

UNITED SECURITY BANCSHARES  
Form 10-K  
March 30, 2012

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

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2011.

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

Commission file number: 000-32987

UNITED SECURITY BANCSHARES  
(Exact name of registrant as specified in its charter)

CALIFORNIA  
(State or other jurisdiction of incorporation or organization)

91-2112732  
(I.R.S. Employer Identification No.)

2126 Inyo Street, Fresno, California  
(Address of principal executive offices)

93721  
(Zip Code)

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

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

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

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Act.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every

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Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrants knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  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, 2011: \$29,052,633

Shares outstanding as of February 29, 2011: 13,531,832

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Definitive Proxy Statement for the 2011 Meeting of Part III, Items 10, 11, 12, 13 and 14 Shareholders is incorporated by reference into Part III.

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PART 1

Certain matters discussed or incorporated by reference in this Annual Report of Form 10-K including, but not limited to, those described in "Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations", are forward-looking statements as defined under the Securities Litigation Reform Act of 1995 that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, among others, (1) competitive pressure in the banking industry increases significantly; (2) changes in the interest rate environment which may reduce margins and devalue assets; (3) general economic conditions, either nationally or regionally, are less favorable than expected, resulting in, among other things, a deterioration in credit quality; (4) changes in the regulatory environment; (5) failure to comply with the regulatory agreement under which the Company is subject; (6) changes in business conditions and inflation; (7) changes in securities markets; (8) asset/liability matching risks and liquidity risks; (9) potential impairment of goodwill and other intangible assets; (10) loss of key personnel; and (11) operational interruptions including data processing systems failure and fraud. Therefore, the information set forth therein should be carefully considered when evaluating the business prospects of the Company.

Item 1 - Business

General

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

United Security Bank

On June 12, 2001, the Bank became the wholly owned subsidiary of United Security Bancshares, through a tax-free holding company reorganization, accounted for on a basis similar to the pooling of interest method. In the transaction, each share of Bank stock was exchanged for a share of Company stock on a one-to-one basis.

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

Financial Institutions (the “DFI”). In addition, the Bank is required to file reports with the FRB and provide such additional information as the FRB may require.

USB Investment Trust Inc. was incorporated effective December 31, 2001 as a special purpose real estate investment trust (“REIT”) under Maryland law. The REIT is a subsidiary of the Bank and was funded with \$133.0 million in real estate-secured loans contributed by the Bank. USB Investment Trust was originally formed to give the Bank flexibility in raising capital, and reduce the expenses associated with holding the assets contributed to USB Investment Trust. For further discussion of the REIT, refer to Item 7 – Management’s Discussion and Analysis of Financial Condition and Results of Operations – Income Taxes.

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Effective April 23, 2004, the Company completed a merger with Taft National Bank headquartered in Taft, California. Taft National Bank (“Taft”) was merged into United Security Bank and Taft’s two branches, one located in Taft and the other located in Bakersfield, California, operate as branches of United Security Bank. The total consideration paid to Taft shareholders was 241,447 shares of the Company’s Common Stock valued at just over \$6 million. In the merger, the Company acquired \$15.4 million in cash and short-term investments \$23.3 million in loans, and \$48.2 million in deposits. This transaction was accounted for using the purchase method of accounting, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Taft based on the fair value of those assets and liabilities, with resultant goodwill of \$1.6 million and core deposits intangibles of \$1.9 million. Goodwill is not amortized but is reviewed at least annually for impairment, while core deposit intangibles are being amortized over a period of approximately 7 years. At the time of the merger, the Company sought opportunities to expand its market area to the south with the expectation that the Bakersfield area would have significant growth given its strategic location just north of Los Angeles. The two branches purchased have grown since the merger in 2004, with loans totaling \$41.7 million, and deposits totaling \$80.4 million at December 31, 2011. Like much of the rest of the San Joaquin Valley, the Bakersfield area has been impacted to a large degree by the slowdown in residential real estate markets and resulting depressed real estate prices. Of the \$31.8 million in total impaired loans reported by the Company at December 31, 2011, \$10.7 million was related to the Bakersfield operation with a specific reserve of \$127,000. The Company believes there was no impairment on either the goodwill or core deposit intangible related to the Taft merger.

