

UNITED SECURITY BANCSHARES

Form 10-Q

August 05, 2013

Table of Contents

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2013

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO .

Commission file number: 000-32897

UNITED SECURITY BANCSHARES

(Exact name of registrant as specified in its charter)

CALIFORNIA

(State or other jurisdiction of incorporation or organization)

91-2112732

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

2126 Inyo Street, Fresno, California

(Address of principal executive offices)

93721

(Zip Code)

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

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

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

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

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

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, 2013: \$43,148,493

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

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

Common Stock, no par value  
(Title of Class)

Shares outstanding as of July 31, 2013: 14,508,275

1

---

Table of Contents

TABLE OF CONTENTS

Facing Page

Table of Contents

PART I. Financial Information

Item 1. Financial Statements

<u>Consolidated Balance Sheets</u>	<u>3</u>
<u>Consolidated Statements of Operations</u>	<u>4</u>
<u>Consolidated Statements of Comprehensive Income</u>	<u>5</u>
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	<u>6</u>
<u>Consolidated Statements of Cash Flows</u>	<u>7</u>
<u>Notes to Consolidated Financial Statements</u>	<u>9</u>

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 42

<u>Overview</u>	<u>42</u>
<u>Results of Operations</u>	<u>46</u>
<u>Financial Condition</u>	<u>52</u>
<u>Asset/Liability Management – Liquidity and Cash Flow</u>	<u>61</u>
<u>Regulatory Matters</u>	<u>63</u>

Item 4. Controls and Procedures 67

Item 1. <u>Legal Proceedings</u>	<u>68</u>
Item 1A. <u>Risk Factors</u>	<u>68</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>68</u>
Item 3. <u>Defaults Upon Senior Securities</u>	<u>68</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>68</u>
Item 5. <u>Other Information</u>	<u>68</u>
Item 6. <u>Exhibits</u>	<u>68</u>

Signatures 69

Table of Contents

## PART I. Financial Information

United Security Bancshares and Subsidiaries  
 Consolidated Balance Sheets – (unaudited)  
 June 30, 2013 and December 31, 2012

(in thousands except shares)	June 30, 2013	December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$23,754	\$27,481
Cash and due from FRB	114,515	114,146
Cash and cash equivalents	138,269	141,627
Interest-bearing deposits in other banks	1,511	1,507
Investment securities available for sale (at fair value)	25,527	31,844
Loans and leases	405,041	400,057
Unearned fees and unamortized loan origination costs	(6	) (24
Allowance for credit losses	(11,157	) (11,784
Net loans	393,878	388,249
Accrued interest receivable	1,536	1,694
Premises and equipment – net	11,922	12,262
Other real estate owned	17,221	23,932
Intangible assets	155	249
Goodwill	4,488	4,488
Cash surrender value of life insurance	16,941	16,681
Investment in limited partnerships	4,240	4,312
Deferred income taxes - net	10,146	9,724
Other assets	9,828	12,308
<b>Total assets</b>	<b>\$635,662</b>	<b>\$648,877</b>
<b>Liabilities &amp; Shareholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest bearing	\$219,693	\$217,014
Interest bearing	327,408	346,273
<b>Total deposits</b>	<b>547,101</b>	<b>563,287</b>
Accrued interest payable	60	71
Accounts payable and other liabilities	5,911	6,010
Junior subordinated debentures (at fair value)	10,882	10,068
<b>Total liabilities</b>	<b>563,954</b>	<b>579,436</b>
<b>Shareholders' Equity</b>		
Common stock, no par value 20,000,000 shares authorized, 14,508,275 issued and outstanding at June 30, 2013, and 14,217,303 at December 31, 2012	44,416	43,173
Retained earnings	27,429	26,179
Accumulated other comprehensive (loss) income	(137	) 89
<b>Total shareholders' equity</b>	<b>71,708</b>	<b>69,441</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$635,662</b>	<b>\$648,877</b>



Table of Contents

United Security Bancshares and Subsidiaries  
Consolidated Statements of Operations  
(Unaudited)

(In thousands except shares and EPS)	Quarter Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Interest Income:</b>				
Loans, including fees	\$5,554	\$5,966	\$11,020	\$12,009
Investment securities – AFS – taxable	140	457	338	978
Interest on deposits in FRB	70	43	135	94
Interest on deposits in other banks	2	10	4	20
Total interest income	5,766	6,476	11,497	13,101
<b>Interest Expense:</b>				
Interest on deposits	331	437	742	915
Interest on other borrowings	93	72	153	136
Total interest expense	424	509	895	1,051
Net Interest Income Before Provision for Credit Losses	5,342	5,967	10,602	12,050
Provision for Credit Losses	39	1,004	30	1,006
Net Interest Income	5,303	4,963	10,572	11,044
<b>Noninterest Income:</b>				
Customer service fees	902	897	1,681	1,801
Increase in cash surrender value of bank-owned life insurance	140	144	277	280
Impairment loss on investment securities	—	(149)	—	(172)
(Loss) gain on fair value of financial liability	(103)	364	(660)	(112)
Gain on sale of other investment	—	1,807	—	1,807
Other	168	177	328	445
Total noninterest income	1,107	3,240	1,626	4,049
<b>Noninterest Expense:</b>				
Salaries and employee benefits	2,113	2,176	4,474	4,598
Occupancy expense	883	840	1,788	1,605
Data processing	33	19	93	37
Professional fees	375	439	820	683
Regulatory assessments	339	417	698	783
Director fees	59	69	117	136
Amortization of intangibles	46	79	93	170
Correspondent bank service charges	81	80	157	160
Loss on California tax credit partnership	32	81	65	184
Net cost (gain) on operation of OREO	(336)	(293)	(1,218)	329
Other	529	646	1,140	1,272
Total noninterest expense	4,154	4,553	8,227	9,957
Income Before Provision for Taxes	2,256	3,650	3,971	5,136
Provision for Taxes on Income	859	1,478	1,499	1,912
Net Income	\$1,397	\$2,172	\$2,472	\$3,224
<b>Net Income per common share</b>				
Basic	\$0.10	\$0.15	\$0.17	\$0.22
Diluted	\$0.10	\$0.15	\$0.17	\$0.22
<b>Shares on which net income per common shares were based</b>				
Basic	14,506,389	14,364,176	14,504,740	14,364,176

Diluted

14,507,783 14,364,176 14,508,329 14,364,176

4

---

Table of Contents

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

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012	
Net Income	\$1,397	\$2,172	\$2,472	\$3,224	
Unrealized holdings gains (losses) on securities	(305	) 39	(415	) 628	
Unrealized gains on unrecognized post retirement costs	21	—	40	—	
Other comprehensive (loss) income, before tax	(284	) 39	(375	) 628	
Tax benefit (expense) related to securities	122	15	166	(218	)
Tax expense related to unrecognized post retirement costs	(8	) —	(17	) —	
Total other comprehensive (loss) income	(170	) 54	(226	) 410	
Comprehensive income	\$1,227	\$2,226	\$2,246	\$3,634	



Table of Contents

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

(In thousands except shares)	Common stock		Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Number of Shares	Amount			
Balance December 31, 2011	13,531,832	\$41,435	\$21,447	\$ (709 )	\$62,173
Other comprehensive income				410	410
Common stock dividends	271,974	642	(642 )		0
Stock-based compensation expense		10			10
Net Income			3,224		3,224
Balance June 30, 2012	13,803,806	\$42,087	\$24,029	\$ (299 )	\$65,817
Other comprehensive income				388	388
Common stock dividends	278,736	694	(694 )		
Common stock issuance	134,761	383			383
Stock-based compensation expense		9			9
Net Income			2,844		2,844
Balance December 31, 2012	14,217,303	\$43,173	\$26,179	\$ 89	\$69,441
Other comprehensive (loss) income				(226 )	(226 )
Common stock dividends	285,770	1,222	(1,222 )		0
Stock options exercised	5,202	12			12
Stock-based compensation expense		9			9
Net Income			2,472		2,472
Balance June 30, 2013	14,508,275	\$44,416	\$27,429	\$ (137 )	\$71,708

Table of ContentsUnited Security Bancshares and Subsidiaries  
Consolidated Statements of Cash Flows (unaudited)

(In thousands)	Six Months Ended June 30,	
	2013	2012
<b>Cash Flows From Operating Activities:</b>		
Net Income	\$2,472	\$3,224
Adjustments to reconcile net income:to cash provided by operating activities:		
Provision for credit losses	30	1,006
Depreciation and amortization	620	603
Amortization of investment securities	14	16
Accretion of investment securities	(34	) (129
Decrease in accrued interest receivable	158	191
Decrease in accrued interest payable	(11	) (16
Increase (decrease) in accounts payable and accrued liabilities	89	(40
Decrease in unearned fees	(18	) (51
Increase in income taxes payable	1,771	1,852
Stock-based compensation expense	9	10
Deferred income taxes	272	(332
Gain on sale of other real estate owned	(1,949	) (337
Impairment loss on other real estate owned	118	—
Impairment loss on investment securities	—	172
Impairment loss on investment in bank stock	—	69
Increase in surrender value of life insurance	(294	) (280
Loss on fair value option of financial liabilities	660	112
Loss on tax credit limited partnership interest	65	184
Amortization of Goodwill and CDI	93	170
Gain on sale of other investment	—	(1,807
Net (increase) decrease in other assets	(221	) 349
Net cash provided by operating activities	3,844	4,966
<b>Cash Flows From Investing Activities:</b>		
Net (increase) decrease in interest-bearing deposits with banks	(4	) 84
Redemption of correspondent bank stock	433	293
Maturities and calls of available-for-sale securities	3,600	—
Principal payments of available-for-sale securities	2,322	3,476
Net (increase) decrease in loans	(3,750	) 10,590
Cash proceeds from sales of other real estate owned	6,651	3,532
Cash proceeds from sale of other investment	—	2,174
Cash proceeds from sale of premises and equipment	—	36
Capital expenditures for premises and equipment	(280	) (520
Net cash provided by investing activities	8,972	19,665
<b>Cash Flows From Financing Activities:</b>		
Net decrease in demand deposits and savings accounts	(10,786	) (20,686
Net decrease in certificates of deposit	(5,400	) (28,739



Table of Contents

Proceeds from exercise of stock options	12	—	
Net cash used in financing activities	(16,174	) (49,425	)
Net decrease in cash and cash equivalents	(3,358	) (24,794	)
Cash and cash equivalents at beginning of period	141,627	124,184	
Cash and cash equivalents at end of period	\$138,269	\$99,390	

Table of Contents

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

1. Organization and Summary of Significant Accounting and Reporting Policies

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

These unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information on a basis consistent with the accounting policies reflected in the audited financial statements of the Company included in its 2012 Annual Report on Form 10-K. These interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of a normal recurring, nature) considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

Certain reclassifications have been made to the 2012 financial statements to conform to the classifications used in 2013.

Recently Issued Accounting Standards:

In February 2013, The Financial Accounting Standards Board (FASB) today issued Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, to improve the transparency of reporting reclassifications out of accumulated other comprehensive income. ASU 2013-02 requires an organization to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income—but only if the item reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for reporting periods beginning after December 15, 2012. The amounts reclassified out of net income were not significant and this ASU did not have a significant impact on the Company's financial statements.

In January 2013, the FASB issued ASU No. 2013-01 Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, which clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11. It further clarifies that the scope of ASU No. 2011-11 applies to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria contained in FASB Accounting Standards Codification® or subject to a master netting arrangement or similar agreement. Both ASU 2011-11 and ASU 2013-1 are effective for annual periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company adopted these ASU's during the first quarter of 2013 and they did not have a material impact on its financial statements.

In December 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-11 Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. The ASU enhances disclosures in order to improve the comparability of offsetting (netting) assets and liabilities reported in accordance with U.S. generally accepted accounting principles ("GAAP") and International Financial Reporting Standards ("IFRS") by requiring entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the statements of condition and instruments and transactions subject to an agreement similar to a master netting arrangement. This ASU did not have a significant impact on the Company's financial

statements.

## 2. Investment Securities Available for Sale and Other Investments

Following is a comparison of the amortized cost and fair value of securities available-for-sale, as of June 30, 2013 and December 31, 2012:

9

---

Table of Contents

(In thousands)	Amortized	Gross	Gross	Fair Value
June 30, 2013	Cost	Unrealized	Unrealized	(Carrying
Securities available for sale:		Gains	Losses	Amount)
U.S. Government agencies	\$18,306	\$739	\$(8	) \$19,037
U.S. Government collateralized mortgage obligations	2,492	193	—	2,685
Mutual Funds	4,000	—	(195	) 3,805
Total securities available for sale	\$24,798	\$932	\$(203	) \$25,527
December 31, 2012	Amortized	Gross	Gross	Fair Value
Securities available for sale:	Cost	Unrealized	Unrealized	(Carrying
U.S. Government agencies	\$23,433	\$933	\$—	Amount)
U.S. Government collateralized mortgage obligations	3,266	251	—	\$24,366
Mutual Funds	4,000	—	(39	) 3,961
Total securities available for sale	\$30,699	\$1,184	\$(39	) \$31,844

The amortized cost and fair value of securities available for sale at June 30, 2013, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns. Mutual funds are included in the due in the one year or less category below.

(In thousands)	June 30, 2013	
	Amortized	Fair Value
	Cost	(Carrying
		Amount)
Due in one year or less	\$4,034	\$3,839
Due after one year through five years	9,129	9,164
Due after five years through ten years	2,186	2,347
Due after ten years	6,957	7,492
Collateralized mortgage obligations	2,492	2,685
	\$24,798	\$25,527

There were no realized gains or losses on sales of available-for-sale securities for the periods ended June 30, 2013 and 2012, respectively. There were no other-than-temporary impairment losses for the three and six months ended June 30, 2013. There were other-than-temporary impairment losses on certain of the Company's private label mortgage-backed securities of \$149,000 and \$172,000 for the three and six months ended June 30, 2012.

At June 30, 2013 available-for-sale securities with an amortized cost of approximately \$20,794,000 (fair value of \$21,718,000) were pledged as collateral for FHLB borrowings and public funds balances.

The Company had no held-to-maturity or trading securities at June 30, 2013 or December 31, 2012.

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

The following summarizes temporarily impaired investment securities:





Table of Contents

(In thousands) June 30, 2013	Less than 12 Months		12 Months or More		Total	
	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
Securities available for sale:						
U.S. Government agencies	\$7,128	\$(8 )	\$—	\$—	\$7,128	\$(8 )
U.S. Government agency collateral mortgage obligations	—	—	—	—	—	—
Mutual Funds	3,805	(195 )	—	—	3,805	(195 )
Total impaired securities	\$10,933	\$(203 )	\$—	\$—	\$10,933	\$(203 )
December 31, 2012:						
Securities available for sale:						
U.S. Government agencies	\$—	\$—	\$—	\$—	\$—	\$—
U.S. Government agency collateral mortgage obligations	—	—	—	—	—	—
Mutual Funds	3,961	(39 )	—	—	3,961	(39 )
Total impaired securities	\$3,961	\$(39 )	\$—	\$—	\$3,961	\$(39 )

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

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

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

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

Table of Contents

other factors shall be recognized in other comprehensive (loss) income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary-impairment recognized in earnings shall become the new amortized cost basis of the investment.

At June 30, 2013, the decline in market value of the impaired securities is attributable to changes in interest rates, and not credit quality. Because the Company does not have the intent to sell these impaired securities and it is not more likely than not that it will be required to sell the securities before their anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at June 30, 2013.

At June 30, 2013 and December 31, 2012, the Company had no securities which have been impaired more than twelve months. At June 30, 2013, the Company had two U.S. Government agency securities and a mutual fund which have been impaired for less than twelve months. The two U.S. Government agency securities had an aggregate fair value of \$7,128,000 and unrealized losses of \$8,000. The mutual fund had a fair value of \$3,805,000 and an unrealized loss of \$195,000.

At June 30, 2012, the Company had three private label mortgage-backed securities which have been impaired more than twelve months. The three private label mortgage-backed securities had an aggregate fair value of \$8,312,000 and unrealized losses of approximately \$1,283,000 at June 30, 2012. All three private label mortgage-backed securities were rated less than high credit quality at June 30, 2012. The Company evaluated these three private label mortgage-backed securities for OTTI by comparing the present value of expected cash flows to previous estimates to determine whether there had been adverse changes in cash flows during the period. The OTTI evaluation was conducted utilizing the services of a third party specialist and consultant in Mortgage Backed Securities (MBS) and Collateralized Mortgage Obligations (CMO) products. The cash flow assumptions used in the evaluation at June 30, 2012 utilized a discounted cash flow valuation technique using a "Liquidation Scenario" whereby loans are evaluated by delinquency and are assigned probability of default and loss factors deemed appropriate in the current economic environment. The liquidation scenario assumes that all loans 60 or more days past due are liquidated and losses are realized over a period of between six and twenty-four months based upon current 3-month trailing loss severities obtained from reputable financial data sources. In determining fair value under the discounted cash flow analysis, all loans within the mortgage pools, including those less than 60 or more past due, are evaluated for other-than-temporary impairment utilizing the following components:

- Collateral Cash Flows: Loan level cash flows are evaluated based upon estimated prepayment speeds, default rates, and estimated loss severities of liquidated assets.
- Prepayment Assumptions: Prepayment speeds are based upon the borrower's incentive to pay as well as their ability to pay based upon their credit. In addition, CPR and CRR rates are evaluated.
- Default Rates: The default assumptions are vectored and are expressed as conditional default rates (CDR), which are based upon the current status of the loan. The model assumes that the 60 day plus population will move to repossession inventory subject to loss migration assumptions and liquidate over the next 24 months. Defaults vector from month 25 to month 36 to the month 37 CDR value. The loans less than 60 days delinquent influence the month 37 CDR value. The default assumptions continue from month 37 but vector down over an extended period of at least 15 years from the valuation date. Default rate assumptions are benchmarked to the recent results experienced by major servicers of non-Agency MBS for securities with similar attributes and forecasts from the industry experts and industry research.
- Loss Severity: Estimates of loss severity for each loan are based upon initial LTV ratios, loan's lien position, mortgage insurance coverage, and any change in the property's price since loan was originated.

