance and procedures established by the Agreement and the Order remain in place, including submission of certain plans and reports to the Federal Reserve and DBO, the Bank’s obligation to maintain a 9.0% tangible shareholder’s equity ratio, and the requirement to seek approvals from the Federal Reserve and the DBO for either the Bank or the Company to pay dividends and for the Company to pay interest on its outstanding junior subordinated debt. While no assurances can be given as to future regulatory approvals, over the last five quarters the DBO and the Federal Reserve have been approving the Bank's

payment of dividends to the Company to cover the Company's operating expenses and its interest payments and the Company's payment of quarterly interest on the junior subordinated debt. The Bank is currently in full compliance with the requirements of the MOU including its deadlines. (For more information on the Agreement see the “Regulatory Matters” section included in this Management’s Discussion and Analysis of Financial Condition and Results of Operations.)

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 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 are considered as well in the planning process to mitigate risk and allow for growth. Net interest income increased during 2015, totaling $26,129,000 and $23,617,000 for the years ended December 31, 2015 and 2014, respectively. The increase in net interest income was primarily the result of an increase in the rates on interest-earning assets. Average interest-earning assets increased approximately

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$30,333,000 between 2015 and 2014 and the rate on interest earning assets increased 19 basis points during the two periods. The increase in average earning assets between 2015 and 2014 consisted of an increase of $70,615,000 in loans, offset by decreases of $31,686,000 in interest-bearing deposits held at the Federal Reserve Bank and $8,603,000 in investment securities. The Company's cost of interest-bearing liabilities declined during 2015, with the average cost of interest-bearing liabilities dropping from 0.38% during 2014 to 0.35% for the year ended December 31, 2015.

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

	YTD Average 12/31/15		YTD Average 12/31/14	
Loans	79.68	%	71.78	%
Investment securities available for sale	6.56	%	8.36	%
Interest-bearing deposits in other banks	0.25	%	0.26	%
Interest-bearing deposits in FRB	13.51	%	19.60	%
Total earning assets	100.00	%	100.00	%
NOW accounts	21.91	%	17.99	%
Money market accounts	38.15	%	40.86	%
Savings accounts	17.03	%	14.99	%
Time deposits	20.33	%	23.12	%
Other borrowings	—	%	—	%
Subordinated debentures	2.58	%	3.04	%
Total interest-bearing liabilities	100.00	%	100.00	%

Since the Bank primarily conducts banking operations in California's Central Valley, its operations and cash flows are subject to changes in the economic condition of the Central Valley. Our business results are dependent in large part upon the business activity, population, income levels, deposits and real estate activity in the Central Valley, and declines in economic conditions can have adverse material effects upon the Bank. In addition, the Central Valley remains largely dependent on agriculture. A downturn in agriculture and agricultural related business could indirectly and adversely affect the Company as many borrowers and customers are involved in, or are impacted to some extent, by the agricultural industry. While a great number of our borrowers are not directly involved in agriculture, they would likely be impacted by difficulties in the agricultural industry since many jobs in our market areas are ancillary to the regular production, processing, marketing and sale of agricultural commodities. The state of California is currently experiencing the worst drought in recorded history, and, of course, it is not possible to predict the potential impact on businesses and consumers located in the Company's market areas or the duration of the drought.

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 2015. 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 between June 2013 to December 2015.

During the year ended December 31, 2015, the Company experienced increases in real estate mortgage loans, commercial real estate loans, agriculture loans and installment loans and decreases in commercial and industrial loans and real estate construction and development loans, compared to the same period ended December 31, 2014. Loans increased $57,399,000 between December 31, 2014 and December 31, 2015. Real estate mortgage loans increased $37,355,000 between December 31, 2014 and December 31, 2015. Agricultural loans increased $20,424,000 between December 31, 2014 and December 31, 2015. Commercial and industrial loans decreased $6,543,000 between December 31, 2014 and December 31, 2015. 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 35.43% and 33.78%, of the total loan portfolio at December 31, 2015 and

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December 31, 2014, respectively. Commercial real estate loans increased $27,882,000 during 2015. 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 $68,811,000 or 13.35% of the portfolio at December 31, 2015, and $59,095,000, or 12.91% of the portfolio at December 31, 2014. The Bank held no purchased loan participations at December 31, 2015 or December 31, 2014. Loan participations sold increased from $6,230,000 or 1.4% of the portfolio at December 31, 2014, to $29,025,000, or 5.6%, at December 31, 2015.

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 increased to 4.22% for the year ended December 31, 2015, when compared to 4.01% for the year ended December 31, 2014. The net interest margin has improved due to growth of the loan portfolio, which is a higher yielding asset, compared to overnight investments with the Federal Reserve Bank. 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 5.36% during the year ended December 31, 2015, as compared to 5.62% for the year ended December 31, 2014. The decrease in the Company's cost of funds over the past few years has also contributed to the improved net interest margin. The Company's average cost of funds was 0.35% for the year ended December 31, 2015, as compared to 0.38% for the year ended December 31, 2014. The Company does not intend to increase its brokered deposits and expects brokered deposit balances to remain level at least in the short-term. Currently, CDARs reciprocal deposits are the only brokered deposits held by the Company. The CDARs reciprocal deposit is preferred by some depositors.