On February 16, 2007, the Company completed its merger with Legacy Bank, N.A., located in Campbell, California, with the acquisition of 100 percent of Legacy’s outstanding common shares. At merger, Legacy Bank’s one branch was merged with and into United Security Bank, a subsidiary of the Company. The purchase of Legacy Bank provided the Company with an opportunity to expand its market area into Santa Clara County and to serve a growing small business niche and individual client base built by Legacy. At the time of the merger, Legacy had \$62.5 million in net loans and \$69.6 million in total deposits. At December 31, 2011 total loans and deposits related to the Campbell branch totaled \$38.4 million and \$25.4 million, respectively, and have decreased as the result of declines in lending markets in that area as well as significant competition for deposits. Impaired loans related to the Campbell branch at December 31, 2011 totaled \$686,000 with a related specific reserve of \$18,000. The Company believes that as the economy recovers from the recent significant downturn, there will be increased opportunities to expand business within the greater Campbell area particularly in lending to small-to-medium sized businesses. The total value of the merger transaction was \$21.5 million, and the shareholders of Legacy Bank received merger consideration consisting of 976,411 shares of common stock of the Company. The merger transaction was accounted for as a purchase transaction, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy Bank based on the fair value of those assets and liabilities, with resultant goodwill of \$8.8 million and core deposits intangibles of \$1.9 million. Goodwill is not amortized but is reviewed at least annually for impairment, while core deposit intangibles are being amortized over a period of approximately 7 years. The Company recognized goodwill impairment charges of \$1.5 million and \$1.4 million and impairment charges related to core deposit intangibles of \$36,000 and \$57,000 for the years ended December 31, 2011 and December 31, 2010, respectively. The Company recognized no impairment charges related to goodwill or core deposit intangibles prior to 2009.

At December 31, 2011, the Bank operates three branches (including its main office), one construction lending office, and one financial services office in Fresno and one branch each, in Oakhurst, Caruthers, San Joaquin, Firebaugh, Coalinga, Bakersfield, Taft, and Campbell. In addition, the Company and Bank have administrative headquarters located at 2126 Inyo Street, Fresno, California, 93721. The Company operates as one operating segment.

At December 31, 2011 and 2010, the consolidated Company had total assets of approximately \$651.2million, and \$678.2 million, respectively. For the year ended December 31, 2011, the Company reported a net loss of \$10.8 million, as compared to a net loss of \$4.5 million for the year ended December 2010. At December 31, 2011, the consolidated Company had approximately \$394.5 million in net loans, \$574.4 million in deposits, and \$62.2 million in

shareholders' equity.

Effective March 23, 2010, United Security Bancshares (the "Company") and its wholly owned subsidiary, United Security Bank (the "Bank"), entered into a written agreement with the Federal Reserve Bank of San Francisco (see "Regulatory Action" included below Supervision and Regulation for further information on terms of the written agreement). As a result of the agreement, the Company will, among other things, continue to focus its attention on reducing the level of problem assets while maintaining adequate liquidity and capital, and reducing its dependence on brokered and other wholesale deposits.

The Company has slowed its loan growth significantly over the past three years as a result of the economic downturn, and will continue to do so as a result of the recent agreement with the Federal Reserve Bank and California Department of Financial Institutions (referred to collectively herein as Federal Reserve Bank unless otherwise noted). While total loans declined 13.1% between December 31, 2009 and December 31, 2010, and declined 7.5% between December 31, 2010 and December 31, 2011, real estate construction and development loans declined 22.7% and 30.4% between those periods, and decreased as a percentage of total loans from 14.8% of total loans at December 31, 2010 to 12.3% of total loans at December 31, 2011. During the same period, nonperforming assets and related loan losses were increasing, with loan loss provisions of \$12.5 million and \$13.6 million for the years ended December 31, 2010, and 2011, respectively. The largest impact of nonperforming assets was in the real estate construction and development area with significant slowdowns in housing starts combined with swift and severe declines in housing prices in the Company's market area as well as the rest of the country during 2008 thru 2011. Management's focus over the past four years, as a result of the depressed economy as well as the recent agreement with the Federal Reserve Bank, has been to concentrate its efforts on reducing the level of nonperforming assets rather than developing new business and growing the loan portfolio. This has been challenging in an economic environment where real estate construction all but stopped in late 2008 and early 2009, and housing prices continued to decline quarter after quarter, while unemployment and other economic factors grew worse. Lending policies and procedures have been enhanced, exposure to real estate loans have been reduced, and loan modifications, including rate and maturity concessions, and forbearance agreements, have been utilized more frequently to minimize loss exposure in the loan portfolio.