- **Bond Waterfall:** With other components of the individual loans within the collateralized mortgage pools evaluated, the cash flows are allocated to securities based upon contractual waterfall rules provided in the securities prospectus.
- **Internal Rate of Return:** Future estimated cash flow streams are discounted at pre-tax yield rates calculated using both credit and non-credit components to determine what the required IRR's would be for similar securities in a market that is generally illiquid.

As a result of the impairment evaluation, the Company determined that there had been adverse changes in cash flows in all three of the private label mortgage-backed securities, and concluded that these three private label mortgage-backed securities were other-than-temporarily impaired. At June 30, 2012, the three private label mortgage-backed securities had cumulative other-than-temporary-impairment losses of \$3,560,000, \$1,283,000 of which was recorded in other comprehensive loss. During the six months ended June 30, 2012, the company recorded OTTI impairment expense of \$172,000 on the three private label

Table of Contents

mortgage-backed securities. These three private label mortgage-backed securities remained classified as available for sale at June 30, 2012 and were subsequently sold during the fourth quarter of 2012.

The following table details the three private label mortgage-backed securities with other-than-temporary-impairment, their credit rating at June 30, 2012, the related credit losses recognized in earnings during the quarter, and impairment losses in other comprehensive loss:

June 30, 2012	RALI 2006-QS1G A10	RALI 2006 QS8 A1	CWALT 2007- 8CB A9	Total
(in thousands)	Rated D	Rated D	Rated CCC	
Amortized cost – before OTTI	\$3,719	\$1,138	\$7,015	\$11,872
Credit loss	(713	) (239	) (1,325	) (2,277
Other impairment (OCI)	(403	) (122	) (758	) (1,283
Carrying amount – June 30, 2012	\$2,603	\$777	\$4,932	\$8,312
Total impairment - June 30, 2012	\$(1,116	) \$(361	) \$(2,083	) \$(3,560

The following table summarizes amounts related to credit losses recognized in earnings for the three and six months ended ended June 30, 2013 and 2012.

(in thousands)	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Beginning balance - credit losses	\$—	\$2,208	\$—	\$2,257
Additions:				
Initial credit impairments	—	—	—	—
Subsequent credit impairments	—	149	—	172
Reductions:				
For securities sold or credit losses realized on principal payments	—	(80	) —	(152
Due to change in intent or requirement to sell	—	—	—	—
For increase expected in cash flows	—	—	—	—
Ending balance - credit losses	\$—	\$2,277	\$—	\$2,277

## 3. Loans and Leases

Loans are comprised of the following:

Table of Contents

(In thousands)	June 30, 2013	December 31, 2012
Commercial and business loans	\$73,372	\$69,780
Government program loans	2,407	2,337
Total commercial and industrial	75,779	72,117
Real estate – mortgage:		
Commercial real estate	146,634	133,599
Residential mortgages	54,972	55,016
Home Improvement and Home Equity loans	1,581	1,319
Total real estate mortgage	203,187	189,934
RE construction and development	86,583	90,941
Agricultural	29,027	36,169
Installment	10,465	10,884
Commercial lease financing	0	12
Total Loans	\$405,041	\$400,057

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

Commercial and industrial loans represent 18.7% of total loans at June 30, 2013 and are generally made to support the ongoing operations of small-to-medium sized commercial businesses. Commercial and industrial loans have a high degree of industry diversification and provide working capital, financing for the purchase of manufacturing plants and equipment, or funding for growth and general expansion of businesses. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases, or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans generally comes from the cash flow of the borrower.

Real estate mortgage loans, representing 50.2% of total loans at June 30, 2013, are secured by trust deeds on primarily commercial property, but are also secured by trust deeds on single family residences. Repayment of real estate mortgage loans generally comes from the cash flow of the borrower.

Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and commercial properties, including: office buildings and shopping centers; apartments and motels; owner-occupied buildings; manufacturing facilities and more. Commercial real estate mortgage loans can also be used to refinance existing debt. Although real estate associated with the business is the primary collateral for commercial real estate mortgage loans, the underlying real estate is not the source of repayment. Commercial real estate loans are made under the premise that the loan will be repaid from the borrower's business operations, rental income associated with the real property, or personal assets.

Residential mortgage loans are provided to individuals to finance or refinance single-family residences. Residential mortgages are not a primary business line offered by the Company, and are generally of a shorter term than conventional mortgages, with maturities ranging from 3 to 15 years on average.

Home Improvement and Home Equity loans comprise a relatively small portion of total real estate mortgage loans, and are offered to borrowers for the purpose of home improvements, although the proceeds may be used for other purposes. Home equity loans are generally secured by junior trust deeds, but may be secured by 1<sup>st</sup> trust deeds.

Real estate construction and development loans, representing 21.4% of total loans at June 30, 2013, consist of loans for residential and commercial construction projects, as well as land acquisition and development, or land held for

future development. Loans in this category are secured by real estate including improved and unimproved land, as well as single-family residential, multi-family residential, and commercial properties in various stages of completion. All real estate loans have established equity requirements. Repayment on construction loans generally comes from long-term mortgages with other lending institutions obtained at completion of the project.

Table of Contents

Agricultural loans represent 7.2% of total loans at June 30, 2013 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Installment loans represent 2.6% of total loans at June 30, 2013 and generally consist of loans to individuals for household, family and other personal expenditures such as credit cards, automobiles or other consumer items.

Commercial lease financing loans, consist of loans to small businesses, which are secured by commercial equipment. Repayment of the lease obligation is from the cash flow of the borrower. The Company has no commercial lease financing loans at June 30, 2013.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At June 30, 2013 and December 31, 2012, these financial instruments include commitments to extend credit of \$51,583,000 and \$60,050,000, respectively, and standby letters of credit of \$2,323,000 and \$2,404,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

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

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

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



Table of Contents

## Past Due Loans

The Company monitors delinquency and potential problem loans on an ongoing basis through weekly reports to the Loan Committee and monthly reports to the Board of Directors. The following is a summary of delinquent loans at June 30, 2013 (in thousands):

June 30, 2013	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	\$174	\$—	\$—	\$174	\$73,198	\$73,372	\$—
Government Program Loans	—	—	61	61	2,346	2,407	—
Total Commercial and Industrial	174	—	61	235	75,544	75,779	—
Commercial Real Estate Loans	1,632	495	5,328	7,455	139,179	146,634	—
Residential Mortgages Home Improvement and Home Equity Loans	451	—	257	708	54,264	54,972	—
Total Real Estate Mortgage	2,169	529	5,585	8,283	194,904	203,187	—
Total RE Construction and Development Loans	—	318	—	318	86,265	86,583	—
Agricultural Loans	—	—	—	—	29,027	29,027	—
Consumer Loans	108	26	—	134	10,110	10,244	—
Overdraft protection Lines	—	—	—	—	92	92	—
Overdrafts	—	—	—	—	129	129	—
Total Installment/other Commercial Lease Financing	108	26	—	134	10,331	10,465	—
Total Loans	\$2,451	\$873	\$5,646	\$8,970	\$396,071	\$405,041	\$—

Table of Contents

The following is a summary of delinquent loans at December 31, 2012 (in thousands):

December 31, 2012	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	\$65	\$—	\$256	\$321	\$69,459	\$69,780	\$—
Government Program Loans	88	—	—	88	2,249	2,337	—
Total Commercial and Industrial	153	—	256	409	71,708	72,117	—
Commercial Real Estate Loans	3,152	2,130	5,328	10,610	122,989	133,599	—
Residential Mortgages	333	322	437	1,092	53,924	55,016	—
Home Improvement and Home Equity Loans	119	140	—	259	1,060	1,319	—
Total Real Estate Mortgage	3,604	2,592	5,765	11,961	177,973	189,934	—
Total RE Construction and Development Loans	—	—	—	—	90,941	90,941	—
Agricultural Loans	—	136	—	136	36,033	36,169	—
Consumer Loans	305	34	—	339	10,300	10,639	—
Overdraft protection Lines	—	—	—	—	90	90	—
Overdrafts	—	—	—	—	155	155	—
Total Installment Commercial Lease Financing	305	34	—	339	10,545	10,884	—
Total Loans	\$4,062	\$2,762	\$6,021	\$12,845	\$387,212	\$400,057	\$—

## Nonaccrual Loans

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

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

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

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

All other loans where principal or interest is due and unpaid for 90 days or more are placed on non-accrual and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

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

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

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

Table of Contents

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

Nonaccrual loans totaled \$10,665,000 and \$13,425,000 at June 30, 2013 and December 31, 2012, respectively. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at June 30, 2013 or December 31, 2012.

The following is a summary of nonaccrual loan balances at June 30, 2013 and December 31, 2012.

	June 30, 2013	December 31, 2012
Commercial and Business Loans	\$339	\$1,093
Government Program Loans	61	88
Total Commercial and Industrial	400	1,181
Commercial Real Estate Loans	7,518	8,415
Residential Mortgages	1,617	1,834
Home Improvement and Home Equity Loans	—	10
Total Real Estate Mortgage	9,135	10,259
Total RE Construction and Development Loans	1,050	1,730
Total Agricultural Loans	—	136
Consumer Loans	80	119
Overdraft protection Lines	—	—
Overdrafts	—	—
Total Installment	80	119
Commercial lease Financing	—	—
Total Loans	\$10,665	\$13,425

**Impaired Loans**

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

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

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

Review for impairment does not include large groups of smaller balance homogeneous loans that are collectively evaluated to estimate the allowance for loan losses. The Company's present allowance for loan losses methodology,

including migration analysis, captures required reserves for these loans in the formula allowance.

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

Table of Contents

For loans secured by collateral including real estate and equipment the fair value of the collateral less selling costs will determine the carrying value of the loan. The difference between the recorded investment in the loan and the fair value, less selling costs, determines the amount of impairment. The Company uses the measurement method based on fair value of collateral when the loan is collateral dependent and foreclosure is probable.

The discounted cash flow method of measuring the impairment of a loan is used for unsecured loans or for loans secured by collateral where the fair value cannot be easily determined. Under this method, the Company assesses both the amount and timing of cash flows expected from impaired loans. The estimated cash flows are discounted using the loan's effective interest rate. The difference between the amount of the loan on the Bank's books and the discounted cash flow amounts determines the amount of impairment to be provided. This method is used for most of the Company's troubled debt restructurings or other impaired loans where some payment stream is being collected.

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

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

Loans other than certain homogeneous loan portfolios are reviewed on a quarterly basis for impairment. Impaired loans are written down to estimated realizable values by the establishment of specific reserves or charge-offs when required.

Table of Contents

The following is a summary of impaired loans at, and for the six months ended June 30, 2013 (in thousands).

June 30, 2013	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized
Commercial and Business Loans	\$1,078	\$450	\$463	\$913	\$14	\$973	\$22
Government Program Loans	90	61	—	61	—	71	—
Total Commercial and Industrial	1,168	511	463	974	14	1,044	22
Commercial Real Estate Loans	10,437	5,992	4,226	10,218	380	10,246	66
Residential Mortgages	6,882	3,173	3,628	6,801	139	6,859	112
Home Improvement and Home Equity Loans	44	—	44	44	2	27	—
Total Real Estate Mortgage	17,363	9,165	7,898	17,063	521	17,132	178
Total RE Construction and Development Loans	2,411	2,420	—	2,420	—	1,917	10
Total Agricultural Loans	319	51	—	51	—	121	5
Consumer Loans	95	74	—	74	—	96	2
Overdraft protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment/other	95	74	—	74	—	96	2
Commercial Lease Financing	—	—	—	—	—	—	—
Total Impaired Loans	\$21,356	\$12,221	\$8,361	\$20,582	\$535	\$20,310	\$217

Table of Contents

The following is a summary of impaired loans at, and for the year ended, December 31, 2012 (in thousands).

December 31, 2012	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Recognized
Commercial and Business Loans	\$1,488	\$767	\$576	\$1,343	\$37	\$5,468	\$26
Government Program Loans	109	88	—	88	—	147	—
Total Commercial and Industrial	1,597	855	576	1,431	37	5,615	26
Commercial Real Estate Loans	11,393	6,818	4,237	11,055	436	8,498	135
Residential Mortgages	7,461	3,726	3,666	7,392	185	4,416	251
Home Improvement and Home Equity Loans	10	10	—	10	—	21	—
Total Real Estate Mortgage	18,864	10,554	7,903	18,457	621	12,935	386
Total RE Construction and Development Loans	1,730	1,730	—	1,730	—	7,298	—
Total Agricultural Loans	504	192	—	192	—	991	50
Consumer Loans	139	121	—	121	—	200	6
Overdraft protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment Lease Financing	139	121	—	121	—	200	6
Total Impaired Loans	\$22,834	\$13,452	\$8,479	\$21,931	\$658	\$27,039	\$468

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

The average recorded investment in impaired loans for the quarter ended June 30, 2013 and 2012 was \$21,542,000 and \$28,402,000, respectively. The average recorded investment in impaired loans for the six months ended June 30, 2013 and 2012 was \$20,310,000 and \$30,706,000, respectively.

Interest income recognized on impaired loans for the quarters ended June 30, 2013 and 2012 was approximately \$121,000 and \$127,000, respectively. Interest income recognized on impaired loans for the six months ended June 30,



2013 and 2012 was approximately \$217,000 and \$253,000, respectively.

#### Troubled Debt Restructurings

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

Table of Contents

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

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

- A transfer from the borrower to the Company of receivables from third parties, real estate, other assets, or an equity interest in the borrower is granted to fully or partially satisfy the loan.

- A modification of terms of a debt such as one or a combination of:

The reduction (absolute or contingent) of the stated interest rate.

The extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.

The reduction (absolute or contingent) of the face amount or maturity amount of debt as stated in the instrument or agreement.

The reduction (absolute or contingent) of accrued interest.

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

The following tables illustrates TDR activity for the periods indicated:

	Six Months Ended June 30, 2013				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	\$—	\$—	—	\$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	1	106
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	18	1,405	1,405	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Commercial Lease Financing	—	—	—	—	—
Total Loans	18	\$1,405	\$1,405	1	\$106



Table of Contents

	Three Months Ended June 30, 2013				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	\$—	\$—	—	\$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—	—
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	1	44	44	—	—
RE Construction and Development Loans	12	793	793	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Commercial Lease Financing	—	—	—	—	—
Total Loans	13	\$ 837	\$ 837	—	\$—

  

	Six Months Ended June 30, 2012				
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	\$—	\$—	—	\$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	5	1,330	1,321	—	—
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	—	—	—	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Commercial Lease Financing	—	—	—	—	—
Total Loans	5	\$1,330	\$1,321	—	\$—

Table of Contents

	Three Months Ended June 30, 2012				
	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Number of Contracts in Default	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings					
Commercial and Business Loans	—	\$—	\$—	—	\$—
Government Program Loans	—	—	—	—	—
Commercial Real Estate Term Loans	1	20	20	—	—
Single Family Residential Loans	—	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—	—
RE Construction and Development Loans	—	—	—	—	—
Agricultural Loans	—	—	—	—	—
Consumer Loans	—	—	—	—	—
Overdraft protection Lines	—	—	—	—	—
Commercial Lease Financing	—	—	—	—	—
Total Loans	1	\$20	\$20	—	\$—

The Company makes various types of concessions when structuring TDRs including rate reductions, payment extensions, and forbearance. At June 30, 2013, the Company had 52 restructured loans totaling \$14,316,000 as compared to 58 restructured loans totaling \$16,773,000 at December 31, 2012.

The following tables summarize TDR activity by loan category for the six months ended June 30, 2013 and June 30, 2012.

Six Months Ended June 30, 2013	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	\$ 990	\$ 5,395	\$ 7,289	\$ 10	\$ 2,860	\$ 191	\$ 38	\$ —	\$ 16,773
Defaults	—	(106 )	—	—	—	—	—	—	(106 )
Additions	—	—	—	44	1,361	—	—	—	1,405
Principal reductions	(178 )	(1,074 )	(506 )	(10 )	(1,810 )	(140 )	(38 )	—	(3,756 )
Ending balance	\$ 812	\$ 4,215	\$ 6,783	\$ 44	\$ 2,411	\$ 51	\$ —	\$ —	\$ 14,316
Allowance for loan loss	\$ 14	\$ 380	\$ 139	\$ 2	\$ —	\$ —	\$ —	\$ —	\$ 535



Table of Contents

Six Months Ended June 30, 2012	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	\$2,619	\$6,850	\$3,457	\$36	\$6,034	\$—	\$54	\$—	\$19,050
Defaults	—	—	—	—	—	—	—	—	—
Additions	—	919	325	—	—	57	20	—	1,321
Principal reductions	(260 )	(1,414 )	(8 )	(24 )	(1,887 )	—	(15 )	—	(3,608 )
Ending balance	\$2,359	\$6,355	\$3,774	\$12	\$4,147	\$57	\$59	\$—	\$16,763
Allowance for loan loss	\$166	\$347	\$153	\$—	\$—	\$—	\$—	\$—	\$666

The following tables summarize TDR activity by loan category for the quarters ended June 30, 2013 and June 30, 2012.

Three months ended June 30, 2013	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	\$877	\$4,258	\$6,901	\$9	\$2,661	\$190	\$38	\$—	\$14,934
Defaults	—	—	—	—	—	—	—	—	—
Additions	—	—	—	44	793	—	—	—	837
Principal reductions	(65 )	(43 )	(118 )	(9 )	(1,043 )	(139 )	(38 )	—	(1,455 )
Ending balance	\$812	\$4,215	\$6,783	\$44	\$2,411	\$51	\$—	\$—	\$14,316
Allowance for loan loss	\$14	\$380	\$139	\$2	\$—	\$—	\$—	\$—	\$535

Three months ended June 30, 2012	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Equity	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Total
Beginning balance	\$2,469	\$6,413	\$3,768	\$36	\$4,964	\$58	\$52	\$—	\$17,760
Defaults	—	—	—	—	—	—	—	—	—
Additions	—	—	—	—	—	—	20	—	20

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Principal reductions	(110	) (58	) 6	(24	) (817	) (1	) (13	) —	(1,017 )
Ending balance	\$2,359	\$6,355	\$3,774	\$12	\$4,147	\$57	\$59	\$—	\$16,763
Allowance for loan loss	\$166	\$347	\$153	\$—	\$—	\$—	\$—	\$—	\$666

Credit Quality Indicators

25

---



Table of Contents

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

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

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

Facility Rating:

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

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

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

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

Borrower Rating:

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

- Quality of management
- Liquidity
- Leverage/capitalization
- Profit margins/earnings trend
- Adequacy of financial records
- Alternative funding sources
- Geographic risk

- Industry risk
- Cash flow risk
- Accounting practices
- Asset protection
- Extraordinary risks

26

---

Table of Contents

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

Grades 1 and 2 – These grades include loans which are given to high quality borrowers with high credit quality and sound financial strength. Key financial ratios are generally above industry averages and the borrower’s strong earnings history or net worth. These may be secured by deposit accounts or high-grade investment securities.