Total noninterest income of $4,735,000 reported for the year ended December 31, 2015 decreased $426,000 or 8.25% as compared to the year ended December 31, 2014. Noninterest income continues to be driven by customer service fees, which totaled $3,620,000 for the year ended December 31, 2015. The decrease in noninterest income between the years ended December 31, 2015 and December 31, 2014, was primarily the result of a $714,000 decrease in gain on sale of other investments between the two periods. A $691,000 gain on sale was realized in 2014 as compared to a $23,000 loss realized in 2015.

Noninterest expense increased approximately $383,000 or 1.99% between the years ended December 31, 2014 and December 31, 2015. The increases experienced during the year ended December 31, 2015, were primarily the result of increases of $282,000 in occupancy expense and $268,000 in salary and employment benefits, partially offset by decreases of $319,000 in professional fees.

On March 24, 2015, June 23, 2015, September 22, 2015, and December 15, 2015, the Company's Board of Directors declared a one-percent (1%) quarterly stock dividend on the Company's outstanding common stock. The Company believes that, given the current uncertainties in the economy, it is prudent to retain capital and better position the Company for future growth opportunities. Based upon the number of outstanding common shares on the record date of April 6, 2015, July 6 2015, October 5, 2015, and January 4, 2016, respectively, an additional 154,249, 155,796, 157,357, and 158,918 shares, respectively, were issued to shareholders. For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to the 1% stock dividends to shareholders for all periods presented.

The Company has sought to maintain a strong, yet conservative balance sheet while continuing to reduce the level of nonperforming assets and maintain adequate liquidity during the year ended December 31, 2015. Total assets increased approximately $62,475,000 during the year ended December 31, 2015, as a result of increases of $58,839,000 in net loans and $22,174,000 in cash and cash equivalents, partially offset by decreases of $17,408,000 in

investment securities and $1,137,000 in OREO. Total deposits increased $56,432,000, including an increase of $46,729,000 in noninterest-bearing deposits, and an increase of $18,689,000 in savings, NOW and money market accounts, offset by a decrease of $8,986,000 in time deposits during the year ended December 31, 2015. Average loans comprised approximately 79.68% and 71.79% of overall average earning assets during the years ended December 31, 2015 and December 31, 2014, respectively.

Nonperforming assets, which are primarily related to the real estate loan and other real estate owned portfolio, remained high during the year ended December 31, 2015, and increased $2,508,000 from a balance of $29,586,000 at December 31, 2014 to a balance of $32,094,000 at December 31, 2015. Nonaccrual loans totaling $8,193,000 at December 31, 2015, decreased $1,742,000 from the balance of $9,935,000 reported at December 31, 2014. In determining the adequacy of the underlying collateral related to these loans, management monitors trends within specific geographical areas, loan-to-value ratios, appraisals, and other credit issues related to the specific loans. Impaired loans increased $7,642,000 during the year ended December 31, 2015 to a balance of $23,679,000 at December 31, 2015. Other real estate owned through foreclosure decreased

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$1,137,000 between December 31, 2014 and December 31, 2015. As a result of the related events, nonperforming assets as a percentage of total assets decreased from 4.46% at December 31, 2014 to 4.42% at December 31, 2015.

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

(In thousands)	December 31, 2015	December 31, 2014	December 31, 2013
Recovery of provision for credit losses during period	$(41)	$(845)	$(1,098)
Allowance as % of nonperforming loans	50.53%	69.15%	60.70%
Nonperforming loans as % total loans	3.73%	3.40%	4.58%
Restructured loans as % total loans	3.59%	3.28%	2.29%

When the economy declined along with asset valuations, increased emphasis was placed on impairment analysis of both tangible and intangible assets on the balance sheet. As of March 31, 2014, the Company conducted annual impairment testing on the largest component of its outstanding balance of goodwill, that of the Campbell operating unit (resulting from the Legacy merger during February 2007.) The Company completed a "Step 0" analysis for the Campbell reporting unit as of March 31, 2015 and March 31, 2014, and concluded that there was no impairment of the goodwill related to the Campbell operating unit for the years ended December 31, 2015 and 2014.