Grade 3 – This grade includes loans to borrowers with solid credit quality with minimal risk. The borrower’s balance sheet and financial ratios are generally in line with industry averages, and the borrower has historically demonstrated the ability to manage economic adversity. Real estate and asset-based loans assigned this risk rating must have characteristics, which place them well above the minimum underwriting requirements for those departments. Asset-based borrowers assigned this rating must exhibit extremely favorable leverage and cash flow characteristics, and consistently demonstrate a high level of unused borrowing capacity.

Grades 4 and 5 – These include “pass” grade loans to borrowers of acceptable credit quality and risk. The borrower’s balance sheet and financial ratios may be below industry averages, but above the lowest industry quartile. Leverage is above and liquidity is below industry averages. Inadequacies evident in financial performance and/or management sufficiency are offset by readily available features of support, such as adequate collateral, or good guarantors having the liquid assets and/or cash flow capacity to repay the debt. The borrower may have recognized a loss over three or four years, however recent earnings trends, while perhaps somewhat cyclical, are improving and cash flows are adequate to cover debt service and fixed obligations. Real estate and asset-borrowers fully comply with all underwriting standards and are performing according to projections would be assigned this rating. These also include grade 5 loans which are “leveraged” or on management’s “watch list.” While still considered pass loans (loans given a grade 5), the borrower’s financial condition, cash flow or operations evidence more than average risk and short term weaknesses, these loans warrant a higher than average level of monitoring, supervision and attention from the Company, but do not reflect credit weakness trends that weaken or inadequately protect the Company’s credit position. Loans with a grade rating of 5 are not normally acceptable as new credits unless they are adequately secured or carry substantial endorser/guarantors.

Grade 6 – This grade includes “special mention” loans which are loans that are currently protected but are potentially weak. This generally is an interim grade classification and should usually be upgraded to an Acceptable rating or downgraded to Substandard within a reasonable time period. Weaknesses in special mention loans may, if not checked or corrected, weaken the asset or inadequately protect the Company’s credit position at some future date. Special mention loans are often loans with weaknesses inherent from the loan origination, loan servicing, and perhaps some technical deficiencies. The main theme in special mention credits is the distinct probability that the classification will deteriorate to a more adverse class if the noted deficiencies are not addressed by the loan officer or loan management.

Grade 7 – This grade includes “substandard” loans which are inadequately supported by the current sound net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well-defined weakness or weaknesses that may impair the regular liquidation of the debt. Substandard loans exhibit a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Substandard loans also include impaired loans.

Grade 8 - This grade includes “doubtful” loans which exhibit the same characteristics as the Substandard loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the

loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include a proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.

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

The Company did not carry any loans graded as loss at June 30, 2013 or December 31, 2012.

Table of Contents

The following tables summarize the credit risk ratings for commercial, construction, and other non-consumer related loans for June 30, 2013 and December 31, 2012:

June 30, 2013 (000's)	Commercial and Industrial	Commercial RE	RE	Agricultural	Total
			Construction and Development		
Grades 1 and 2	\$807	\$—	\$—	\$20	\$827
Grade 3	19	5,409	836	—	6,264
Grades 4 and 5 – pass	73,290	129,173	71,443	29,007	302,913
Grade 6 – special mention	978	1,845	—	—	2,823
Grade 7 – substandard	685	10,207	14,304	—	25,196
Grade 8 – doubtful	—	—	—	—	—
Total	\$75,779	\$146,634	\$86,583	\$29,027	\$338,023

  

December 31, 2012 (000's)	Commercial and Industrial	Commercial RE	RE	Agricultural	Total
			Construction and Development		
Grades 1 and 2	\$825	\$—	\$—	\$60	\$885
Grade 3	2,071	5,947	856	—	8,874
Grades 4 and 5 – pass	66,098	116,606	75,191	35,973	293,868
Grade 6 – special mention	1,867	—	141	—	2,008
Grade 7 – substandard	1,256	11,046	14,753	136	27,191
Grade 8 – doubtful	—	—	—	—	—
Total	\$72,117	\$133,599	\$90,941	\$36,169	\$332,826

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

The following tables summarize the credit risk ratings for consumer related loans and other homogeneous loans for June 30, 2013 and December 31, 2012:

(000's)	June 30, 2013				December 31, 2012			
	Residential Mortgages	Home Improvement and Home Equity	Installment	Total	Residential Mortgages	Home Improvement and Home Equity	Installment	Total
Not graded	\$29,614	\$1,537	\$8,536	\$39,687	\$30,727	\$1,309	\$9,221	\$41,257
Pass	23,097	0	1,813	24,910	20,572	0	1,422	21,994
Special Mention	—	0	36	36	909	0	49	958
Substandard	2,261	44	80	2,385	2,808	10	192	3,010
Total	\$54,972	\$1,581	\$10,465	\$67,018	\$55,016	\$1,319	\$10,884	\$67,219

## Allowance for Loan Losses

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

Table of Contents

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

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

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

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

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

Real estate construction and development loans –In a normal economy, this segment of loans is considered to have a higher risk profile due to construction and market value issues in conjunction with normal credit risks. In the current distressed residential real estate markets the risk has increased.

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

Installment loans (includes consumer loans, overdrafts, and overdraft protection lines) – This segment is higher risk because many of the loans are unsecured.

Commercial lease financing – This segment of the portfolio is small, but is considered to be vulnerable to economic cycles given the nature of the leasing relationship where businesses are relatively small or have minimal cash flow. This lending program was terminated in 2005.

The following summarizes the activity in the allowance for credit losses by loan category for the six months ended June 30, 2013 and 2012.

Six Months Ended June 30, 2013 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	\$1,614	\$1,292	\$ 2,814	\$ 352	\$288	\$1	\$ 5,423	\$11,784
Provision for credit losses	1,362	600	158	27	24	(1 )	(2,140 )	30
Charge-offs	(349 )	(216 )	—	(136 )	(27 )	—	—	(728 )
Recoveries	38	3	—	—	30	—	—	71
Net charge-offs	(311 )	(213 )	—	(136 )	3	—	—	(657 )

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Ending balance	\$2,665	\$1,679	\$2,972	\$243	\$315	\$—	\$3,283	\$11,157
Period-end amount allocated to:								
Loans individually evaluated for impairment	380	139	2	—	—	—	14	535
Loans collectively evaluated for impairment	2,285	1,540	2,970	243	315	—	3,269	10,622
Ending balance	\$2,665	\$1,679	\$2,972	\$243	\$315	\$—	\$3,283	\$11,157

29

---



Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Table of Contents

Six Months Ended June 30, 2012 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	\$6,787	\$1,416	\$ 4,579	\$508	\$116	\$1	\$ 241	\$13,648
Provision for credit losses	(2,521)	) (313	) 1,231	1,938	344	2	325	1,006
Charge-offs	(763	) (53	) (10	) (2,169	) (137	) —	—	(3,132 )
Recoveries	61	4	—	—	23	—	—	88
Net charge-offs	(702	) (49	) (10	) (2,169	) (114	) —	—	(3,044 )
Ending balance	\$3,564	\$1,054	\$ 5,800	\$277	\$346	\$3	\$ 566	\$11,610
Period-end amount allocated to:								
Loans individually evaluated for impairment	166	670	—	—	—	—	—	836
Loans collectively evaluated for impairment	3,398	384	5,800	277	346	3	566	10,774
Ending balance	\$3,564	\$1,054	\$ 5,800	\$277	\$346	\$3	\$ 566	\$11,610

The following summarizes the activity in the allowance for credit losses by loan category for the quarters ended June 30, 2013 and 2012.

Three Months Ended June 30 2013 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	\$1,462	\$1,201	\$ 1,805	\$ 278	\$250	\$—	\$ 6,407	\$11,403
Provision for credit losses	1,240	569	1,167	101	86	—	(3,124 )	39
Charge-offs	(59	) (93	) —	(136	) (24	) —	—	(312 )
Recoveries	22	2	—	—	3	—	—	27
Net charge-offs	(37	) (91	) —	(136	) (21	) —	—	(285 )
Ending balance	\$2,665	\$1,679	\$ 2,972	\$ 243	\$315	\$—	\$ 3,283	\$11,157
Period-end amount allocated to:								
	380	139	2	—	—	—	14	535

Loans individually evaluated for impairment								
Loans collectively evaluated for impairment	2,285	1,540	2,970	243	315	—	3,269	10,622
Ending balance	\$2,665	\$1,679	\$2,972	\$243	\$315	\$—	\$3,283	\$11,157

30

---

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Table of Contents

Three Months Ended June 30 2012 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Commercial Lease Financing	Unallocated	Total
Beginning balance	\$5,220	\$1,472	\$ 4,523	\$1,116	\$87	\$1	\$631	\$13,050
Provision for credit losses	(1,533 )	(401 )	1,287	1,330	384	2	(65 )	1,004
Charge-offs	(146 )	(20 )	(10 )	(2,169 )	(135 )	—	—	(2,480 )
Recoveries	23	3	—	—	10	—	—	36
Net charge-offs	(123 )	(17 )	(10 )	(2,169 )	(125 )	—	—	(2,444 )
Ending balance	\$3,564	\$1,054	\$ 5,800	\$277	\$346	\$3	\$566	\$11,610
Period-end amount allocated to:								
Loans individually evaluated for impairment	166	670	—	—	—	—	—	836
Loans collectively evaluated for impairment	3,398	384	5,800	277	346	3	566	10,774
Ending balance	\$3,564	\$1,054	\$ 5,800	\$277	\$346	\$3	\$566	\$11,610

The following summarizes information with respect to the loan balances at June 30, 2013 and December 31, 2012.

(000's)	June 30, 2013			December 31, 2012		
	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Loans
Commercial and Business Loans	\$913	\$72,459	\$73,372	\$1,343	\$68,437	\$69,780
Government Program Loans	61	2,346	2,407	88	2,249	2,337
Total Commercial and Industrial	974	74,805	75,779	1,431	70,686	72,117
Commercial Real Estate Loans	10,218	136,416	146,634	11,055	122,544	133,599
Residential Mortgage Loans	6,801	48,171	54,972	7,392	47,624	55,016
Home Improvement and Home Equity Loans	44	1,537	1,581	10	1,309	1,319
Total Real Estate Mortgage	17,063	186,124	203,187	18,457	171,477	189,934
Total RE Construction and Development Loans	2,420	84,163	86,583	1,730	89,211	90,941

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Total Agricultural Loans	51	28,976	29,027	192	35,977	36,169
Total Installment Loans	74	10,391	10,465	121	10,763	10,884
Commercial Lease Financing	—	—	—	—	12	12
Total Loans	\$20,582	\$384,459	\$405,041	\$21,931	\$378,126	\$400,057

31

---

Table of Contents

## 4. Deposits

Deposits include the following:

(In thousands)	June 30, 2013	December 31, 2012
Noninterest-bearing deposits	\$219,693	\$217,014
Interest-bearing deposits:		
NOW and money market accounts	191,260	203,771
Savings accounts	42,163	43,117
Time deposits:		
Under \$100,000	30,787	32,532
\$100,000 and over	63,198	66,853
Total interest-bearing deposits	327,408	346,273
Total deposits	\$547,101	\$563,287
Total brokered deposits included in time deposits above	\$16,232	\$17,984

## 5. Short-term Borrowings/Other Borrowings

At June 30, 2013, the Company had collateralized lines of credit with the Federal Reserve Bank of San Francisco totaling \$237,891,000, as well as Federal Home Loan Bank (FHLB) lines of credit totaling \$8,078,000. All lines of credit are on an “as available” basis and can be revoked by the grantor at any time. There are currently no restrictions on these lines of credit, although under the current Written Agreement with the Federal Reserve, the Bank’s liquidity position as well as its use of borrowing lines is monitored closely. These lines of credit have interest rates that are generally tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB lines of credit are collateralized by investment securities, while lines of credit with the Federal Reserve Bank are collateralized by certain qualifying loans. As of June 30, 2013, \$8,516,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, \$355,080,000 in qualifying loans were pledged at June 30, 2013 as collateral for borrowing lines with the Federal Reserve Bank totaling \$237,891,000. At June 30, 2013, the Company had no outstanding borrowings.

At December 31, 2012, the Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco totaling \$217,841,000, as well as Federal Home Loan Bank (“FHLB”) lines of credit totaling \$10,493,000. At December 31, 2012, the Company had no outstanding borrowing balances. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by all of the Company’s stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of December 31, 2012, \$11,054,000 in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, \$324,462,000 in real estate-secured loans were pledged at December 31, 2012, as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling \$217,841,000. All lines of credit are on an “as available” basis and can be revoked by the grantor at any time.

## 6. Supplemental Cash Flow Disclosures

(In thousands)	Six Months Ended June 30,	
	2013	2012
Cash paid during the period for:		
Interest	\$752	\$1,067
Income Taxes	\$—	\$—
Noncash investing activities:		

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Loans transferred to foreclosed assets	\$437	\$—
OREO financed	\$2,328	\$—

7.Common Stock Dividend

32

---

Table of Contents

On June 25, 2013, the Company's Board of Directors declared a one-percent (1%) stock dividend on the Company's outstanding common stock. Based upon the number of outstanding common shares on the record date of July 12, 2013, 143,613 additional shares were issued to shareholders on July 24, 2013. Because the stock dividend was considered a "small stock dividend," approximately \$603,000 was transferred from retained earnings to common stock based upon the \$4.20 closing price of the Company's common stock on the declaration date of June 25, 2013. There were no fractional shares paid. Except for earnings-per-share calculations, shares issued for the stock dividend have been treated prospectively for financial reporting purposes. For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders for all periods presented.

During the first quarter of 2013, the Company's Board of Director's issued a one-percent (1%) stock dividend on the Company's outstanding common stock. Approximately \$619,000 was transferred from retained earnings to common stock and 142,157 additional shares were issued to shareholders.

## 8. Net Income per Common Share

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

	Three Months Ended		Six Months Ended	
	June 30,	2012	June 30,	2012
	2013		2013	
Net income available to common shareholders (in thousands)	\$ 1,397	\$ 2,172	\$ 2,472	\$ 3,224
Weighted average shares issued	14,506,389	14,364,176	14,504,740	14,364,176
Add: dilutive effect of stock options	1,394	—	3,589	—
Weighted average shares outstanding adjusted for potential dilution	14,507,783	14,364,176	14,508,329	14,364,176
Basic earnings per share	\$0.10	\$0.15	\$0.17	\$0.22
Diluted earnings per share	\$0.10	\$0.15	\$0.17	\$0.22
Anti-dilutive stock options excluded from earnings per share calculation	158,000	189,000	163,000	189,000

## 9. Taxes on Income

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

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. At June 30, 2013 and December 31, 2012, the Company had a recorded valuation allowance of \$2,686,000. The Company performs an

analysis of the valuation allowance considering both tax planning strategies and future earnings as a basis for utilizing the deferred tax assets. The tax planning strategies include the sale of certain bank premise and the surrender of Bank Owned Life Insurance. In its review of a requirement for a valuation allowance, the Company identifies both positive and negative evidence to determine whether a valuation allowance is required. Negative evidence would include pretax losses recorded during each of the last three calendar years. These losses were the result of the severe economic downturn that began in 2008 resulting in substantial increases in the provision for loan losses as well as impairment losses related to other real estate owned through foreclosure, goodwill, and private label residential mortgage obligations. At December 31, 2012, the Company performed an analysis of future projected earnings to provide positive evidence that sufficient earnings would be generated to utilize the deferred tax assets. Underlying assumptions included continued reductions in nonperforming assets and general improvements in the economy, resulting in

33

---



## Table of Contents

reduced provisions for loans losses and impairment charges, as well as reductions in expenses related to other real estate owned. Based upon this analysis, the Company has concluded that the valuation allowance of \$2,686,000 at June 30, 2013 and December 31, 2012 is reasonable.

The Company and its subsidiary file income tax returns in the U.S federal jurisdiction, and several states within the U.S. There are no filings in foreign jurisdictions. During 2010, the Company amended its federal tax returns for the year 2004 through 2009 to utilize the five-year NOL carry-back provisions allowed by the IRS for 2009. These amended tax returns were audited by the IRS and the examination was finalized during the first quarter of 2013 and the settlement did not have a material impact on the Company's financial statements. The Company is not currently aware of any other tax jurisdictions where the Company or any subsidiary is subject to examination by federal, state, or local taxing authorities.

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

Effective September 30, 2009 and beginning with the quarterly interest payment due October 1, 2009, the Company elected to defer interest payments on the Company's \$15.0 million of junior subordinated debentures relating to its trust preferred securities. The terms of the debentures and trust indentures allow for the Company to defer interest payments for up to 20 consecutive quarters without default or penalty. During the period that the interest deferrals are elected, the Company will continue to record interest expense associated with the debentures. Upon the expiration of the deferral period, all accrued and unpaid interest will be due and payable. During the deferral period, the Company is precluded from paying cash dividends to shareholders or repurchasing its stock.

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

At June 30, 2013 the Company performed a fair value measurement analysis on its junior subordinated debt using a cash flow model approach to determine the present value of those cash flows. The cash flow model utilizes the forward 3-month LIBOR curve to estimate future quarterly interest payments due over the thirty-year life of the debt instrument, adjusted for deferrals of interest payments per the Company's election at September 30, 2009. These cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for additional credit and liquidity risks associated with the junior subordinated debt. Although there is little market data in the current relatively illiquid credit markets, we believe the 7.76% discount rate used represents what a market participant would consider under the circumstances based on current market assumptions.

The fair value calculation performed at June 30, 2013 resulted in a pretax loss adjustment of \$103,000 (\$60,000, net of tax) for the quarter ended June 30, 2013 and a pretax loss adjustment of \$660,000 (\$388,000, net of tax) for the six months ended June 30, 2013. The previous year's fair value calculation performed at June 30, 2012 resulted in pretax gain adjustment of \$364,000 (\$214,000, net of tax) for the quarter ended June 30, 2012, and a pretax loss adjustment of \$112,000 (\$66,000, net of tax) for the six months ended June 30, 2012.

### 11. Fair Value Measurements and Disclosure

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

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

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

Table of Contents

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

June 30, 2013

(In thousands)	Carrying Amount	Estimated Fair Value	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 138,269	\$ 138,269	\$ 138,269		
Interest-bearing deposits	1,511	1,511		1,511	
Investment securities	25,527	25,527	10,813	14,714	
Loans	393,878	392,738			392,738
Cash surrender value of life insurance	16,941	16,941			16,941
Accrued interest receivable	1,536	1,536		1,536	
<b>Financial Liabilities:</b>					
<b>Deposits:</b>					
Noninterest-bearing	219,693	219,693	219,693		
NOW and money market	191,260	191,260	191,260		
Savings	42,163	42,163	42,163		
Time Deposits	93,985	94,119			94,119
Total Deposits	547,101	547,235	453,116		94,119
Junior Subordinated Debt	10,882	10,882			10,882
Accrued interest payable	60	60		60	

(In thousands)	Carrying Amount	Estimated Fair Value	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 141,627	\$ 141,627	\$ 141,627		
Interest-bearing deposits	1,507	1,507		1,507	
Investment securities	31,844	31,844	13,593	18,251	
Loans	388,249	386,836			386,836
Cash surrender value of life insurance	16,681	16,681			16,681
Accrued interest receivable	1,694	1,694		1,694	
<b>Financial Liabilities:</b>					
<b>Deposits:</b>					
Noninterest-bearing	217,014	217,014	217,014		
NOW and money market	203,771	203,771	203,771		
Savings	43,117	43,117	43,117		
Time Deposits	99,385	99,529			99,529
Total Deposits	563,287	563,431	463,902		99,529
Junior Subordinated Debt	10,068	10,068			10,068

Accrued interest payable	71	71	71
--------------------------	----	----	----

35

---

## Table of Contents

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

The Company's Level 1 financial assets consist of money market funds and highly liquid mutual funds for which fair values are based on quoted market prices. The Company's Level 2 financial assets include highly liquid debt instruments of U.S. government agencies, collateralized mortgage obligations, and debt obligations of states and political subdivisions, whose fair values are obtained from readily-available pricing sources for the identical or similar underlying security that may, or may not, be actively traded. The Company's Level 3 financial assets include certain investments securities, certain impaired loans, other real estate owned, goodwill, and intangible assets where the assumptions may be made by us or third parties about assumptions that market participants would use in pricing the asset or liability. From time to time, the Company recognizes transfers between Level 1, 2, and 3 when a change in circumstances warrants a transfer. There were no significant transfers in or out of Level 1 and Level 2 fair value measurements during the three months ended June 30, 2013.

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

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

**Interest-bearing Deposits** – Interest bearing deposits in other banks consist of fixed-rate certificates of deposits. Accordingly, fair value has been estimated based upon interest rates currently being offered on deposits with similar characteristics and maturities.

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

**Loans** - Fair values of variable rate loans, which reprice frequently and with no significant change in credit risk, are based on carrying values adjusted for credit risk. Fair values for all other loans, except impaired loans, are estimated using discounted cash flows over their remaining maturities, using interest rates at which similar loans would currently be offered to borrowers with similar credit ratings and for the same remaining maturities.

**Impaired Loans** - Fair value measurements for impaired loans are performed pursuant to authoritative accounting guidance and are based upon either collateral values supported by appraisals, observed market prices, or discounted cash flows. Changes are not recorded directly as an adjustment to current earnings or comprehensive income, but rather as an adjustment component in determining the overall adequacy of the loan loss reserve. Such adjustments to the estimated fair value of impaired loans may result in increases or decreases to the provision for credit losses recorded in current earnings.

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

Goodwill and Core Deposit Intangibles - Goodwill is not amortized but is evaluated periodically for impairment. Fair value of goodwill is determined by comparing the fair value of the operating unit with its carrying value. Fair value is determined on a discounted cash flow methodology using estimated market discount rates and projections of future cash flows for the related operating unit. In addition to projected cash flows, other market metrics are utilized including industry multiples of earnings and price-to-book ratios to estimate what a market participant would pay for the operating unit in the current business environment. Determining the fair value involves a significant amount of judgment, including estimates of changes in revenue growth, changes in discount rates, competitive forces within the industry, and other specific industry and market valuation conditions. If it is determined that goodwill impairment exists, impairment amounts are recorded as an impairment loss in other non-interest expense, and the carrying value of goodwill is reduced by the amount of the impairment. Core deposit intangibles are amortized over the estimated useful lives of the related deposits and are evaluated for impairment periodically. Core deposit intangibles are reviewed for impairment utilizing a discounted cash flow methodology based upon the anticipated deposit runoff over the estimated lives of the deposits, generally six to eight years. If it is determined that impairment exists on the core

Table of Contents

deposit intangible, impairment amounts are recorded as an impairment loss in other non-interest expense, and the carrying value of core deposit intangible is reduced by the amount of the impairment.

Bank-owned Life Insurance – Fair values of life insurance policies owned by the Company approximate the insurance contract's cash surrender value.

Deposits – In accordance with authoritative accounting guidance, fair values for transaction and savings accounts are equal to the respective amounts payable on demand at June 30, 2013 and December 31, 2012 (i.e., carrying amounts). The Company believes that the fair value of these deposits is clearly greater than that prescribed under authoritative accounting guidance. Fair values of fixed-maturity certificates of deposit were estimated using the rates currently offered for deposits with similar remaining maturities.

Junior Subordinated Debt – The fair value of the junior subordinated debt was determined based upon a discounted cash flows model utilizing observable market rates and credit characteristics for similar debt instruments. In its analysis, the Company used characteristics that market participants generally use, and considered factors specific to (a) the liability, (b) the principal (or most advantageous) market for the liability, and (c) market participants with whom the reporting entity would transact in that market. For the six months ended June 30, 2013, cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for credit and liquidity risks associated with similar junior subordinated debt and circumstances unique to the Company. The Company believes that the subjective nature of these inputs, due primarily to the current economic environment, require the junior subordinated debt to be classified as a Level 3 fair value.

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

Off-balance sheet instruments - Off-balance sheet instruments consist of commitments to extend credit, standby letters of credit and derivative contracts. Fair values of commitments to extend credit are estimated using the interest rate currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present counterparties' credit standing. There was no material difference between the contractual amount and the estimated value of commitments to extend credit at June 30, 2013 and December 31, 2012.

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

The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring basis at June 30, 2013:

Financial Instrument	Valuation Technique	Unobservable Input	Weighted Average
Subordinated Debt	Discounted cash flow	Discount Rate	7.76%

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

month LIBOR swap curve will result in positive fair value adjustments (and decrease the fair value measurement). Conversely, a decrease in the credit risk adjusted spread and/or an increase in the three month LIBOR swap curve will result in negative fair value adjustments (and increase the fair value measurement).



Table of Contents

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of June 30, 2013 (in 000's):

Description of Assets	June 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities (2):				
U.S. government agencies	\$19,037	\$7,008	\$12,029	\$—
U.S. government agency CMO's	2,685	—	2,685	—
Mutual Funds	3,805	3,805	—	—
Total AFS securities	\$25,527	\$10,813	\$14,714	\$—
Impaired loans (1):				
Commercial and industrial	463	—	—	463
Real estate mortgage	7,898	—	—	7,898
RE construction & development	0	—	—	—
Agricultural	0	—	—	—
Installment/Other	0	—	—	—
Total impaired loans	\$8,361	\$—	\$—	\$8,361
Other real estate owned (1)	17,221	—	—	17,221
Total	\$51,109	\$10,813	\$14,714	\$25,582

Description of Liabilities	June 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt (2)	\$10,882	—	—	\$10,882
Total	\$10,882	—	—	\$10,882

(1)Nonrecurring

(2)Recurring

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of December 31, 2012 (in 000's):

Table of Contents

Description of Assets	December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities:				
U.S Govt agencies	\$24,366	\$9,632	\$14,734	\$—
U.S Govt collateralized mortgage obligations	3,517	—	3,517	—
Mutual Funds	3,961	3,961	—	—
Total AFS securities	31,844	13,593	18,251	\$—
Impaired Loans (1):				
Commercial and industrial	576	—	—	576
Real estate mortgage	7,903	—	—	7,903
RE construction & development	—	—	—	—
Agricultural	—	—	—	—
Installment/Other	—	—	—	—
Total impaired loans	\$8,479	\$—	\$—	\$8,479
Other real estate owned (1)	23,932	—	—	23,932
Total	\$64,255	\$13,593	\$18,251	\$32,411
Description of Liabilities	December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt (2)	\$10,068	\$—	\$—	\$10,068
Total	\$10,068	\$—	\$—	\$10,068

(1)Nonrecurring

(2)Recurring

The Company recorded an impairment loss of \$118,000 on other real estate owned during the six months ended June 30, 2013. There were no fair value impairment adjustments for the nonrecurring fair value measurements performed during the six months ended June 30, 2012.

The following tables provide a reconciliation of assets and liabilities at fair value using significant unobservable inputs (Level 3) on a recurring basis during the six months ended June 30, 2013 and 2012 (in 000's):

Table of Contents

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
	Private label mortgage-backed securities	Private label mortgage-backed securities	Private label mortgage-backed securities	Private label mortgage-backed securities
Reconciliation of Assets:				
Beginning balance	\$ —	\$ —	\$ 8,566	\$ 7,973
Total gains or (losses) included in earnings	—	—	(254 )	339
Total gains or (losses) included in other comprehensive income	—	—	—	—
Transfers in and/or out of Level 3	—	—	—	—
Ending balance	\$ —	\$ —	\$ 8,312	\$ 8,312

The amount of total gains or (losses) for the period included in earnings (or other comprehensive loss) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date

	\$ —	\$ —	\$ (254 )	\$ 339
--	------	------	-----------	--------

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
	Junior Subordinated Debt	Junior Subordinated Debt	Junior Subordinated Debt	Junior Subordinated Debt
Reconciliation of Liabilities:				
Beginning balance	\$ 10,685	\$ 10,068	\$ 9,567	\$ 9,027
Total losses (gains) included in earnings (or changes in net assets)	103	660	(364 )	112
Transfers in and/or (out) of Level 3	94	154	73	137
Ending balance	\$ 10,882	\$ 10,882	\$ 9,276	\$ 9,276
The amount of total losses (gains) for the period included in earnings attributable to the change in unrealized gains or losses relating to liabilities still held at the reporting date	\$ 103	\$ 660	\$ (364 )	\$ 112

## 12. Goodwill and Intangible Assets

At June 30, 2013 and December 31, 2012 the Company had goodwill, core deposit intangibles, and other identified intangible assets which were recorded in connection with various business combinations and purchases. The following table summarizes the carrying value of those assets at June 30, 2013 and December 31, 2012.

	June 30, 2013	December 31, 2012
Goodwill	\$4,488	\$4,488
Core deposit intangible assets	155	249
Total goodwill and intangible assets	\$4,643	\$4,737

Core deposit intangibles are amortized over their useful lives, while goodwill is not amortized. The Company conducts periodic impairment analysis on goodwill and intangible assets at least annually or more often as conditions require.

Goodwill: The largest component of goodwill is related to the Legacy merger (Campbell reporting unit) completed during February 2007 and totaled approximately \$2.9 million at June 30, 2013. Annually, the Company conducts its impairment testing of the goodwill related to the Campbell reporting unit. Impairment testing for goodwill is a two-step process.

The first step in impairment testing is to identify potential impairment, which involves determining and comparing the fair value of the operating unit with its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is not impaired. If the carrying value exceeds fair value, there is an indication of possible impairment and the second step is performed to determine the amount of the impairment, if any. The fair value determined in the step one testing is determined

Table of Contents

based on a discounted cash flow methodology using estimated market discount rates and projections of future cash flows for the Campbell reporting unit. In addition to projected cash flows, the Company also utilizes other market metrics including industry multiples of earnings and price-to-book ratios to estimate what a market participant would pay for the operating unit in the current business environment. Determining the fair value involves a significant amount of judgment, including estimates of changes in revenue growth, changes in discount rates, competitive forces within the industry, and other specific industry and market valuation conditions. If at the conclusion of the step 1 analysis, the Company concludes that the potential for goodwill impairment exists, step-two testing will be required to determine goodwill impairment and the amount of goodwill that might be impaired, if any. The second step in impairment analysis compares the fair value of the Campbell reporting unit to the aggregate fair values of its individual assets, liabilities and identified intangibles. Based on the results of the first step of the impairment analysis at March 31, 2013, the Company concluded that the fair value of the reporting unit exceeds its carrying value. Therefore, goodwill was not impaired.

**Core Deposit Intangibles:** The core deposit intangible asset related to the Legacy Bank Merger, which totaled \$3.0 million at the time of merger, was amortized over an estimated life of approximately seven years. At June 30, 2013, there was no remaining carrying value of the core deposit intangible related to the Legacy Bank merger. The Company recognized no amortization expense related to the Legacy operating unit during the six months ended June 30, 2013. The Company recognized \$12,000 in amortization expense related to the Legacy operating unit during the six months ended June 30, 2012. At June 30, 2013, there was \$155,000 in remaining carrying value of core deposit intangible related to the Taft branch acquisitions completed in April 2004.

The Company did not record an impairment loss for the three or six months ended June 30, 2013 or June 30, 2012.

### 13. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Unrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were issued.

Table of Contents

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

Overview

Certain matters discussed or incorporated by reference in this Quarterly Report of Form 10-Q are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, but are not limited to, those described in Management's Discussion and Analysis of Financial Condition and Results of Operations. Such risks and uncertainties include, but are not limited to, the following factors: i) competitive pressures in the banking industry and changes in the regulatory environment; ii) exposure to changes in the interest rate environment and the resulting impact on the Company's interest rate sensitive assets and liabilities; iii) decline in the health of the economy nationally or regionally which could reduce the demand for loans or reduce the value of real estate collateral securing most of the Company's loans; iv) credit quality deterioration that could cause an increase in the provision for loan losses; v) Asset/Liability matching risks and liquidity risks; volatility and devaluation in the securities markets, vi) failure to comply with the regulatory agreements 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. For additional information concerning risks and uncertainties related to the Company and its operations, please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

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

Effective 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 Agreement was a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions in June 2009 and is intended to improve the overall condition of the Bank through, among other things, increased Board oversight; formal plans to monitor and improve processes related to asset quality, liquidity, funds management, capital, and earnings; and the prohibition of certain actions that might reduce capital, including the distribution of dividends or the repurchase of the Company's common stock. The Board of Directors and management believe that the Company is in compliance with the terms of the Agreement. (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.)

During May of 2010, the California Department of Financial Institutions issued a written order (the "Order") to the Bank as a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions in June 2009. The Order issued by the California Department of Financial Institutions is similar to the written agreement with the Federal Reserve Bank of San Francisco. The Board of Directors and management believe that the Company is in compliance with the terms of the Agreement. (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.)

Trends Affecting Results of Operations and Financial Position

The Company's overall operations are impacted by a number of factors, including not only interest rates and margin spreads, which impact the results of operations, but also the composition of the Company's balance sheet. One of the primary strategic goals of the Company is to maintain a mix of assets that will generate a reasonable rate of return without undue risk, and to finance those assets with a low-cost and stable source of funds. Liquidity and capital resources must also be considered in the planning process to mitigate risk and allow for growth. Net interest income before provision for credit losses has decreased between the three and six months ended June 30, 2013 and 2012, totaling \$5,342,000 for the three months ended June 30, 2013 as compared to \$5,967,000 for the three months ended June 30, 2012, and \$10,602,000 for the six months ended June 30, 2013 as compared to \$12,050,000 for the six months ended June 30, 2012. The decrease in net interest income between 2012 and 2013 was primarily the result of a shift in the mix as well as a decline in the yield on interest-earning assets which outweighed the decrease in the Company's cost of funding between the two periods.

Table of Contents

Average interest-earning assets increased approximately \$24,659,000 between the six month periods ended June 30, 2013 and 2012. Components of the \$24,659,000 increase in average earning assets between 2012 and 2013 included a decrease of \$3,183,000 in loans and a \$8,518,000 decrease in investment securities. More than offsetting these decreases between the comparative periods was an increase of \$36,955,000 in overnight funds sold to the Federal Reserve Bank. During the past year, the Company's cost of interest-bearing liabilities have continued to decline, with the average cost of interest-bearing liabilities dropping from 0.63% during the six months ended June 30, 2012, to 0.52% during the six months ended June 30, 2013.

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

	YTD Average 6/30/13	YTD Average 12/31/12	YTD Average 6/30/12
Loans and Leases	72.80%	74.20%	76.88%
Investment securities available for sale	5.27%	7.30%	7.16%
Interest-bearing deposits in other banks	0.28%	0.35%	0.41%
Interest-bearing deposits in FRB	21.65%	18.15%	15.55%
Total interest-earning assets	100.00%	100.00%	100.00%
NOW accounts	15.28%	14.44%	14.59%
Money market accounts	41.37%	37.39%	35.00%
Savings accounts	12.36%	11.99%	11.92%
Time deposits	27.98%	33.44%	35.92%
Other borrowings	0.00%	0.00%	0.00%
Subordinated debentures	3.01%	2.74%	2.57%
Total interest-bearing liabilities	100.00%	100.00%	100.00%

The residential real estate markets in the five county region from Merced to Kern showed signs of improvement during 2012 and those trends continued into the second quarter of 2013. The severe declines in residential construction and home prices that began in 2008 continue to show signs of easing and reversing direction. The sustained period of double-digit price declines from 2008 – 2011 adversely impacted the Company's operations and increased the levels of nonperforming assets, expenses related to foreclosed properties, and decreased profit margins. As the Company continues its business development and expansion efforts throughout its market areas, a primary focus is reduction of nonperforming assets while providing customers options to work through this difficult economic period. Options include combinations of rate and term concessions, as well as forbearance agreements with borrowers. Median sales prices improved in the five county region from Merced to Kern between June 2012 to June 2013. Total nonperforming loans decreased during the six months ended June 30, 2013, totaling \$20,548,000 at June 30, 2013 compared to \$23,142,000 reported at December 31, 2012.