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. The number of restructured loans decreased from 58 loans totaling $16,773,000 at December 31, 2012, to approximately 35 loans totaling $9,059,000 at December 31, 2013, but increased to 33 loans totaling $15,000,000 at December 31, 2014. The number of restructures decreased in 2015 to 29 loan restructures but the balance increased to $18,508,000 at December 31, 2015. A recovery of provision was made to the allowance for credit losses totaling $41,000 during the year ended December 31, 2015, as compared to $845,000 for the year ended December 31, 2014. The level in the allowance for credit losses is deemed adequate to cover inherent losses in the loan portfolio. Net loan charge-offs during the year ended December 31, 2015 totaled $1,017,000, as compared to $629,000 in net recoveries for the year ended December 31, 2014. The Company charged-off approximately 9 loans during the year ended December 31, 2015, compared to 13 loans during the year ended December 31, 2014. Net loan charge-offs totaling $1,017,000 during the year ended December 31, 2015, included $60,000 in net recoveries during the quarter ended March 31, 2015, $264,000 in net recoveries during the quarter ended June 30, 2015, $39,000 in net recoveries during the quarter ended September 30, 2015, and $1,380,000 in net charge-offs during the fourth quarter of 2015. The percentage of net charge-offs to average loans was 0.21%, for the year ended December 31, 2015. The percentages for the years ended December 31, 2014 and 2013 reflected net recoveries to average loans of 0.15% and net recoveries of 0.08%, respectively.

Deposits increased by $56,432,000 during the year ended December 31, 2015, with increases in savings, NOW, and money market accounts and non interest bearing deposits, partially offset by decreases in time accounts. Time deposits decreased $8,986,000 during the year ended December 31, 2015, due to management's focus on reducing time deposits and lowering the bank's average cost of funds.

The Company continues to maintain a low reliance on brokered deposits, while maintaining sufficient liquidity. Currently, the Company does not utilize wholesale funding sources. Brokered deposits totaled $8,546,000 or 1.37% of total deposits at December 31, 2015, as compared to $11,480,000, or 2.03%. The Company has reduced its reliance on brokered deposits to 1.37%, a level comparable with peers, which is currently about 2.75% of total deposits.

The Company had no borrowings at December 31, 2015 and 2014, but the Company will maintain overnight borrowing and other term credit lines as deemed prudent.

The cost of the Company's subordinated debentures issued by USB Capital Trust II has remained low along 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 1.90% and 1.55% at December 31, 2015 and 2014, respectively. Pursuant to fair value accounting guidance, the Company has recorded $73,000 in pretax fair value losses on its junior subordinated debt during the year ended December 31, 2015, bringing the total cumulative gain recorded on the debt to $4,214,000 at December 31, 2015.

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The Company continues to emphasize relationship banking and core deposit growth, focusing greatest attention on its market areas of Fresno, Madera, and Kern Counties, as well as Campbell, in Santa Clara County. The San Joaquin Valley and other California markets are exhibiting improving demand for construction lending and commercial lending from small and medium size businesses. We have seen improvement over the last four years, and are optimistic that these positive trends will continue. There are continued challenges for the banking industry with tight credit markets and relatively weak real estate markets adversely affecting the Banking industry and the Company.

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 2016 and beyond. The banking industry is still experiencing downward pressure on net margins as interest rates remain at historical lows. As a result, market rates of interest and asset quality will continue 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 collateralized mortgage obligations and other investment securities, and 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 and 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, change.

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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 defines 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, 2015 and 2014, the Company recorded fair value adjustments related to its junior subordinated debt totaling losses of $73,000 and $102,000, 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, 2015 and 2014.

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-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.

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

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On a year-to-date basis, the Company reported net income of $6,810,000 or $0.42 per share ($0.42 diluted) for the year ended December 31, 2015, as compared to $6,216,000 or $0.39 per share ($0.39 diluted) for the same period in 2014. The increase of $594,000 between December 31, 2014 and December 31, 2015 was primarily the result of increases in interest-earning assets. Interest income increased by $2,448,000 between December 31, 2014 and December 31, 2015 and non-interest income decreased by $426,000.

The Company's return on average assets was 0.98% for the year ended December 31, 2015, as compared to 0.93% for the year ended December 31, 2014. The Company's return on average equity was 7.88% for the year ended December 31, 2015, as compared to 7.80% for the year ended December 31, 2014.

As with variances in net income, changes in the return on average assets and average equity experienced by the Company during 2015 and 2014 were effected by increases in average loan balances and net 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, 2015, 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).

(In thousands except per share data and ratios)	2015	2014	2013	2012	2011
Selected Financial Ratios:					
Return on average assets	0.98%	0.93%	1.13%	0.97%	(1.64)%
Return on average shareholders' equity	7.88%	7.80%	10.09%	9.23%	(15.86)%
Average shareholders' equity to average assets	12.41%	11.88%	11.20%	10.55%	10.36%
Dividend payout ratio	—%	—%	—%	—%	—%

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 $26,129,000 for the year ended December 31, 2015, representing an increase of $2,512,000, or 10.64%, when compared to the $23,617,000 reported for the same period of the previous year. The Company's year-to-date net interest margin, as shown in Table 1, increased to 4.22% at December 31, 2015 from 4.01% at December 31, 2014, an increase of 21 basis points (100 basis points = 1%) between the two periods.

Table 1. – Distribution of Average Assets, Liabilities and Shareholders' Equity:
Interest rates and interest differentials
Years ended December 31, 2015 and 2014

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(Dollars in thousands)	2015 Average Balance	2015 Interest	2015 Yield/Rate	2014 Average Balance	2014 Interest	2014 Yield/Rate
Assets:						
Interest-earning assets:						
Loans and leases (1)	$493,375	$26,469	5.36 %	$422,760	$23,777	5.62 %
Investment Securities – taxable	40,616	722	1.78 %	49,219	901	1.83 %
Interest-bearing deposits in other banks	1,525	6	0.39 %	1,518	7	0.46 %
Interest-bearing deposits in FRB	83,709	213	0.25 %	115,395	277	0.24 %
Total interest-earning assets	619,225	$27,410	4.43 %	588,892	$24,962	4.24 %
Allowance for credit losses	(11,357)			(11,118)		
Noninterest-earning assets:						
Cash and due from banks	22,279			20,447		
Premises and equipment, net	11,174			11,936		
Accrued interest receivable	1,601			1,434		
Other real estate owned	13,466			14,188		
Other assets	40,086			45,254		
Total average assets	$696,474			$671,033		
Liabilities and Shareholders' Equity:						
Interest-bearing liabilities:						
NOW accounts	$79,977	$108	0.14 %	$63,251	$77	0.12 %
Money market accounts	139,220	461	0.33 %	143,627	504	0.35 %
Savings accounts	62,163	159	0.26 %	52,681	130	0.25 %
Time deposits	74,193	328	0.44 %	81,271	393	0.48 %
Junior subordinated debentures	9,410	225	2.39 %	10,681	241	2.26 %
Total interest-bearing liabilities	364,963	$1,281	0.35 %	351,511	$1,345	0.38 %
Noninterest-bearing liabilities:						
Noninterest-bearing checking	237,034			230,876		
Accrued interest payable	73			76		
Other liabilities	8,005			8,878		
Total average liabilities	610,075			591,341		
Total average shareholders' equity	86,399			79,692		
Total average liabilities and shareholders' equity	$696,474			$671,033		
Interest income as a percentage of average earning assets			4.43 %			4.24 %
Interest expense as a percentage of average earning assets			0.21 %			0.23 %
Net interest margin			4.22 %			4.01 %

(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 fees of approximately $163,000 and $419,000 for the years ended December 31, 2015 and 2014, respectively.

The prime rate was raised from its long-standing rate of 3.25% to 3.50% in December 2015 and is expected to see further increases during 2016. 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

	2015 compared to 2014			2014 compared to 2013		
(In thousands)	Total	Rate	Volume	Total	Rate	Volume
Increase (decrease) in interest income:						
Loans	$2,692	$(1,136)	3,828	$1,798	$87	1,711
Investment securities	(179)	(25)	(154)	198	(174)	372
Interest-bearing deposits in other banks	(1)	(1)	—	(1)	(1)	—
Interest-bearing deposits in FRB	(64)	20	(84)	35	1	(36)
Total interest income	2,448	(1,142)	3,590	1,960	(87)	2,047
Increase (decrease) in interest expense:						
Interest-bearing demand accounts	(12)	(45)	33	(94)	(121)	27
Savings accounts	29	5	24	46	24	22
Time deposits	(65)	(32)	(33)	(178)	(111)	(67)
Subordinated debentures	(16)	14	(30)	(40)	(41)	1
Total interest expense	(64)	(58)	(6)	(266)	(249)	(17)
Increase (decrease) in net interest income	$2,512	$(1,084)	3,596	$2,226	$162	2,064

For the year ended December 31, 2015, total interest income increased approximately $2,448,000 or 9.81% as compared to the year ended December 31, 2014, reflective of an increase of $2,692,000 in loan interest income. Earning asset volumes decreased in investment securities available for sale, which on average decreased $8,603,000 between the two periods, and remained constant in interest-bearing deposits in other banks between the two periods. Interest-bearing deposits in FRB decreased by $31,686,000 on average between the two periods. The average rates on loans decreased 26 basis points between the two periods, and the average rate on investment securities decreased approximately 5 basis points during the year ended December 31, 2015, as compared to the same period of 2014.

For the year ended December 31, 2015, total interest expense decreased approximately $64,000, or 4.76%, as compared to the year ended December 31, 2014. Between those two periods, average interest-bearing liabilities increased by $13,452,000, while the average rates paid on these liabilities decreased by 3 basis points.

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, 2015, the recovery of provision to the allowance for credit losses amounted to $41,000. The recovery of provision for the year ended December 31, 2014 totaled $845,000.

The allowance for credit losses decreased to 1.88% of total loans during the year ended December 31, 2015, as compared to a 2.35% balance at December 31, 2014. The negative loan loss provisions recorded during 2014 and 2015 are a result of continuing improvements in the overall credit quality of the loan portfolio, overall improvements in the loss history over the recent years, and improvements in property values that serve as loan collateral through December 31, 2014 and December 31, 2015.

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Noninterest Income

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

(In thousands)	2015	2014	Amount of Change	Percent Change
Customer service fees	$3,620	$3,473	$147	4.23%
Increase in cash surrender value of BOLI/COLI	519	514	5	0.97%
Loss on fair value option of financial liabilities	(73)	(102)	29	(28.43)%
Gain on sale of other assets	10	25	(15)	(60.00)%
Gain on redemption of junior subordinated debenture	78	—	78	100.00%
(Loss) gain on other investments	(23)	691	(714)	(103.33)%
Other	604	560	44	7.86%
Total	$4,735	$5,161	$(426)	(8.25)%

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.