As a result of a modest improvement in the economy, the Company has experienced improvement in the loan portfolio between 2012 and 2013. During the six months ended June 30, 2013, the Company experienced increases in commercial and industrial and real estate mortgage loans, but experienced decreases in real estate construction development and agricultural loan categories. Loans increased \$4,984,000 between December 31, 2012 and June 30, 2013, and increased \$9,960,000 between June 30, 2012 and June 30, 2013. Commercial and industrial loans increased \$3,662,000 between December 31, 2012 and June 30, 2013 and decreased \$5,857,000 between June 30, 2012 and June 30, 2013. Real estate mortgage loans increased \$13,253,000 between December 31, 2012 and June 30, 2013, and \$20,566,000 between June 30, 2012 and June 30, 2013. Agricultural loans decreased \$7,142,000 between December 31, 2012 and June 30, 2013 and decreased \$10,053,000 between June 30, 2012 and June 30,



2013. Commercial real estate loans (a component of real estate mortgage loans) have remained as a significant percentage of total loans over the past year, amounting to 36.20%, 33.39%, and 34.83%, of the total loan portfolio at June 30, 2013, December 31, 2012, and June 30, 2012, respectively. 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 several years to facilitate take-out loans for construction borrowers when they were not able to obtain permanent financing elsewhere. These loans are generally 30-year amortizing loans with maturities of between three and five years. Residential mortgages totaled \$54,972,000 or 13.57% of the portfolio at June 30, 2013, \$55,016,000, or 13.75% of the portfolio at December 31, 2012, and \$43,252,000 or 10.95% of the portfolio at June 30, 2012. Loan participations purchased have decreased from \$2,078,000 or 0.53% of the portfolio at June 30, 2012, to \$33,000 or 0.01% of the portfolio at December 31, 2012, to \$30,000 or less than 0.01% of the

Table of Contents

portfolio at June 30, 2013. Loan participations sold increased from \$11,477,000 or 2.90% of the portfolio at June 30, 2012, to \$12,117,000 or 3.0% of the portfolio at December 31, 2012, compared to \$12,412,000, or 3.1%, at June 30, 2013.

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 decreased to 3.94% for the six months ended June 30, 2013, when compared to 4.67% for the six months ended June 30, 2012. The net interest margin has also been impacted by a decline in loans, the Company's highest yielding asset, which has been partially offset by an increase in overnight investments with the Federal Reserve Bank, a much lower yielding asset. 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 5.62% during the six months ended June 30, 2013, as compared to 6.06% for the six months ended June 30, 2012. The decrease in the Company's cost of funds over the past year has mitigated the impact of declining yields on earning assets. The Company's average cost of funds was 0.52% for the six months ended June 30, 2013 as compared to 0.63% for the six months ended June 30, 2012. Although the Company does not intend to increase its current level of brokered deposits, and in fact as a result of the 2010 Agreement with the Federal Reserve Bank and Order with the California Department of Financial Institutions, continues to systematically reduce brokered deposit levels as they mature in the future, the \$16,232,000 in brokered deposits at June 30, 2013 continues to provide the Company with a low-cost source of deposits. The Company will continue to utilize these funding sources when required to maintain prudent liquidity levels, while seeking to increase core deposits when possible.

Total noninterest income of \$1,626,000 reported for the six months ended June 30, 2013 decreased \$2,423,000 or 59.84% as compared to the six months ended June 30, 2012. Noninterest income continues to be driven by customer service fees, which totaled \$1,681,000 for the six months ended June 30, 2013, however the decrease in noninterest income between the six months ended June 30, 2013 and June 30, 2012, was primarily the result of a \$1,807,000 decrease in gain on sale of other investments and a decrease of \$548,000 due to a loss on fair value of financial liability, partially offset by an increase of \$172,000 on impairment losses on investment securities.

Noninterest expense decreased approximately \$1,730,000 or 17.37% between the six months ended June 30, 2012 and June 30, 2013. The decrease experienced during the six months ended June 30, 2013 were primarily the result of a decrease of \$1,547,000 in the net operating cost on OREO and a decrease in salary expenses.

Effective March 31, 2009, and beginning with the quarterly interest payment due October 1, 2009, the Company deferred interest payments on the Company's \$15.0 million of junior subordinated debentures relating to its trust preferred securities. This was the result of regulatory restraints which have precluded the Bank from paying dividends to the Holding Company. The Agreement with the Federal Reserve Bank entered into during March 2010 specifically prohibits the Company and the Bank from making any payments on the junior subordinated debt without prior approval of the Federal Reserve Bank. 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 are elected, the Company will continue to record interest expense associated with the debentures. Upon the expiration of the deferral period, all accrued and unpaid interest will be due and payable. Under the terms of the debenture, the Company is precluded from paying cash dividends to shareholders or repurchasing its stock during the deferral period.

The Company has not paid any cash dividends on its common stock since the second quarter of 2008 and does not expect to resume cash dividends on its common stock for the foreseeable future. Because the Company has elected to defer the quarterly payments of interest on its junior subordinated debentures issued in connection with the trust preferred securities as discussed above, the Company is prohibited under the subordinated debenture agreement from paying cash dividends on its common stock during the deferral period. In addition, pursuant to the Agreement entered into with the Federal Reserve Bank during March of 2010, the Company and the Bank are precluded from paying cash

dividends without prior consent of the Federal Reserve Bank. On June 25, 2013, the Company's Board of Directors declared a one-percent (1%) quarterly stock dividend on the Company's outstanding common stock. The Company believes, given the current uncertainties in the economy and unprecedented declines in real estate valuations in our markets, it is prudent to retain capital in this environment, and better position the Company for future growth opportunities. Based upon the number of outstanding common shares on the record date of July 12, 2013, an additional 143,613 shares 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 improve liquidity during the six months ended June 30, 2013. Total assets decreased approximately \$13,215,000 during the six months ended June 30, 2013, including a decrease of \$6,711,000 in OREO, a decrease of

Table of Contents

\$3,358,000 in cash and cash equivalents, and a decrease of \$6,317,000 in investment securities. Total deposits decreased \$16,186,000, including decrease of \$13,465,000 in savings and NOW and money market accounts, \$2,679,000 in noninterest-bearing deposits and \$5,400,000 in time deposits during the six months ended June 30, 2013. Average loans comprised approximately 72.80% and 76.88% of overall average earning assets during the six months ended June 30, 2013 and June 30, 2012, respectively.

Nonperforming assets, which are primarily related to the real estate loan and other real estate owned portfolio, remained high during the six months ended June 30, 2013, but decreased \$9,305,000 from a balance of \$47,074,000 at December 31, 2012 to a balance of \$37,769,000 at June 30, 2013. Nonaccrual loans totaling \$10,665,000 at June 30, 2013, decreased \$2,760,000 from the balance of \$13,425,000 reported at December 31, 2012. In determining the adequacy of the underlying collateral related to these loans, management monitors trends within specific geographical areas, loan-to-value ratios, appraisals, and other credit issues related to the specific loans. Impaired loans decreased \$1,349,000 during the six months ended June 30, 2013 with a balance of \$20,582,000 at June 30, 2013. Other real estate owned through foreclosure decreased \$6,711,000 between December 31, 2012 and June 30, 2013 as a result of the sale of various properties. As a result of the related events, nonperforming assets as a percentage of total assets decreased from 7.25% at December 31, 2012 to 5.94% at June 30, 2013.

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)	June 30, 2013	December 31, 2012	June 30, 2012	
Provision for credit losses during period	\$30	\$1,019	\$1,006	
Allowance as % of nonperforming loans	54.30	% 50.92	% 40.26	%
Nonperforming loans as % total loans	5.07	% 5.78	% 7.30	%
Restructured loans as % total loans	3.53	% 4.19	% 4.24	%

Management continues to monitor economic conditions in the real estate market for signs of further deterioration or improvement which may impact the level of the allowance for loan losses required to cover identified losses in the loan portfolio. Greater focus has been placed on monitoring and reducing the level of problem assets, while working with borrowers to find more options, including loan restructures, to work through these difficult economic times. Restructured loans were comprised of 52 loans totaling \$14,316,000 at June 30, 2013, compared to 58 loans totaling \$16,773,000 at December 31, 2012.

The Company recorded a provision of \$30,000 to the allowance for credit losses during the six months ended June 30, 2013 as compared to a provision of \$1,006,000 for the six months ended June 30, 2012. Net loan and lease charge-offs during the six months ended June 30, 2013 totaled \$657,000 as compared to \$3,044,000 for the six months ended June 30, 2012. The Company charged-off, or had partial charge-offs on, approximately 28 loans during the six months ended June 30, 2013, as compared to 15 loans during the same period ended June 30, 2012, and 26 loans during year ended December 31, 2012. The annualized percentage charge-offs to average loans were 0.34% and 1.54% for the six months ended June 30, 2013 and 2012, respectively, as compared to 0.74% for the year ended December 31, 2012.

Deposits decreased by \$16,186,000 during the six months ended June 30, 2013, with decreases experienced in all interest-bearing deposit categories, partially offset by an increase in non-interest bearing deposits. The Company continues to reduce its reliance on brokered deposits and other wholesale funding sources, while maintaining sufficient liquidity.

Brokered deposits have provided the Company a relatively inexpensive funding source over the past several years totaling \$16,232,000 or 2.97% of total deposits at June 30, 2013, as compared to \$17,984,000 or 3.19% of total

deposits at December 31, 2012, and \$30,457,000 or 5.80% of total deposits at June 30, 2012. Brokered deposits and other wholesale funding sources were used to some degree to fund loan growth in 2007 and 2008, but 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 continues its efforts to develop core deposit growth with employee training throughout the entire organization and a deposit-gathering program that incents employees to bring in new deposits from our local market area and establish more extensive relationships with our customers. As part of its liquidity position improvement plan resulting from the formal agreement with the Federal Reserve Bank issued in March 2010, the Company has reduced its reliance on brokered deposits in order to achieve levels more comparable with peers. The Company will seek to continue replacing maturing brokered deposits with core deposits, but may also control loan growth to help achieve that objective.

Table of Contents

The cost of the Company's subordinated debentures issued by USB Capital Trust II has remained low as market rates have remained low during the first three months of 2013. With pricing at 3-month-LIBOR plus 129 basis points, the effective cost of the subordinated debt was 1.57% at June 30, 2013 as compared to 1.89% at December 31, 2012. Pursuant to fair value accounting guidance, the Company has recorded \$660,000 in pretax fair value loss on its junior subordinated debt during the six months ended June 30, 2013, bringing the total cumulative gain recorded on the debt to \$5,626,000 at June 30, 2013.

The Company continues to emphasize relationship banking and core deposit growth, and has focused greater attention on its market area of Fresno, Madera, and Kern Counties, as well as Campbell, in Santa Clara County. The San Joaquin Valley and other California markets continue to exhibit weak demand for construction lending and commercial lending from small and medium size businesses, as commercial and residential real estate markets remain depressed, compared with prior years.

## Results of Operations

For the quarters ended June 30, 2013 and 2012, the Company reported net income of \$1,397,000 or \$0.10 per share (\$0.10 diluted) and \$2,172,000 or \$0.15 per share (\$0.15 diluted), respectively. On a year-to-date basis, the Company reported net income of \$2,472,000 or \$0.17 per share (\$0.17 diluted) for the six months ended June 30, 2013, as compared to \$3,224,000 or \$0.22 per share (\$0.22 diluted) for the same period in 2012.

The Company's return on average assets was 0.78% for the six months ended June 30, 2013 as compared to 1.05% for the six months ended June 30, 2012 and was 0.88% for the quarter ended June 30, 2013, compared to 1.42% for the quarter ended June 30, 2012. The Bank's return on average equity was 7.04% for the six months ended June 30, 2013 as compared to 10.23% for the six months ended June 30, 2012 and was 7.85% for the quarter ended June 30, 2013, compared to 13.40% for the quarter ended June 30, 2012.

## Net Interest Income

Net interest income before provision for credit losses totaled \$10,602,000 for the six months ended June 30, 2013, representing a decrease of \$1,448,000, or 12.02%, when compared to the \$12,050,000 reported for the same period of the previous year.

The Company's year-to-date net interest margin, as shown in Table 1, decreased to 3.94% at June 30, 2013 from 4.67% at June 30, 2012, a decrease of 73 basis points (100 basis points = 1%) between the two periods. While average market rates of interest have remained level between the six month periods ended June 30, 2013 and 2012 (the Prime rate averaged 3.25% during both periods), the decrease in the Company's yield on loans and investment securities negatively impacted the net margin between the two six month periods.

Table 1. Distribution of Average Assets, Liabilities and Shareholders' Equity:  
Interest rates and Interest Differentials  
Six Months Ended June 30, 2013 and 2012

Table of Contents

(dollars in thousands)	2013			2012				
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate		
Assets:								
Interest-earning assets:								
Loans and leases (1)	\$395,138	\$11,020	5.62	% \$398,321	\$12,009	6.06	%	
Investment Securities – taxable	28,595	338	2.38	% 37,113	978	5.30	%	
Interest-bearing deposits in other banks	1,509	4	0.53	% 2,104	20	1.91	%	
Interest-bearing deposits in FRB	117,536	135	0.23	% 80,581	94	0.23	%	
Total interest-earning assets	542,778	\$11,497	4.27	% 518,119	\$13,101	5.08	%	
Allowance for credit losses	(11,506 )			(12,963 )				
Noninterest-earning assets:								
Cash and due from banks	22,892			22,767				
Premises and equipment, net	12,077			12,736				
Accrued interest receivable	1,302			1,582				
Other real estate owned	21,675			25,476				
Other assets	47,665			49,931				
Total average assets	\$636,883			\$617,648				
Liabilities and Shareholders' Equity:								
Interest-bearing liabilities:								
NOW accounts	\$52,757	\$31	0.12	% \$49,136	\$37	0.15	%	
Money market accounts	142,810	354	0.50	% 117,864	363	0.62	%	
Savings accounts	42,650	43	0.20	% 40,113	52	0.26	%	
Time deposits	96,569	314	0.66	% 120,949	463	0.77	%	
Other borrowings	0	0	0.00	% 0	—	0.00	%	
Junior subordinated debentures	10,410	153	2.96	% 8,646	136	3.16	%	
Total interest-bearing liabilities	345,196	\$895	0.52	% 336,708	\$1,051	0.63	%	
Noninterest-bearing liabilities:								
Noninterest-bearing checking	214,801			210,751				
Accrued interest payable	104			131				
Other liabilities	5,938			6,208				
Total Liabilities	566,039			553,798				
Total shareholders' equity	70,844			63,850				
Total average liabilities and shareholders' equity	\$636,883			\$617,648				
Interest income as a percentage of average earning assets			4.27	%		5.08	%	
Interest expense as a percentage of average earning assets			0.33	%		0.41	%	
Net interest margin			3.94	%		4.67	%	

Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the (1) period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan fees of approximately \$21,000 and \$355,000 for the six months ended June 30, 2013 and 2012, respectively.





Table of Contents

## Interest rates and Interest Differentials

Three Months Ended June 30, 2013 and 2012

(dollars in thousands)	Average Balance	2013 Interest	Yield/Rate	Average Balance	2012 Interest	Yield/Rate	
Assets:							
Interest-earning assets:							
Loans and leases (1)	\$396,203	\$5,554	5.62	% \$392,013	\$5,966	6.05	%
Investment Securities – taxable	26,396	140	2.13	% 36,096	457	5.04	%
Interest-bearing deposits in other banks	1,510	2	0.53	% 1,682	10	2.37	%
Interest-bearing deposits in FRB	119,860	70	0.23	% 72,544	43	0.24	%
Total interest-earning assets	543,969	\$5,766	4.25	% 502,335	\$6,476	5.13	%
Allowance for credit losses	(11,257 )			(12,171 )			
Noninterest-earning assets:							
Cash and due from banks	22,773			22,081			
Premises and equipment, net	11,978			12,532			
Accrued interest receivable	1,287			1,506			
Other real estate owned	20,005			23,978			
Other assets	46,853			60,732			
Total average assets	\$635,608			\$610,993			
Liabilities and Shareholders' Equity:							
Interest-bearing liabilities:							
NOW accounts	\$52,829	\$16	0.12	% \$49,029	\$15	0.12	%
Money market accounts	138,877	143	0.41	% 115,293	175	0.60	%
Savings accounts	42,204	20	0.19	% 39,513	22	0.22	%
Time deposits	95,281	152	0.64	% 117,447	225	0.76	%
Other borrowings	0	0	0.00	% 0	—	0.00	%
Junior subordinated debentures	10,721	93	3.48	% 8,791	72	3.26	%
Total interest-bearing liabilities	339,912	\$424	0.50	% 330,073	\$509	0.61	%
Noninterest-bearing liabilities:							
Noninterest-bearing checking	218,089			199,083			
Accrued interest payable	97			126			
Other liabilities	6,076			6,206			
Total Liabilities	564,174			535,488			
Total shareholders' equity	71,434			75,505			
Total average liabilities and shareholders' equity	\$635,608			\$610,993			
Interest income as a percentage of average earning assets			4.25	%		5.13	%
Interest expense as a percentage of average earning assets			0.32	%		0.40	%
Net interest margin			3.93	%		4.73	%



Table of Contents

Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the (1) period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan fees of approximately \$13,000 and \$196,000 for the quarters ended June 30, 2013 and 2012, respectively.

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

Table 2. Rate and Volume Analysis

(In thousands)	Increase (decrease) in the six months ended June 30, 2013 compared to June 30, 2012		
	Total	Rate	Volume
Increase (decrease) in interest income:			
Loans and leases	\$ (989	) \$ (891	) \$ (98 )
Investment securities available for sale	(640	) (452	) (188 )
Interest-bearing deposits in other banks	(16	) (16	) —
Interest-bearing deposits in FRB	41	(1	) 42
Total interest income	(1,604	) (1,360	) (244 )
Increase (decrease) in interest expense:			
Interest-bearing demand accounts	(15	) (77	) 62
Savings and money market accounts	(9	) (12	) 3
Time deposits	(149	) (63	) (86 )
Other borrowings	—	0	—
Subordinated debentures	17	(9	) 26
Total interest expense	(156	) (161	) 5
Increase (decrease) in net interest income	\$ (1,448	) \$ (1,199	) \$ (249 )

For the six months ended June 30, 2013, total interest income decreased approximately \$1,604,000 or 12.24% as compared to the six month period ended June 30, 2012. Earning asset volumes decreased in all earning-asset categories except interest bearing deposits with the FRB between the two six month periods with a large decrease experienced in securities and loans, which on average decreased \$8,518,000 and \$3,183,000, respectively between the two six month periods. The average rates on loans decreased 44 basis points between the two six month periods, and the average rate on investment securities decreased approximately 292 basis points during the six months ended June 30, 2013 as compared to the same period of 2012. The decrease in the average rate on investment securities is a result of the sale of \$7.5 million in impaired residential mortgage obligations during the fourth quarter of 2012.