Noninterest income for the year ended December 31, 2015 decreased $426,000 or 8.25% when compared to the same period of 2014. Customer service fees, the primary component of noninterest income, increased $147,000 or 4.23% between the two periods presented. The decrease in noninterest income of $426,000 between the two periods is the result of a gain on sale of other investments of $691,000 realized in 2014 on the sale of a local property investment contrasted with a loss of $23,000 realized in 2015.

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, 2015 and 2014:

	2015		2014	
(Dollars in thousands)	Amount	% of Average Earning Assets	Amount	% of Average Earning Assets
Salaries and employee benefits	$9,921	1.60%	$9,653	1.64%
Occupancy expense	4,042	0.65%	3,760	0.64%
Data processing	126	0.02%	134	0.02%
Professional fees	1,137	0.18%	1,456	0.25%
FDIC/DFI assessments	959	0.15%	943	0.16%
Directors fees	277	0.04%	232	0.04%
Amortization of intangibles	—	—%	62	0.01%
Correspondent bank service charges	75	0.01%	117	0.02%
Loss on CA Tax Credit Partnership	73	0.01%	39	0.01%
OREO expense	619	0.10%	571	0.10%
Other	2,369	0.38%	2,248	0.38%
Total	$19,598	3.17%	$19,215	3.26%

Noninterest expense increased $383,000 between the years ended December 31, 2015 and 2014. The net increase in noninterest expense between the comparative periods is primarily the result of increases in salaries and employee

benefits and occupancy expense, partially offset by decreases in professional fees and correspondent bank charges.

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Included in net costs on operations of OREO for the years ended December 31, 2015 and 2014, are gains on the sale of OREO totaling $16,000 and $114,000, respectively, and OREO operating expenses totaling $447,000 and $685,000, respectively. Net cost on operation of OREO for the year ended December 31, 2015 also includes a $188,000 write-down on OREO.

During the years ended December 31, 2015 and 2014, the Company recognized stock-based compensation expense of $26,000 and $28,000 (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 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 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.

The Company reviews its current tax positions at least quarterly based 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, 2015, 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 $62,475,000 or 9.42% during the year from a balance of $663,169,000 at December 31, 2014 to $725,644,000 at December 31, 2015, and increased $89,715,000 or 14.11% from the balance of $635,929,000 at December 31, 2013. During the year ended December 31, 2015, increases of $58,839,000 were experienced in net loans. Overnight interest-bearing deposits in the Federal Reserve Bank and federal funds sold increased a net $13,789,000, while investment securities decreased by $17,408,000 during the year ended December 31, 2015. Total deposits of $621,805,000 at December 31, 2015, increased $56,432,000 or 9.98% from the balance reported of $565,373,000 at December 31, 2014, and increased $79,316,000, or 14.62%, from the balance of $542,489,000 reported at December 31, 2013.

During the year ended December 31, 2014, increases of $62,602,000 were experienced in net loans. Overnight interest-bearing deposits in the Federal Reserve Bank and federal funds sold, decreased a net $32,790,000, while investment securities increased by $4,685,000 during the year ended December 31, 2014. Total deposits of $565,373,000 at December 31, 2014 increased $22,884,000, or 4.22%, from the balance reported at December 31, 2013 of $542,489,000, and $2,086,000 or 0.37% from the balance of $563,287,000 reported at December 31, 2012.

Earning assets averaged approximately $619,225,000 during the year ended December 31, 2015, as compared to $588,892,000 for the year ended December 31, 2014. Average interest-bearing liabilities increased to $364,963,000 for the year ended December 31, 2015, as compared to $351,511,000 for the year ended December 31, 2014.

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 $515,318,000 at December 31, 2015, representing an increase of $57,399,000 or 12.53% when compared to the balance of $457,919,000 at December 31, 2014. During 2015, average loans increased 16.70% when compared to the year ended December 31, 2014. Average loans totaled $493,375,000, $422,760,000, and $392,340,000 for the years ended December 31, 2015, 2014 and 2013, 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)	2015 Dollar Amount	% of Loans		2014 Dollar Amount	% of Loans		2013 Dollar Amount	% of Loans		2012 Dollar Amount	% of Loans		2011 Dollar Amount	% of Loans	
Commercial and Industrial	$55,826	10.8	%	$62,369	13.6	%	$70,686	17.9	%	$72,117	18.0	%	$99,060	24.2	%
Real estate mortgage	252,232	48.9	%	214,877	46.9	%	197,365	49.9	%	189,934	47.5	%	182,131	44.6	%
RE construction & development	130,596	25.3	%	137,158	30.0	%	87,004	22.0	%	90,941	22.7	%	70,877	17.3	%
Agricultural	52,137	10.1	%	31,713	6.9	%	30,932	7.8	%	36,169	9.0	%	45,483	11.1	%
Installment/other	24,527	4.9	%	11,802	2.6	%	9,330	2.4	%	10,884	2.7	%	11,115	2.8	%
Lease financing	—	—	%	—	—	%	—	—	%	12	0.1	%	49	—	%
Total Loans	$515,318	100.0	%	$457,919	100.0	%	$395,317	100.0	%	$400,057	100.0	%	$408,715	100.0	%

Loan volume continues to be greatest in what has historically been the Bank's primary lending emphasis: commercial, real estate mortgage, and construction lending. Total loans increased $57,399,000 during 2015. With continuing recovery in the real estate markets, the Company experienced increases of $37,355,000, or 17.4%, in real estate mortgage, which includes purchased residential mortgage pools, and an increase in commercial real estate of $27,882,000, or 18.03%. Commercial and industrial loans decreased $6,543,000 or 10.49%, agriculture loans increased $20,424,000, or 64.4% Installment loans increased $12,725,000, or 107.8% when compared to the previous year due to growth in the student loan portfolio.

During 2014, the Company experienced an increase of $50,154,000 or 57.6% in construction loans, an increase of $17,512,000 or 8.9% in real estate mortgage loans, an increase of $781,000 or 2.5% in agricultural loans and an increase of $2,472,000 or 26.5% in installment loans.

At December 31, 2015, approximately 53.4% 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 regained some momentum in 2015, and as a result, real estate mortgage loans increased $37,355,000. However, real estate construction loans decreased $6,562,000 or 4.8% during 2015, as compared to an increase in real estate construction loans of $50,154,000 or 57.6% during 2014. 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 $20,424,000 or 64.4% between December 31, 2014 and December 31, 2015; and commercial loans consisting primarily of loans for non real estate business operations, decreased $6,543,000 or 10.49%. Installment loans increased $12,725,000 or 107.8% during that same period.

The real estate mortgage loan portfolio totaling $252,232,000 at December 31, 2015, consists of commercial real estate, residential mortgages, and home equity loans. Commercial real estate is the predominate segment of the portfolio, with balances of $182,554,000, and $154,672,000 at December 31, 2015 and 2014, 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 purchases mortgage portfolios. The residential real estate mortgage portfolio had balances of $68,811,000 and $59,095,000 at December 31, 2015 and 2014, respectively. The Company also offers short to medium-term, fixed-rate, home equity loans, which totaled $867,000 at December 31, 2015 and $1,110,000 at December 31, 2014.

The following table sets forth the maturities of the Bank's loan portfolio at December 31, 2015. Amounts presented are shown by maturity dates rather than repricing periods:

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(In thousands)	Due in one year or less	Due after one year through five years	Due after five years	Total
Commercial and agricultural	$38,250	$37,942	$31,771	$107,963
Real estate construction & development	47,438	83,059	99	130,596
Real estate – mortgage	30,250	123,814	98,168	252,232
All other loans	2,455	22,043	29	24,527
Total Loans	$118,393	$266,858	$130,067	$515,318

For the year ended December 31, 2015 and 2014, the average yield on loans was 5.36% and 5.62%, respectively. This consistent yield was due in part to the Company utilizing 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, 2015 and 2014, approximately 43.2% and 39.9% 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, 2015. 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	$31,378	$214,196	$40,291	$285,865
Floating rate loans	80,263	51,548	89,449	221,260
Total accruing loans	111,641	265,744	129,740	507,125
Nonaccrual loans:				
Fixed rate loans	5,719	1,113	—	6,832
Floating rate loans	1,034	—	327	1,361
Total nonaccrual loans	6,753	1,113	327	8,193
Total Loans	$118,394	$266,857	$130,067	$515,318

Securities

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

	December 31, 2015				December 31, 2014			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
Available-for-sale:								
U.S. Government agencies	$9,778	$453	$(108)	$10,123	$12,097	$399	$—	$12,496
U.S. Government sponsored entities & agencies collateralized by	16,835	175	(52)	16,958	31,659	336	(13)	31,982

mortgage obligations								
Mutual Funds	4,000	—	(188	) 3,812	4,000	—	(177	) 3,823
Total available-for-sale	$ 30,613	$ 628	$ (348	) $ 30,893	$ 47,756	$ 735	$ (190	) $ 48,301

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The contractual maturities of investment securities as well as yields based on amortized cost of those securities at December 31, 2015 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.

	One year or less			After one year to five years			After five years to ten years			After ten years			Total		
(Dollars in thousands)	Amount	Yield (1)		Amount	Yield (1)		Amount	Yield (1)		Amount	Yield (1)		Amount	Yield (1)	
Available-for-sale:															
U.S. Government agencies	$—	—	%	$13	2.55	%	$1,025	0.71	%	$8,740	1.36	%	$9,778	1.29	%
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	—	—	%	4,130	1.88	%	11,883	1.74	%	822	2.04	%	16,835	1.79	%
Mutual Funds	—	—	%	—	—	%	—	—	%	4,000	2.02	%	4,000	2.02	%
Total estimated fair value	$—	—	%	$4,143	1.88	%	$12,908	1.66	%	$13,562	1.60	%	$30,613	1.66	%

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

At December 31, 2015 and 2014, available-for-sale securities with an amortized cost of approximately $16,253,074 and $20,865,000, respectively (fair value of $16,670,290 and $21,503,000, 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. Total deposits increased $56,432,000 or 9.98% during the year to a balance of $621,805,000 at December 31, 2015. 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 96.9% and 95.8% of the total deposit portfolio at December 31, 2015 and 2014, respectively.