For the quarter ended June 30, 2013, total interest income decreased \$710,000 or 10.96%, as compared to the quarter ended June 30, 2012. Comparing those two periods, average interest earning assets increased \$41,634,000, with the largest increase experienced in interest-bearing deposits in FRB. The average rate on total interest-earning assets decreased 88 basis points, primarily due to a decrease of 291 basis points on average rates paid on investment securities.

For the six months ended June 30, 2013, total interest expense decreased approximately \$156,000, or 14.84% as compared to the six month period ended June 30, 2012. Between those two periods, average interest-bearing liabilities

increased by \$8,488,000, while the average rates paid on these liabilities decreased by 11 basis points.

For the quarter ended June 30, 2013, total interest expense decreased \$85,000 or 16.70% as compared to the quarter ended June 30, 2012, as a result of an 11 basis point decrease on the average rates paid on interest-bearing liabilities. The average rate paid on interest-bearing liabilities was 0.50% for the quarter ended June 30, 2013, compared to 0.61% for the same period ended June 30, 2012.

Table of Contents

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 six months ended June 30, 2013, the provision to the allowance for credit losses amounted to \$30,000 as compared to \$1,006,000 for the six months ended June 30, 2012. For the quarter ended June 30, 2013, the provision to the allowance for credit losses amounted to \$39,000, as compared to \$1,004,000 for the quarter ended June 30, 2012. The amount provided to the allowance for credit losses during the first six months of 2013 brought the allowance to 2.75% of net outstanding loan balances at June 30, 2013, as compared to 2.95% of net outstanding loan balances at December 31, 2012, and 2.94% at June 30, 2012.

## Table 3. Changes in Noninterest Income

The following table sets forth the amount and percentage changes in the categories presented for the six months ended June 30, 2013 and 2012:

(In thousands)	2013	2012	Amount of Change	Percent Change	
Customer service fees	\$1,681	\$1,801	\$(120)	(6.66)	)%
Increase in cash surrender value of BOLI	277	280	(3)	(1.07)	)%
Impairment loss on investment securities, other than-temporary loss	—	(172)	) 172	(100.00)	)%
(Loss) gain on fair value of financial liability	(660)	) (112)	) (548)	(100.00)	)%
Gain on sale of other investment	—	1,807	(1,807)	(100.00)	)%
Other	328	445	(117)	(26.29)	)%
Total noninterest income	\$1,626	\$4,049	\$(2,423)	(59.84)	)%

Noninterest income for the six months ended June 30, 2013 decreased \$2,423,000 or 59.84% when compared to the same six month period of 2012. Customer service fees, the primary component of noninterest income, decreased \$120,000 or 6.66% between the two six month periods presented. The decrease in noninterest income of \$2,423,000 between the two six month periods includes a decrease in gain on sale of other investment due to a gain of \$1,807,000 realized in 2012 on the sale of a tax credit partnership, a decrease due to loss on fair value of financial liability, partially offset by an increase in impairment loss on investment securities.

## Noninterest Expense

The following table sets forth the amount and percentage changes in the categories presented for the six months ended June 30, 2013 and 2012:

## Table 4. Changes in Noninterest Expense

Table of Contents

(In thousands)	2013	2012	Amount of Change	Percent Change	
Salaries and employee benefits	\$4,474	\$4,598	\$(124)	(2.70)	)%
Occupancy expense	1,788	1,605	183	11.40	%
Data processing	93	37	56	151.35	%
Professional fees	820	683	137	20.06	%
FDIC/DFI insurance assessments	698	783	(85)	(10.86)	)%
Director fees	117	136	(19)	(13.97)	)%
Amortization of intangibles	93	170	(77)	(45.29)	)%
Correspondent bank service charges	157	160	(3)	(1.88)	)%
Loss on California tax credit partnership	65	184	(119)	(64.67)	)%
Net (gain) cost on operation of OREO	(1,218)	) 329	(1,547)	(470.21)	)%
Other	1,140	1,272	(132)	(10.38)	)%
Total expense	\$8,227	\$9,957	\$(1,730)	(17.37)	)%

Noninterest expense decreased \$1,730,000 between the six months ended June 30, 2013 and 2012. The net decrease in noninterest expense between the comparative periods is primarily the result of a decrease on net cost of operation on OREO, a decrease in loss on California tax credit partnership and reductions in salary expense.

Included in net costs on operations of OREO for the six month period and quarter ended June 30, 2013 are gains on the sale of OREO totaling \$1,949,000 and \$924,000, respectively, which were partially offset by impairment losses of \$118,000 and \$0, as well as OREO operating expenses totaling \$613,000 and \$588,000, respectively.

Net operating cost on operations of OREO for the six month period and quarter ended June 30, 2012 includes gains on sale of OREO of \$337,000 and \$275,000, respectively, which were offset by OREO operating expenses \$666,000 and OREO operating revenue of \$18,000, respectively.

## 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, 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 upon accounting standards related to uncertainty in income taxes which includes the criteria required for the income tax benefit, all or in part, to be recognized in a taxable entity's financial statements. Under the income tax guidelines, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. The term "more likely than not" means a likelihood of more than 50 percent. In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority. The Company has reviewed all of its tax positions as of June 30, 2013, and has determined that there are no material amounts that should be recorded under the current income tax accounting guidelines.

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. At June 30, 2013

and December 31, 2012, the Company had a recorded valuation allowance of \$2,686,000. The Company performs an analysis of the valuation allowance considering both tax planning strategies and future earnings as a basis for utilizing the deferred tax assets. The tax planning strategies include the sale of certain bank premise and the surrender of Bank Owned Life Insurance. In its review of a requirement for a valuation allowance, the Company identifies both positive and negative evidence to determine whether a valuation allowance is required. Negative evidence would include pretax losses recorded during each of the last three calendar years. These losses were the result of the severe economic downturn that began in 2008 and resulted in substantial increases in the provision for loan losses as well as impairment losses related to other real estate owned through foreclosure, goodwill, and private label residential mortgage obligations. At December 31, 2012, the Company performed an analysis of future projected earnings to provide positive evidence that sufficient earnings would be generated to utilize the deferred tax assets. Underlying

Table of Contents

assumptions included continued reductions in nonperforming assets and general improvements in the economy, resulting in reduced provisions for loans losses and impairment charges, as well as reductions in expenses related to other real estate owned. Based upon this analysis, the Company has concluded that the valuation allowance of \$2,686,000 at June 30, 2013 and December 31, 2012 is reasonable.

## Financial Condition

Total assets decreased \$13,215,000, or 2.04% to a balance of \$635,662,000 at June 30, 2013, from the balance of \$648,877,000 at December 31, 2012, and increased \$30,055,000, or 4.96%, from the balance of \$605,607,000 at June 30, 2012. Total deposits of \$547,101,000 at June 30, 2013 decreased \$16,186,000, or 2.87% from the balance reported at December 31, 2012, and increased \$22,099,000, or 4.21%, from the balance of \$525,002,000 reported at June 30, 2012. Cash and cash equivalents decreased \$3,358,000, or 2.37%, between December 31, 2012 and June 30, 2013; net loans increased \$5,629,000, or 1.45% to a balance of \$393,878,000; and investment securities decreased by \$6,317,000, or 19.84% during the same six month period in 2013.

Earning assets averaged approximately \$542,778,000 during the six months ended June 30, 2013, as compared to \$518,119,000 for the same six month period of 2012. Average interest-bearing liabilities increased to \$345,196,000 for the six months ended June 30, 2013, from \$336,708,000 reported for the comparative six month period of 2012.

## Loans and Leases

The Company's primary business is that of acquiring deposits and making loans, with the loan portfolio representing the largest and most important component of earning assets. Loans totaled \$405,041,000 at June 30, 2013, an increase of \$4,984,000, or 1.25%, when compared to the balance of \$400,057,000 at December 31, 2012, and an increase of \$9,960,000, or 2.52%, when compared to the balance of \$395,081,000 reported at June 30, 2012. Loans on average decreased \$3,183,000, or 0.80%, between the six month periods ended June 30, 2012 and June 30, 2013, with loans averaging \$395,138,000 for the six months ended June 30, 2013, as compared to \$398,321,000 for the same six month period of 2012.

During the first six months of 2013, increases of \$3,662,000 and \$13,253,000 were experienced in commercial and industrial loans and real estate mortgage loans, respectively. There was a small decrease in installment loans. Real estate construction and agricultural loans decreased \$4,358,000 or 4.79%, and \$7,142,000 or 19.75%, respectively, during the first six months of 2013.

The following table sets forth the amounts of loans outstanding by category at June 30, 2013 and December 31, 2012, the category percentages as of those dates, and the net change between the two periods presented.

Table 5. Loans

(In thousands)	June 30, 2013		December 31, 2012		Net Change	% Change	
	Dollar Amount	% of Loans	Dollar Amount	% of Loans			
Commercial and industrial	\$75,779	18.7	% \$72,117	18.0	% \$3,662	5.08	%
Real estate – mortgage	203,187	50.2	% 189,934	47.5	% 13,253	6.98	%
RE construction & development	86,583	21.4	% 90,941	22.7	% (4,358)	-4.79	%
Agricultural	29,027	7.2	% 36,169	9.0	% (7,142)	-19.75	%
Installment/other	10,465	2.5	% 10,884	2.8	% (419)	(3.85)	)%
Commercial lease financing	—	0.0	% 12	0.0	% (12)	-100.00	%
Total Gross Loans	\$405,041	100.0	% \$400,057	100.0	% \$4,984	1.25	%



The overall average yield on the loan portfolio was 5.62% for the six months ended June 30, 2013, as compared to 6.06% for the six months ended June 30, 2012. At June 30, 2013, 40.3% of the Company's loan portfolio consisted of floating rate instruments, as compared to 49.9% of the portfolio at December 31, 2012, with the majority of those tied to the prime rate. Approximately 43.49% or \$70,950,000 million of the floating rate loans have rate floors at June 30, 2013 making them effectively fixed-rate loans for certain increases in interest rates, and fixed-rate loans for all decreases in interest rates. Approximately \$25,656,000 of the \$70,950,000 in loans with floors have floor spreads of 100 basis points or more, meaning that interest rates would need to increase more than 1% (or 100 basis points) before the rates on those loans would increase and

Table of Contents

effectively become floating rate loans again. The portfolio of floating rate loans with floors has a relatively short duration with \$19,956,000 million maturing in one year or less, and \$26,884,000 maturing in less than two years.

## Deposits

Total deposits were \$547,101,000 at June 30, 2013, representing a decrease of \$16,186,000, or 2.87% from the balance of \$563,287,000 reported at December 31, 2012, and an increase of \$22,099,000, or 4.21% from the balance of \$525,002,000 reported at June 30, 2012.

The following table sets forth the amounts of deposits outstanding by category at June 30, 2013 and December 31, 2012, and the net change between the two periods presented.

Table 6. Deposits

(In thousands)	June 30, 2013	December 31, 2012	Net Change	Percentage Change	
Noninterest bearing deposits	\$219,693	\$217,014	\$2,679	1.23	%
Interest bearing deposits:					
NOW and money market accounts	191,260	203,771	(12,511)	-6.14	%
Savings accounts	42,163	43,117	(954)	-2.21	%
Time deposits:					
Under \$100,000	30,787	32,532	(1,745)	-5.36	%
\$100,000 and over	63,198	66,853	(3,655)	-5.47	%
Total interest bearing deposits	327,408	346,273	(18,865)	-5.45	%
Total deposits	\$547,101	\$563,287	\$(16,186)	-2.87	%

The Company's deposit base consists of two major components represented by noninterest-bearing (demand) deposits and interest-bearing deposits, totaling \$219,693,000 and \$327,408,000 at June 30, 2013, respectively. Interest-bearing deposits consist of time certificates, NOW and money market accounts, and savings deposits. Total interest-bearing deposits decreased \$18,865,000, or 5.45%, between December 31, 2012 and June 30, 2013, and noninterest-bearing deposits increased \$2,679,000, or 1.23% between the same two periods presented. Included in the decrease of \$18,865,000 in interest bearing deposits during the six months ended June 30, 2013, is a decrease of \$12,511,000 in NOW and money market accounts and a decrease of \$3,655,000 in Time Deposits of \$100,000 and over.

Core deposits, as defined by the Company as consisting of all deposits other than time deposits of \$100,000 or more, and brokered deposits, continue to provide the foundation for the Company's principal sources of funding and liquidity. These core deposits amounted to 85.79% and 85.55% of the total deposit portfolio at June 30, 2013 and December 31, 2012, respectively. Brokered deposits totaled \$16,232,000 at June 30, 2013, as compared to \$17,984,000 at December 31, 2012, and \$30,457,000 at June 30, 2012.

As a result of the March 2010 agreement with the Federal Reserve Bank, the Company has continued to reduce its reliance on brokered and other wholesale funding sources. The Company has a written plan, approved by the Federal Reserve Bank, to improve its liquidity position which includes a timetable to reduce the Bank's reliance on brokered deposits and other wholesale funding, and specific liquidity targets and parameters to meet contractual obligations and unanticipated demands. Under the plan, the Company has systematically reduced the level of brokered deposits to peer levels, or approximately 5% of total deposits. This was achieved by letting some or all of the maturing brokered deposits run-off as needed during the estimated reduction period. Brokered deposits were 2.97% and 3.19% of total deposits at June 30, 2013 and December 31, 2012, respectively.

During the six months ended June 30, 2013, decreases were experienced in time deposits, as brokered time deposits were allowed to runoff as part of the Company's plan to reduce brokered deposits and other wholesale funding. While total time deposits decreased by \$5,400,000, or 1.56%, during the six months ended June 30, 2013, brokered deposits, a component of total time deposits, decreased \$1,752,000, or 9.74%, during the six month period. Pricing of brokered time deposits and other wholesale deposits have remained low over the past two years and have provided a viable alternate to borrowing from the Federal Reserve or the FHLB. The Company believes this rate structure will eventually turn, and wholesale funding sources,

## Table of Contents

both deposits and borrowings, will again become more expensive relative to other core deposits in the marketplace. Although the Company will continue to use pricing strategies to control the overall level of time deposits and other borrowings as part of its balance sheet and liquidity planning process, the March 2010 agreement with the Federal Reserve Bank required reductions in brokered deposits, which places increased emphasis on core deposits as part of the Company's long-term relationship banking strategy. As a result, core deposits, including NOW and money market accounts, savings accounts, and noninterest-bearing checking accounts, continue to provide the Company's primary funding source.

On a year-to-date average, the Company experienced an increase of \$10,774,000, or 2.00%, in total deposits between the six month periods ended June 30, 2013 and June 30, 2012. Between these two periods, average interest-bearing deposits increased \$6,724,000 or 2.05% ,and total noninterest-bearing deposits increased \$4,050,000, or 1.92%, on a year-to-date average basis.

### Short-Term Borrowings

The Company had collateralized FRB and FHLB lines of credit totaling \$237,891,000 and \$8,078,000 at June 30, 2013, respectively. These lines of credit generally have interest rates tied to either, the Federal Funds rate, short-term U.S. Treasury rates or LIBOR. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time. At June 30, 2013 and June 30, 2012, the Company had no outstanding borrowings. The Company had collateralized FRB lines of credit of \$217,841,000, as well as collateralized FHLB lines of credit totaling \$10,493,000 at December 31, 2012.

### 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.

As a result of the March 2010 agreement with the Federal Reserve Bank, the Company has written several plans to address the management of asset quality and the adequacy of the allowance for loan and lease losses. Specifically, the Company has three written plans which directly address these issues:

Plan to Strengthen Credit Risk Management Practices – Includes the responsibility of Board to establish appropriate risk tolerance guidelines and limits, timely and accurate identification and quantification of credit risk, strategies to minimize credit losses and reduce the level of problem assets, procedures for the ongoing review of the investment portfolio to evaluate other-than-temporary-impairment, stress testing for commercial real estate loans and portfolio segments, and measures to reduce the levels of other real estate owned.

Plan to Improve Adversely Classified Assets – Includes specific plans and strategies to improve the Bank's asset position through repayment, amortization, liquidation, additional collateral, or other means on each loan, relationship, or other asset in excess of \$1.5 million including OREO, that are past due more than 90 days as of the date of the written agreement.

Plan for Maintenance of Adequate Allowance for Loan Losses – Includes policies and procedures to ensure adherence to the Bank's revised ALLL methodology, provides for periodic reviews of the methodology as appropriate, and provides for review of ALLL by the Board at least quarterly.

Also as part of the agreement with the Federal Reserve Bank, Board oversight has been enhanced to monitor the operations of the Company including, but not limited to, asset improvement and adequacy of the allowance for loan and lease losses. With regard to asset improvement, the Company will not, directly or indirectly, extend, renew, or

restructure any loan to any borrower, including any related interest of the borrower, whose loans were criticized by the Federal Reserve Bank in their June 2009 examination, or any subsequent examination, without prior approval of a majority of the Board of Directors. Any extensions of credit, renewals, or restructurings on loans to such borrowers approved by the Board of Directors, will be supported with detailed written justification. Any additional loan, relationship, or asset in excess of \$1.5 million that becomes past due more than 90 days, will be subject to a written plan to improve the Company's position with regard to the asset, and that plan will be submitted to the Federal Reserve Bank. The Company will submit written reports to the Federal Reserve Bank on a quarterly basis to include updates of progress made on asset improvement, as well as review and monitoring of the adequacy of the allowance for loan and lease losses.

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

## Table of Contents

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 evaluated individually for specific impairment under the asset-specific component of the allowance.