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:

	December 31,			Change during Year			
(In thousands)	2015	2014	2013	2015		2014	
Noninterest-bearing deposits	$262,168	$215,439	$214,317	$46,729		$1,122	
Interest-bearing deposits:							
NOW and money market accounts	226,886	211,290	198,928	15,596		12,362	
Savings accounts	63,592	60,499	45,758	3,093		14,741	
Time deposits:							
Under $250,000	58,122	65,844	73,829	(7,722	)	(7,985	)
$250,000 and over	11,037	12,301	9,657	(1,264	)	2,644	
Total interest-bearing deposits	359,637	349,934	328,172	9,703		21,762	
Total deposits	$621,805	$565,373	$542,489	$56,432		$22,884	

The Company continues to have a low reliance on brokered and other wholesale funding sources. As of December 31, 2015, brokered deposits totaled 1.37% of total deposits, which the Company believes to be in line with peers.

During the year ended December 31, 2015, increases were experienced across all categories except for time deposits. Total time deposits decreased $8,986,000, or 11.50%, during the year ended December 31, 2015, and brokered deposits, a component of total time deposits, decreased slightly by $2,934,000, or 1.37%, during the year. Noninterest-bearing deposits increased $46,729,000 during the year and increases in savings accounts and NOW and money market accounts of $3,093,000, or 5.11%, and $15,596,000, or 7.38%, respectively, were also realized during the year ended December 31, 2015.

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During the year ended December 31, 2014, increases were experienced across all categories except for time deposits. Total time deposits decreased $5,341,000, or 1.63%, during the year ended December 31, 2014, and brokered deposits, a component of total time deposits, decreased slightly by $20,000, or 2.03%, during the year. Noninterest bearing deposits increased $1,122,000 during the year. Additionally, increases in savings accounts and NOW and money market accounts of $14,741,000, or 32.22%, and $12,362,000, or 6.21%, respectively, were realized during the year ended December 31, 2014.

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. Significant increases in deposits were realized during 2015. Total noninterest-bearing deposits increased $46,729,000, or 21.7%, between December 31, 2014 and December 31, 2015, and total interest-bearing deposits increased $9,703,000, or 2.8%, during the same period. Between December 31, 2013 and December 31, 2014, total interest-bearing deposits increased $21,762,000, or 6.6%, and total noninterest-bearing deposits increased $1,122,000, or 0.5%.

On a year-to-date average basis, total deposits increased $20,881,000, or 3.7%, between the years ended December 31, 2014 and December 31, 2015. Of that total, interest-bearing deposits increased by $14,723,000, or 4.3%, and noninterest-bearing deposits increased $6,158,000, or 2.67%, during 2015. On average, the Company experienced decreases in time deposits, while NOW accounts, money market and savings accounts increased between the years ended December 31, 2014 and December 31, 2015. On a year-to-date average basis, total deposits increased by $16,979,000 or 3.1% between the years ended December 31, 2013 and December 31, 2014. Of that total, interest-bearing deposits increased by $6,106,000 or 1.8%, while noninterest-bearing deposits increased $10,873,000 or 4.94% during 2014. On average, the Company experienced decreases in time deposits, while NOW accounts, money market and savings accounts increased between the years ended December 31, 2013 and December 31, 2014.

The following table sets forth the average deposits and average rates paid on those deposits for the years ended December 31, 2015, 2014, and 2013:

	2015		2014		2013	
(Dollars in thousands)	Average Balance	Rate %	Average Balance	Rate %	Average Balance	Rate %
Interest-bearing deposits:						
Checking accounts	$219,197	0.26 %	$206,878	0.28 %	$198,651	0.34 %
Savings	62,163	0.26 %	52,681	0.25 %	42,837	0.20 %
Time deposits (1)	74,193	0.44 %	81,271	0.48 %	93,236	0.61 %
Noninterest-bearing deposits	237,034		230,876		220,003	

(1) Included at December 31, 2015, are $11,037,000 in time certificates of deposit of $250,000 or more, of which $11,383,000 matures in three months or less, $19,391,000 matures in three to twelve months, and $7,392,000 matures in more than twelve months.

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.