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

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

The formula allowance is calculated by applying loss factors to outstanding loans and certain unfunded loan commitments. Loss factors are based on the Company’s historical loss experience and on the internal risk grade of those loans and, may be adjusted for significant factors, including economic factors that, in management’s judgment, affect the collectability of the portfolio as of the evaluation date. Management determines the loss factors for problem graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates loan losses over the previous quarters as determined by management (four years) 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, which are “pass”, “special mention”, “substandard”, “doubtful”, and “loss”. Certain loans are homogeneous in nature and are therefore pooled by risk grade. These homogeneous loans include consumer installment and home equity loans. 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 downgrade. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as “doubtful” has critical weaknesses that make full collection of the obligation improbable. Classified loans, as defined by the Company, include impaired loans and loans categorized as substandard, doubtful, and loss which are not considered impaired. At June 30, 2013, “classified” loans totaled \$32,574,000 or 8.01% of gross loans as compared to \$35,036,000 or 8.8 % of gross loans at December 31, 2012.

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

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

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

Table of Contents

The following table summarizes the specific allowance, formula allowance, and unallocated allowance at June 30, 2013 and December 31, 2012, as well as classified loans at those period-ends.

(in 000's)	June 30, 2013	December 31, 2012
Specific allowance – impaired loans	\$535	\$658
Formula allowance – classified loans not impaired	2,991	2,871
Formula allowance – special mention loans	62	113
Total allowance for special mention and classified loans	3,588	3,642
Formula allowance for pass loans	4,286	2,719
Unallocated allowance	3,283	5,423
Total allowance for loan losses	\$11,157	\$11,784
Impaired loans	20,582	21,931
Classified loans not considered impaired	11,992	13,105
Total classified loans	\$32,574	\$35,036
Special mention loans not considered impaired	\$2,858	\$2,057

Impaired loans decreased \$1,349,000 between December 31, 2012 and June 30, 2013 and the specific allowance related to those impaired loans decreased \$123,000 between December 31, 2012 and June 30, 2013. The formula allowance related to loans that are not impaired (including special mention and substandard) increased by \$69,000 between December 31, 2012 and June 30, 2013. The level of “pass” loans increased approximately \$11,961,000 between December 31, 2012 and June 30, 2013, while the related formula allowance increased \$1,567,000 during the period as the result of increases in the level of “pass loans”, the loan loss factors assigned to "pass" loans as determined under migration analysis and decreases in qualitative factors assigned to the formula allowance.

The Company’s methodology includes features that are intended to reduce the difference between estimated and actual losses. The specific allowance portion of the analysis is designed to be self-correcting by taking into account the current loan loss experience based on that portion of the portfolio. By analyzing the estimated losses inherent in the loan portfolio on a quarterly basis, management is able to adjust specific and inherent loss estimates using the most recent information available. In performing the periodic migration analysis, management believes that historical loss factors used in the computation of the formula allowance need to be adjusted to reflect current changes in market conditions and trends in the Company’s loan portfolio. There are a number of other factors which are reviewed when determining adjustments in the historical loss factors. Those factors include 1) trends in delinquent and nonaccrual loans, 2) trends in loan volume and terms, 3) effects of changes in lending policies, 4) concentrations of credit, 5) competition, 6) national and local economic trends and conditions, 7) experience of lending staff, 8) loan review and Board of Directors oversight, 9) high balance loan concentrations, and 10) other business conditions. There were no changes in estimation methods or assumptions that affected the methodology for assessing the adequacy of the allowance for credit losses during the six months ended June 30, 2013.

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



agreement, quarterly updates are provided to the Federal Reserve Bank of San Francisco and the California Department of Financial Institutions with regard to problem assets levels and trends, liquidity, and capital trends, among other things. (See regulatory section for more details.)

The specific allowance for impaired loans is measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. The amount of impaired loans is not directly comparable to the amount of nonperforming loans disclosed later in this section. The primary differences

Table of Contents

between impaired loans and nonperforming loans are: i) all loan categories are considered in determining nonperforming loans while impaired loan recognition is limited to commercial and industrial loans, commercial and residential real estate loans, construction loans, and agricultural loans, and ii) impaired loan recognition considers not only loans 90 days or more past due, restructured loans and nonaccrual loans but may also include problem loans other than delinquent loans.

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

At June 30, 2013 and December 31, 2012, the Company's recorded investment in impaired loans totaled \$20,582,000 and \$21,931,000, respectively. Included in total impaired loans at June 30, 2013, are \$8,361,000 of impaired loans for which the related specific allowance is \$535,000, as well as \$12,221,000 of impaired loans that as a result of write-downs or the sufficiency of the fair value of the collateral, did not have a specific allowance. Total impaired loans at December 31, 2012 included \$8,479,000 of impaired loans for which the related specific allowance is \$658,000 and \$13,452,000 of impaired loans that, as a result of write-downs or the sufficiency of the fair value of the collateral, did not have a specific allowance. The average recorded investment in impaired loans was \$20,310,000 during the first six months of 2013. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring, for which the loan has been performing for a prescribed period of time under the current contractual terms, income is recognized under the accrual method. At June 30, 2013, included in impaired loans, are troubled debt restructures totaling \$14,316,000. Of the \$14,316,000 in troubled debt restructures at June 30, 2013, \$4,433,000 are on nonaccrual status. Troubled debt restructures on accrual status totaling \$9,883,000 are current with regards to payments, and are performing according to the modified contractual terms.

The largest category of impaired loans at June 30, 2013 is real estate mortgage, comprising approximately 82.90% of total impaired loans at June 30, 2013. Additionally, commercial and industrial and real estate construction loans combined represent approximately another 16.49% of total impaired loan balances at June 30, 2013. Of the \$974,000 in commercial and industrial impaired loans reported at June 30, 2013, approximately \$109,000 or 11.23% are secured by real estate. Specific collateral related to impaired loans is reviewed for current appraisal information, economic trends within geographic markets, loan-to-value ratios, and other factors that may impact the value of the loan collateral. Adjustments are made to collateral values as needed for these factors. Of total impaired loans at June 30, 2013, approximately \$19,592,000 or 95.19% are secured by real estate. The majority of impaired real estate construction and development loans are for the purpose of residential construction, residential and commercial acquisition and development, and land development. Residential construction loans are made for the purpose of building residential 1-4 single family homes. Residential and commercial acquisition and development loans are made for the purpose of purchasing land, developing that land if required, and developing real estate or commercial construction projects on those properties. Land development loans are made for the purpose of converting raw land into construction-ready building sites. The following table summarizes the components of impaired loans and their related specific reserves at June 30, 2013 and December 31, 2012.

	Balance	Reserve	Balance	Reserve
(in 000's)	June 30, 2013	June 30, 2013	December 31, 2012	December 31, 2012
Commercial and industrial	\$974	\$14	\$1,431	\$37

Edgar Filing: UNITED SECURITY BANCSHARES - Form 10-Q

Real estate – mortgage	17,063	521	18,457	621
RE construction & development	2,420	—	1,730	—
Agricultural	51	—	192	—
Installment/other	74	—	121	—
Commercial lease financing	—	—	—	—
Total Impaired Loans	\$20,582	\$535	\$21,931	\$658

Included in impaired loans are loans modified in troubled debt restructurings (“TDRs”), where concessions have been granted to borrowers experiencing financial difficulties in an attempt to maximize collection. The Company makes various types of concessions when structuring TDRs including rate reductions, payment extensions, and forbearance. At June 30, 2013,

Table of Contents

approximately \$11,043,000 of the total \$14,316,000 in TDRs was for real estate mortgages, and another \$2,410,000 related real estate construction and development loans at June 30, 2013.

Total troubled debt restructurings decreased 14.65% at June 30, 2013 compared to December 31, 2012. Nonaccrual TDRs decreased by 37.94% and accruing TDRs increased by 2.63% over the same period. Within TDR categories, total residential mortgages and real estate construction TDRs showed a decrease of 13.51%. The majority of these credits are related to real estate construction projects that slowed significantly or stalled, and the Company pursued restructuring the qualified credits while the construction industry recovers and allow developers an opportunity to finish projects at a slower pace. Concessions granted in these circumstances include lengthened maturities, lower lot release prices, or rate reductions that enable the borrower to finish the construction projects and repay loans to the Company. The Company has had general success in its restructuring efforts even though not all restructured efforts will be entirely successful. In large part the successes are related to a recovering real estate market that began in late 2011 and is continuing into 2013.

The following table summarizes TDRs by type, classified separately as nonaccrual or accrual, which are included in impaired loans at June 30, 2013 and December 31, 2012.

(in thousands)	Total TDRs June 30, 2013	Nonaccrual TDRs June 30, 2013	Accruing TDRs June 30, 2013
Commercial and industrial	\$812	\$241	\$571
Real estate - mortgage:			
Commercial real estate	4,216	1,526	2,690
Residential mortgages	6,783	1,617	5,166
Home equity loans	44	—	44
Total real estate mortgage	11,043	3,143	7,900
RE construction & development	2,410	1,049	1,361
Agricultural	51	—	51
Installment/other	—	—	—
Commercial lease financing	—	—	—
Total Troubled Debt Restructurings	\$14,316	\$4,433	\$9,883
	Total TDRs December 31, 2012	Nonaccrual TDRs December 31, 2012	Accruing TDRs December 31, 2012
(in thousands)			
Commercial and industrial	\$990	\$740	\$250
Real estate - mortgage:			
Commercial real estate	5,395	2,763	2,632
Residential mortgages	7,289	1,745	5,544
Home equity loans	10	10	—
Total real estate mortgage	12,694	4,518	8,176
RE construction & development	2,860	1,730	1,130
Agricultural	191	136	55
Installment/other	38	19	19
Commercial lease financing	—	—	—
Total Troubled Debt Restructurings	\$16,773	\$7,143	\$9,630

Of the \$14,316,000 in total TDRs at June 30, 2013, \$4,433,000 were on nonaccrual status at period-end. Of the \$16,773,000 in total TDRs at December 31, 2012, \$7,143,000 were on nonaccrual status at period-end. As of June 30, 2013, the Company has



Table of Contents

no commercial real estate (CRE) workouts whereby an existing loan was restructured into multiple new loans (i.e., A Note/B Note structure).

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

The following table summarizes special mention loans by type at June 30, 2013 and December 31, 2012.

(in thousands)	June 30, 2013	December 31, 2012
Commercial and industrial	\$978	\$1,867
Real estate - mortgage:		
Commercial real estate	1,845	—
Residential mortgages	—	909
Home equity loans	—	—
Total real estate mortgage	1,845	909
RE construction & development	—	141
Agricultural	—	—
Installment/other	36	49
Commercial lease financing	—	—
Total Special Mention Loans	\$2,859	\$2,966

The Company focuses on competition and other economic conditions within its market area and other geographical areas in which it does business, which may ultimately affect the risk assessment of the portfolio. The Company continues to experience increased competition from major banks, local independents and non-bank institutions creating pressure on loan pricing. Low interest rates and a weak economy continue to dominate, even though real estate prices show signs of stabilization. The Company continues to place increased emphasis on reducing both the level of nonperforming assets and the level of losses on the disposition of these assets. It is in the best interest of both the Company and the borrowers to seek alternative options to foreclosure in an effort to reduce the impacts on the real estate market. As part of this strategy, the Company has increased its level of troubled debt restructurings, when it makes economic sense. While business and consumer spending show improvement in recent quarters, current GDP remains anemic. It is difficult to forecast what impact the Federal Reserve actions to hold rates low will have on the economy. The local market has remained more relatively stable economically during the past several years than some areas of the state and the nation, where more volatile economic impacts were experienced, including more severe deterioration of residential real estate markets. Although the local area residential housing markets have been hard hit, they continue to perform better than some parts of the state which bodes well for sustained, but slower growth in the Company's market areas of Fresno and Madera, Kern, and Santa Clara Counties. Local unemployment rates in the San Joaquin Valley remain high compared with other regions but are historically high as a result of the area's agricultural dynamics. The Company believes that the Central San Joaquin Valley will continue to grow and diversify as property and housing costs remain low relative to other areas of the state. Management recognizes increased risk of loss due to the Company's exposure to local and worldwide economic conditions, as well as potentially volatile real estate markets, and takes these factors into consideration when analyzing the adequacy of the allowance for credit losses.

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



Table of Contents

Table 7. Allowance for Credit Losses - Summary of Activity

(In thousands)	June 30, 2013	June 30, 2012		
Total loans outstanding at end of period before deducting allowances for credit losses	\$405,035	\$394,563		
Average loans outstanding during period	395,138	398,321		
Balance of allowance at beginning of period	11,784	13,648		
Loans charged off:				
Real estate	(216	) (63	)	)
Commercial and industrial	(485	) (2,932	)	)
Installment and other	(27	) (137	)	)
Total loans charged off	(728	) (3,132	)	)
Recoveries of loans previously charged off:				
Real estate	3	4		
Commercial and industrial	38	61		
Installment and other	30	23		
Total loan recoveries	71	88		
Net loans charged off	(657	) (3,044	)	)
Provision charged to operating expense	30	1,006		
Balance of allowance for credit losses at end of period	\$11,157	\$11,610		
Net loan charge-offs to total average loans (annualized)	0.34	%	1.54	%
Net loan charge-offs to loans at end of period (annualized)	0.32	%	1.54	%
Allowance for credit losses to total loans at end of period	2.75	%	2.94	%
Net loan charge-offs to allowance for credit losses (annualized)	11.78	%	52.44	%
Provision for credit losses to net charge-offs (annualized)	9.13	%	66.10	%

Net loan charge-offs decreased \$2,387,000 during the six months ended June 30, 2013 when compared to the six months ended June 30, 2012. Loan charge-offs of \$728,000 experienced during the six months ended June 30, 2013 included full or partial charge-offs of \$289,000 in impaired loans.

At June 30, 2013 and June 30, 2012, \$144,000 and \$171,000, respectively, of the formula allowance is allocated to unfunded loan commitments and is, therefore, reported separately in other liabilities. Management believes that the 2.75% credit loss allowance at June 30, 2013 is adequate to absorb known and inherent risks in the loan portfolio. No assurance can be given, however, regarding economic conditions or other circumstances which may adversely affect the Company's service areas and result in losses to the loan portfolio.

It is the Company's policy to discontinue the accrual of interest income on loans when reasonable doubt exists with respect to the timely collectability of interest or principal due or the ability of the borrower to otherwise comply with the terms of the loan agreement. Such loans are placed on nonaccrual status whenever the payment of principal or interest is 90 days past due, or earlier when the conditions warrant. Interest collected is thereafter credited to principal. Management may grant exceptions to this policy if the loans are well secured and in the process of collection.



Table of Contents

Table 8. Nonperforming Assets

(In thousands)	June 30, 2013	December 31, 2012	
Nonaccrual Loans	\$10,665	\$13,425	
Restructured Loans (1)	9,883	9,716	
Total nonperforming loans	20,548	23,141	
Other real estate owned	17,221	23,932	
Total nonperforming assets	\$37,769	\$47,073	
Loans past due 90 days or more, still accruing	\$0	\$0	
Nonperforming loans to total gross loans	5.07	%	5.78 %
Nonperforming assets to total assets	5.94	%	7.25 %
Allowance for loan losses to nonperforming loans	54.30	%	50.92 %

(1) Included in nonaccrual loans at June 30, 2013 and December 31, 2012 are restructured loans totaling \$4,433,000 and \$7,144,000, respectively.

Non-performing loans decreased \$2,594,000 between December 31, 2012 and June 30, 2013. Nonaccrual loans decreased \$2,760,000 between December 31, 2012 and June 30, 2013 with real estate mortgage and real estate construction loans each comprising approximately 95.50% of total nonaccrual loans at June 30, 2013. The following table summarizes the nonaccrual totals by loan category for the periods shown. The ratio of the allowance for loan losses to nonperforming loans increased from 50.92% at December 31, 2012 to 54.30% at June 30, 2013.

	Balance	Balance	Change from
Nonaccrual Loans (in 000's):	June 30, 2013	December 31, 2012	December 31, 2012
Commercial and industrial	\$400	\$1,181	\$(781)
Real estate - mortgage	9,135	10,259	(1,124)
RE construction & development	1,050	1,730	(680)
Agricultural	—	136	(136)
Installment/other	80	119	(39)
Commercial lease financing	0	0	0
Total Nonaccrual Loans	\$10,665	\$13,425	\$(2,760)

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

Except for the nonaccrual loans included in the above table, or those included in the impaired loan totals, there were no loans at June 30, 2013 where the known credit problems of a borrower caused the Company to have serious doubts as to the ability of such borrower to comply with the present loan repayment terms and which would result in such loan being included as a nonaccrual, past due, or restructured loan at some future date.

## Asset/Liability Management – Liquidity and Cash Flow

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

## Liquidity



## Table of Contents

Liquidity management may be described as the ability to maintain sufficient cash flows to fulfill financial obligations, including loan funding commitments and customer deposit withdrawals, without straining the Company's equity structure. To maintain an adequate liquidity position, the Company relies on, in addition to cash and cash equivalents, cash inflows from deposits and short-term borrowings, repayments of principal on loans and investments, and interest income received. The Company's principal cash outflows are for loan origination, purchases of investment securities, depositor withdrawals and payment of operating expenses.

The Company continues to emphasize liability management as part of its overall asset/liability strategy. Through the discretionary acquisition of short term borrowings, the Company has, when needed, been able to provide liquidity to fund asset growth while, at the same time, better utilizing its capital resources, and better controlling interest rate risk. This does not preclude the Company from selling assets such as investment securities to fund liquidity needs but, with favorable borrowing rates, the Company has maintained a positive yield spread between borrowed liabilities and the assets which those liabilities fund. If, at some time, rate spreads become unfavorable, the Company has the ability to utilize an asset management approach and, either control asset growth or, fund further growth with maturities or sales of investment securities. At June 30, 2013, the Company had no borrowings, as its deposit base currently provides funding sufficient to support its asset values.

The Company's liquid asset base which generally consists of cash and due from banks, federal funds sold, securities purchased under agreements to resell ("reverse repos") and investment securities, is maintained at a level deemed sufficient to provide the cash outlay necessary to fund loan growth as well as any customer deposit runoff that may occur. Additional liquidity requirements may be funded with overnight or term borrowing arrangements with various correspondent banks, FHLB and the Federal Reserve Bank. Within this framework is the objective of maximizing the yield on earning assets. This is generally achieved by maintaining a high percentage of earning assets in loans, which historically have represented the Company's highest yielding asset. At June 30, 2013, the Bank had 63.72% of total assets in the loan portfolio and a loan to deposit ratio of 74.03%, as compared to 61.65% of total assets in the loan portfolio and a loan to deposit ratio of 71.02% at December 31, 2012. Liquid assets at June 30, 2013 include cash and cash equivalents totaling \$138,269,000 as compared to \$141,627,000 at December 31, 2012. Other sources of liquidity include collateralized lines of credit from the Federal Home Loan Bank, and from the Federal Reserve Bank totaling \$245,969,000 at June 30, 2013.

The liquidity of the parent company, United Security Bancshares, is primarily dependent on the payment of cash dividends by its subsidiary, United Security Bank, subject to limitations imposed by the Financial Code of the State of California. The Bank currently has limited ability to pay dividends or make capital distributions (see Dividends section included in Regulatory Matters of this Management's Discussion). The limited ability of the Bank to pay dividends may impact the ability of the Company to fund its ongoing liquidity requirements including ongoing operating expenses, as well as quarterly interest payments on the Company's junior subordinated debt (Trust Preferred Securities.) Since the quarter ended March 31, 2009, the Bank has been precluded from paying a cash dividend to the Company. To conserve cash and capital resources, the Company elected at March 31, 2009 to defer the payment of interest on its junior subordinated debt beginning with the quarterly payment due October 1, 2009. The Company has not determined how long it will defer interest payments, but under the terms of the debenture, interest payments may be deferred up to five years (20 quarters). During such deferral periods, the Company is prohibited from paying dividends on its common stock (subject to certain exceptions) and will continue to accrue interest payable on the junior subordinated debt. During the six months ended June 30, 2013, the Bank paid did not pay any cash dividends to the parent company.

### Cash Flow

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

	Balance
December 31, 2011	\$124,184
June 30, 2012	\$99,390
December 31, 2012	\$141,627
June 30, 2013	\$138,269

Cash and cash equivalents decreased \$3,358,000 during the six months ended June 30, 2013, as compared to a decrease of \$24,794,000 during the six months ended June 30, 2012.

## Table of Contents

The Company had a net cash inflow from operations of \$3,844,000 for the six months ended June 30, 2013 and a positive cash inflow from operations totaling \$4,966,000 for the period ended June 30, 2012. The Company experienced net cash inflows from investing activities totaling \$8,972,000 and \$19,665,000 during the six months ended June 30, 2013 and June 30, 2012, respectively, as settlement of OREO properties, proceeds from other investment sales and paydowns, and maturities of investment securities outweighed capital and investment expenditures.

During the six months ended June 30, 2013, the Company experienced net cash outflows from financing activities totaling \$16,174,000 primarily as the result of decreases in demand deposits and savings accounts. For the six months ended June 30, 2012, the Company experienced net cash outflows of \$49,425,000 from financing activities due to decreases in brokered deposits and demand deposits and savings accounts.

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

## Regulatory Matters

### Regulatory Agreement with the Federal Reserve Bank of San Francisco

Effective March 23, 2010, United Security Bancshares (the "Company") and its wholly owned subsidiary, United Security Bank (the "Bank"), entered into a written agreement (the "Agreement") with the Federal Reserve Bank of San Francisco. Under the terms of the Agreement, the Company and the Bank agreed to strengthen board oversight of management and the Bank's operations; submit an enhanced written plan to strengthen credit risk management practices and improve the Bank's position on the past due loans, classified loans, and other real estate owned; maintain a sound process for determining, documenting, and recording an adequate allowance for loan and lease losses; improve the management of the Bank's liquidity position and funds management policies; maintain sufficient capital at the Company and Bank level; and improve the Bank's earnings and overall condition. The Company and Bank have 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 Bank. 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. The inability of the Bank to pay cash dividends to the Company may hinder the Company's ability to meet its ongoing operating obligations.

This Agreement entered into with the Federal Reserve Bank of San Francisco was a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions in June 2009 ("Report of Examination"). The Agreement was the result of significant increases in nonperforming assets, both classified loans and OREO, during 2008 and 2009 increasing the overall risk profile of the Bank. The increased risk profile of the Bank included heightened concerns about the Bank's use of brokered and other whole funding sources which had been used to fund loan growth and reduce the Company's overall cost of interest bearing liabilities. With loan growth funded to some degree by wholesale funding sources, liquidity risk increased, and higher levels of nonperforming assets increased risk to equity capital and potential volatility in earnings.

The Agreement's major components and requirements for the Bank are as follows:

Strengthen board oversight of the Bank's management and operations by the Bank submitting a written plan to the Federal Reserve Bank to address and include (i) the actions that the board will take to improve the Bank's conditions and maintain effective control over, and supervision of, the Bank's major operations and activities, (ii) the responsibility of the board to monitor management's adherence to approved policies and procedures, and applicable

laws and regulations; and (iii) a description of the information and reports that are regularly reviewed by the board in its oversight of the operations and management of the Bank;

Strengthen credit risk management practices of the Bank by the Bank submitting a written plan to the Federal Reserve Bank to address and include (i) the responsibility of the Board of Directors to establish appropriate risk tolerance guidelines and risk limits; (ii) timely and accurate identification and quantification of credit risk within the loan portfolio; (iii) strategies to minimize credit losses and reduce the level of problem assets; (iv) procedures for the on-going review of the investment portfolio to evaluate other-than temporary-impairment (“OTTI”) and accurate accounting for OTTI; (v) stress testing of commercial real estate loan and portfolio segments; and (vi) measures to reduce the amount of other real estate owned;

Table of Contents

Strengthen asset quality at the Bank by (i) not extending, renewing, or restructuring any credit to or for the benefit of any borrower, including any related interest of the borrower, whose loans or other extensions of credit were criticized in the Report of Examination or in any subsequent report of examination, without appropriate underwriting analysis, documentation, board or committee approval and certification that the board or committee reasonably believes that the extension of credit will not impair the Bank's interest in obtaining repayment of the already outstanding credit and that the extension of credit or renewal will be repaid according to its terms, (ii) submitting to the Federal Reserve Bank an acceptable written plan designed to improve the Bank's position through repayment, amortization, liquidation, additional collateral, or other means on each loan or other asset in excess of \$1.5 million including other real estate owned that is past due as to principal or interest more than 90 days, on the Bank's problem loan list, or was adversely classified in the Report of Examination or subsequent report of examination;

Improve management of the Bank's allowance for loan losses by (i) eliminating from its books, by charge-off or collection, all assets or portions of assets classified "loss" in the Report of Examination that have not been previously collected in full or charged off within 10 days of the Agreement, and, within 30 days from the receipt of any federal or state report of examination, charge off all assets classified "loss" unless otherwise approved in writing by the Federal Reserve Bank, (ii) maintain a sound process for determining, documenting, and recording an adequate allowance for loan and lease losses ("ALLL") in accordance with regulatory reporting instructions and relevant supervisory guidance, and (iii) within 60 days of the date of the Agreement, submitting to the Federal Reserve Bank an acceptable written program for the maintenance of an adequate ALLL, including provision for a review of the ALLL by the board on at least a quarterly calendar basis and remedying any deficiency found in the ALLL in the quarter it is discovered, and the board maintaining written documentation of its review of the ALLL;

Maintain sufficient capital at the Company and Bank by submitting to the Federal Reserve Bank an acceptable written plan to maintain sufficient capital at the Company, on a consolidated basis, and the Company and the Bank shall jointly submit to the Reserve Bank an acceptable written plan to maintain sufficient capital at the Bank, as a separate legal entity on a stand-alone basis that (i) complies with the applicable bank and bank holding company capital maintenance regulations and regulatory guidelines and that also considers the adequacy of the Bank's capital, (ii) takes into account the volume of classified credits, concentrations of credit, ALLL, current and projected asset growth, and projected retained earnings, the source and timing of additional funds to fulfill the Company's and the Bank's future capital requirements, and a provision to notify the Federal Reserve Bank when either entity falls below the capital ratios in the accepted plan;.

- Submit a revised business plan and budget to the Federal Reserve Bank for 2010 and subsequent calendar years that the Bank is subject to the Agreement to improve the Bank's earnings and overall condition, which plan at a minimum provides a realistic and comprehensive budget for the remainder of calendar year 2010, and description of the operating assumptions that form the basis for, and adequately support, major projected income, expense, and balance sheet components;

Not make certain distributions, dividends, and payments, specifically that (i) the Company and Bank agreeing not to declare or pay any dividends without the prior written approval of the Federal Reserve Bank and the Director of the Division of Banking Supervision and Regulation of the Board of Governors ("Director"), (ii) the Company not taking any other form of payment representing a reduction in capital from the Bank without the prior written approval of the Federal Reserve Bank, and (iii) the Company and its nonbank subsidiaries not making any distributions of interest, principal, or other sums on subordinated debentures or trust preferred securities without the prior written approval of the Federal Reserve Bank and the Director;

- Not incur debt or redeem stock, without the prior written approval of the Federal Reserve Bank. The Company agrees not to incur, increase, or guarantee any debt or purchase or redeem any shares of its stock;

Correct violations of the laws by (i) the Bank immediately taking all necessary steps to correct all violations of law and regulation cited in the Report of Examination, (ii) the board of the Bank taking the necessary steps to ensure the Bank's future compliance with all applicable laws and regulations, (iii) complying with the notice provisions of Section 32 of the FDI Act (12 U.S.C. § 1831i) and Subpart H of Regulation Y of the Board of Governors of the Federal Reserve System (12 C.F.R. §§ 225.71 et seq) prior to appointing any new director or senior executive officer, or changing the responsibilities of any senior executive officer so that the officer would assume a different senior executive officer position, and (iv) complying with the restrictions on indemnification and severance payments of Section 18(k) of the FDI Act (12 U.S.C. § 1828(k)) and Part 359 of the FDIC's regulations (12 C.F.R. Part 359);



## Table of Contents

Comply with the Agreement by (i) appointing a compliance committee of the Bank (“Compliance Committee”) within 10 days of the date of the Agreement to monitor and coordinate the Bank’s compliance with the provisions of the Agreement, which Compliance Committee is composed of a majority of outside directors who are not executive officers or principal shareholders of the Bank and which is to meet at least monthly and report its findings to the board of directors of the Bank, and (ii) the Company and Bank within 30 days after the end of each calendar quarter following the date of the Agreement submitting to the Federal Reserve Bank written progress reports detailing the form and manner of all actions taken to secure compliance with the Agreement and the results of such actions.

For a copy of the Agreement with the Federal Reserve Bank of San Francisco, see the Company’s Form 8-K filed with the Securities and Exchange Commission on March 25, 2010.

Since the effective date of the Agreement, the Bank submitted quarterly progress reports to the Federal Reserve. As of the July 23, 2013 progress report submitted for the second quarter of 2013, the Company and the Bank believe they are in compliance with the Agreement, including deadlines and remediation of violations of laws and regulations regarding stale loan appraisals.

### Regulatory Order from the California Department of Financial Institutions

During May of 2010, the California Department of Financial Institutions issued a written order (the “Order”) pursuant to section 1913 of the California Financial Code to the Bank as a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions in June 2009. The Order issued by the California Department of Financial Institutions is similar to the agreement with the Federal Reserve Bank of San Francisco, except for certain additional requirements. The additional requirements in the Order for the Bank are as follows:

Develop and adopt a capital plan to maintain a ratio of tangible shareholders’ equity to total tangible assets equal to or greater than 9.5% and include in such capital plan a capital contingency plan for raising additional capital in the event of various contingencies;

Maintain a ratio of tangible shareholders’ equity to total tangible assets equal to or greater than 9.5%

Maintain an adequate allowance for loan losses and remedy any deficiency in the allowance for loan losses in the calendar quarter in which it is discovered; and

Not establish any new branches or other offices without the prior written consent of the Commissioner of the California Department of Financial Institutions

- Provide progress reports within 30 days after the end of each calendar quarter following the date of the Order to the California Department of Financial Institutions detailing the form and manner of all actions taken to secure compliance with the Order and Agreement and the results of such actions.

The Bank is currently in full compliance with the requirements of the Order including its deadlines.

### Capital Adequacy

The Board of Governors of the Federal Reserve System (“Board of Governors”) has adopted regulations requiring insured institutions to maintain a minimum leverage ratio of Tier 1 capital (the sum of common stockholders’ equity, noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries, minus intangible assets, identified losses and investments in certain subsidiaries, plus unrealized losses or minus unrealized gains on available

for sale securities) to total assets. Institutions which have received the highest composite regulatory rating and which are not experiencing or anticipating significant growth are required to maintain a minimum leverage capital ratio of 3% Tier 1 capital to total assets. All other institutions are required to maintain a minimum leverage capital ratio of at least 100 to 200 basis points above the 3% minimum requirement.

The Board of Governors has also adopted a statement of policy, supplementing its leverage capital ratio requirements, which provides definitions of qualifying total capital (consisting of Tier 1 capital and Tier 2 supplementary capital, including the allowance for loan losses up to a maximum of 1.25% of risk-weighted assets) and sets forth minimum risk-based capital ratios of capital to risk-weighted assets. Insured institutions are required to maintain a ratio of qualifying total capital to risk weighted assets of 8%, at least one-half (4%) of which must be in the form of Tier 1 capital.

Table of Contents

Pursuant to the March 2010 Agreement with the Federal Reserve Bank, the Company and the Bank are required to maintain sufficient capital to support current and future capital needs, including compliance with Capital Adequacy Guidelines taking into account the volume of classified assets, concentrations of credit, the level of the allowance for loan losses, current and projected growth, and projected retained earnings. Pursuant to the Order issued by the California Department of Financial Institutions in May 2010, the Bank is required to maintain a ratio of tangible shareholders' equity to total tangible assets equal to or greater than 9.5%. For purposes of the Order, "tangible shareholders' equity" is defined as shareholders' equity minus intangible assets. The Bank's ratio of tangible shareholders' equity to total tangible assets was 12.37% at June 30, 2013.

As part of the March 2010 Agreement, the Company has written, and submitted to the Federal Reserve Bank, a capital plan that includes guidelines and trigger points to ensure sufficient capital is maintained at the Bank and the Company, and that capital ratios are maintained at a level deemed appropriate under regulatory guidelines given the level of classified assets, concentrations of credit, ALLL, current and projected growth, and projected retained earnings. The capital plan also contains contingency strategies to obtain additional capital as required to fulfill future capital requirements for both the Bank as a separate legal entity, and the Company on a consolidated basis. The capital plan also addresses the requirement of both the Bank and the Company to comply with the Federal Banks' Capital Adequacy Guidelines, and contingency plans to ensure the maintenance of adequate capital levels under those guidelines.

The following table sets forth the Company's and the Bank's actual capital positions at June 30, 2013, as well as the minimum capital requirements and requirements to be well capitalized under prompt corrective action provisions (Bank required only) under the regulatory guidelines discussed above:

Table 9. Capital Ratios

	Company	Bank	Minimum	To Be Well Capitalized under Prompt Corrective Action Provisions
	Actual Capital Ratios	Actual Capital Ratios	Capital Ratios	
Total risk-based capital ratio	16.28%	16.43%	10.00%	10.00%
Tier 1 capital to risk-weighted assets	15.01%	15.17%	5.00%	6.00%
Leverage ratio	11.02%	11.16%	4.00%	5.00%

As is indicated by the above table, and the above discussion of the required ratio of tangible shareholders' equity to total tangible assets under the Order, the Company and the Bank exceeded all applicable regulatory capital guidelines at June 30, 2013. Management believes that, under the current regulations, both will continue to meet their minimum capital requirements in the foreseeable future.

## Dividends

Dividends paid to shareholders by the Company are subject to restrictions set forth in the California General Corporation Law. The California General Corporation Law provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal to the amount of the proposed distribution. The primary source of funds with which dividends will be paid to shareholders will come from cash dividends received by the Company from the Bank.

As noted earlier, the Company and the Bank have entered into an agreement with the Federal Reserve Bank that, among other things, requires prior approval before paying a cash dividend or otherwise making a distribution of stock, increasing debt, repurchasing the Company's common stock, or any other action which would reduce capital of either the Bank or the Company. In addition, effective October 2009, the Company elected to defer regularly scheduled quarterly interest payments on its junior subordinated debentures issued in connection with its trust preferred securities. Under the subordinated debenture agreement, the Company is prohibited from paying any dividends or making any other distribution on its common stock for so long as interest payments are being deferred. In addition, under the agreement with the Federal Reserve Bank, the Company is now prohibited from making interest payments on the junior subordinated debentures without prior approval of the Federal Reserve Bank. During the six months ended June 30, 2013, the Company received no cash dividends from the Bank.

## Table of Contents

The Bank, as a state-chartered bank, is subject to dividend restrictions set forth in California state banking law and administered by the California Commissioner of Financial Institutions (“Commissioner”). Under such restrictions, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank’s net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the Commissioner, in an amount not exceeding the Bank’s net income for its last fiscal year or the amount of its net income for the current fiscal year. Such restrictions do not apply to stock dividends, which generally require neither the satisfaction of any tests nor the approval of the Commissioner. Notwithstanding the foregoing, if the Commissioner finds that the shareholders’ equity is not adequate or that the declarations of a dividend would be unsafe or unsound, the Commissioner may order the state bank not to pay any dividend. The FRB may also limit dividends paid by the Bank. As noted above, the terms of the regulatory agreement with the Federal Reserve prohibit both the Company and the Bank from paying dividends without prior approval of the Federal Reserve.

## Reserve Balances

The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At June 30, 2013, the bank was not subject to a reserve requirement.

## Item 4. Controls and Procedures

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

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

As of June 30, 2013, the end of the period covered by this report, an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures was carried out. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

### Changes in Internal Control over Financial Reporting

During the quarter ended June 30, 2013, there were no material changes in the Company’s internal control over financial reporting that materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all error and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent

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

Table of Contents

PART II. Other Information

Item 1. Not applicable

Item 1A. There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

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

None during the quarter ended June 30, 2013.

Item 3. Not applicable

Item 4. Not applicable

Item 5. Not applicable

Item 6. Exhibits:

(a) Exhibits:

- 11 Computation of Earnings per Share\*
- 31.1 Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Data required by Statement of Financial Accounting Standards No. 128, Earnings per Share, is provided in Note 8 to the consolidated financial statements in this report.

Table of Contents

Signatures

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

United Security Bancshares

Date: August 2, 2013

/S/ Dennis R. Woods  
Dennis R. Woods  
President and  
Chief Executive Officer

/ S/ Richard B. Shupe  
Richard B. Shupe  
Senior Vice President and Chief Financial Officer