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The Company had collateralized lines of credit with the FRB of $302,456,000 and $286,993,000, as well as FHLB lines of credit totaling $2,854,000 and $5,814,000 at December 31, 2015 and 2014, respectively. In addition, the Company obtained a $10,000,000 uncollateralized line of credit during 2013 from Pacific Coast Bankers Bank and a $20,000,000 uncollateralized line of credit during 2014 from Zion's Bank. At December 31, 2015, 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. 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 eleven 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 these financial statements):

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Loan Segments for Loan Loss Reserve Analysis	Loan Balances at December 31,				
(Dollars in thousands)	2015	2014	2013	2012	2011
Commercial and Business Loans	$54,503	$60,422	$68,460	$69,780	$96,076
Government Program Loans	1,323	1,947	2,226	2,337	2,984
Total Commercial and Industrial	55,826	62,369	70,686	72,117	99,060
Commercial Real Estate Term Loans	182,554	154,672	143,919	133,599	140,590
Single Family Residential Loans	68,811	59,095	52,036	55,016	39,682
Home Improvement/Home Equity Loans	867	1,110	1,410	1,319	1,859
Total Real Estate Mortgage	252,232	214,877	197,365	189,934	182,131
RE Construction and Development Loans	130,596	137,158	87,004	90,941	70,877
Agricultural Loans	52,137	31,713	30,932	36,169	45,483
Consumer Loans	24,527	11,802	9,330	10,639	10,907
Overdraft protection Lines	—	—	—	90	85
Overdrafts	—	—	—	155	124
Total Installment/other	24,527	11,802	9,330	10,884	11,116
Commercial Lease Financing	—	—	—	12	49
Total Loans	$515,318	$457,919	$395,317	$400,057	$408,716

The Company’s methodology for assessing the adequacy of the allowance for credit losses consists of several key elements, which include:
- the formula allowance,
- specific allowances for problem graded loans identified as impaired
- and the unallocated allowance

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

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

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

satisfaction of the debt. A loan classified as doubtful has critical weaknesses that make full collection of the obligation improbable. Classified loans, as defined by the Company, include impaired loans and loans categorized as substandard, doubtful, and loss which are not considered impaired. At December 31, 2015, “classified” loans totaled $39,512,000 or 7.67% of gross loans as compared to $34,358,000 or 7.50% of gross loans at December 31, 2014.

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,

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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, 2015 and 2014, the formula reserve allocated to undisbursed commitments totaled $299,000 and $294,000, 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, 2015, 2014 and 2013.

(In thousands)	December 31, 2015	December 31, 2014	December 31, 2013
Specific allowance – impaired loans	$3,097	$715	$762
Formula allowance – classified loans not impaired	1,385	2,450	3,205
Formula allowance – special mention loans	75	39	31
Total allowance for special mention and classified loans	4,557	3,204	3,998
Formula allowance for pass loans	5,086	6,739	6,595
Unallocated allowance	70	847	395
Total allowance	9,713	10,790	10,988
Impaired loans	23,612	16,037	18,132
Classified loans not considered impaired	15,900	18,321	20,233
Total classified loans	39,512	34,358	38,365
Special mention loans not considered impaired	2,562	1,766	1,825

The loan portfolio increased from $395,317,000 at December 31, 2013, to $457,919,000 at December 31, 2014, and increased to $515,318,000 at December 31, 2015. Nonperforming loans increased to $19,221,000 at December 31, 2015, from $15,576,000 at December 31, 2014, and $18,102,000 at December 31, 2013. Nonaccrual loans and accruing restructured loans are included in nonperforming loans. During the same period, total classified loans increased from $34,358,000 at December 31, 2014, to $39,512,000 at December 31, 2015.

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(Dollars in thousands)	December 31, 2015	December 31, 2014	December 31, 2013
Allowance for loan losses - period end	$9,713	$10,771	$10,988
Net loans charged off (recovered) during period	1,017	(629)	(302)
Recovery of provision for credit loss	(41)	(845)	(1,098)
Loans outstanding at period-end	515,318	457,919	395,317
ALLL as % of loans at period-end	1.88 %	2.35 %	2.78 %
Nonaccrual loans	8,193	9,935	12,341
Restructured Loans	11,028	5,641	5,761
Total nonperforming loans	19,221	15,576	18,102
ALLL as % of nonperforming loans	50.53 %	69.15 %	60.7 %
Impaired loans	23,612	16,037	18,132
Classified loans not considered impaired	15,900	18,321	20,233
Total classified loans	$39,512	$34,358	$38,365
ALLL as % of classified loans	24.58 %	31.35 %	28.64 %

Impaired loans increased $7,642,000 between December 31, 2014 and December 31, 2015 and the specific allowance related to those impaired loans increased $2,382,000 between December 31, 2014 and December 31, 2015. The formula allowance related to criticized loans that are not impaired (including special mention and substandard) decreased by $1,029,000 between December 31, 2014 and December 31, 2015. The reduction in nonaccrual loans between December 31, 2014 and December 31, 2015 is attributed to $1,412,000 in charge-offs during the period ended December 31, 2015. The level of "pass" loans increased approximately $51,377,000 between December 31, 2014 and December 31, 2015, while the related formula allowance decreased $1,653,000 during the same period. The formula allowance for "pass loans" is derived from the loan loss factors under migration analysis. Due to improvements in economic conditions and credit quality, less reserve is required for pass loans.

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, 2015, 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