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While loan growth prior to 2007 was funded to some degree by brokered deposits and other wholesale funding sources, the current state of the economy and the financial condition of the Company have made it increasingly important to continue to develop core deposits and reduce the Company's dependence on brokered and other wholesale funding sources, including lines of credit the Federal Reserve Bank and the FHLB. The Company increased its efforts early in 2009 to develop core deposit growth with employee training throughout the entire organization and a deposit-gathering program that incited employees to bring in new deposits from our local market area and establish more extensive relationships with our customers. The Company continues its deposit gathering program and has committed additional resources to its efforts during 2010 including two full time employees dedicated to business development. As a result of the formal agreement with the Federal Reserve Bank issued in March 2010, the Bank will reduce its dependence on wholesale funding sources, including brokered deposits, to a level more in-line with peers. The Bank, as part of its Liquidity Improvement Plan, will continue to reduce levels of brokered deposits to peer levels over the coming year.

While we still have a higher percentage of brokered deposits than peers at December 31, 2011, efforts to restructure the balance sheet through reducing the level of total assets, and specifically real estate loans, are proving successful. Total wholesale borrowings and brokered deposits decreased from \$113.5 million at December 31, 2010 to \$40.6 million at December 31, 2011, representing a decrease of \$72.9 million, and the Company improved its liquidity positions with an increase in fed funds sold and other overnight investments of \$84.6 million at December 31, 2010 to \$93.8 million at December 31, 2011.

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

### Bank Services

As a state-chartered commercial bank, United Security Bank offers a full range of commercial banking services primarily to the business and professional community and individuals located in Fresno, Madera, Kern, and Santa Clara Counties.

The Bank offers a wide range of deposit instruments including personal and business checking accounts and savings accounts, interest-bearing negotiable order of withdrawal ("NOW") accounts, money market accounts and time certificates of deposit. Most of the Bank's deposits are attracted from individuals and from small and medium-sized business-related sources. Time deposits have provided a significant portion of the Bank's deposit base amounting to 25.0% and 35.8% of total deposits as December 31, 2011 and 2010, respectively. A portion of those time deposits are brokered deposits which are considered wholesale funding sources generally from out of the Bank's market area. Brokered deposits comprised 7.1% and 14.6% of total deposits as December 31, 2011 and 2010, respectively. As a result of the formal agreement with the Federal Reserve Bank issued in March 2010, the Bank will reduce its dependence on wholesale funding sources, including brokered deposits, to a level more in-line with peers which is currently approximately 4% of total deposits. The Bank, as part of its Liquidity Improvement Plan, will reduce levels of brokered deposits to peer levels over a period of approximately two years.

The Bank also engages in a full complement of lending activities, including real estate mortgage (35.4% of total loans at December 31, 2011), commercial and industrial (40.7% of total loans at December 31, 2011), real estate construction (12.3% of total loans at December 31, 2011), as well as agricultural (8.8% of total loans at December 31, 2011), lease financing (0.1% of total loans at December 31, 2011), and consumer loans (2.8% of total loans at December 31, 2011), with particular emphasis on short and medium-term obligations. Approximately 70% of the Bank's loans are secured by real estate at December 31, 2010. A loan may be secured (in whole or in part) by real estate even though the purpose of the loan is not to facilitate the purchase or development of real estate. At December 31, 2011, the Bank had loans (net of unearned fees) outstanding of \$408.1 million, which represented approximately



71.0% of the Bank's total deposits and approximately 62.4% of its total assets.

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

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Although the Bank has a high concentration of commercial real estate loans, the Bank is not in the business of making residential mortgage loans to individuals. Residential mortgage loans totaled \$24.0 million or 5.9% of the total portfolio at December 31, 2011. The Bank does not originate, or have in its loans portfolio, any subprime, Alt-A, or option adjustable rate loans. The Bank does originate interest-only loans which are generally revolving lines of credit to commercial and agricultural businesses or for real estate development where the borrowers business may be seasonal or cash flows may be restricted until the completion of the project. In addition, the Bank has restructured certain loans to allow the borrower to continue to perform on the loan under a troubled debt restructuring plan. Interest-only loans comprised 33.5% and 38.4% of total loans at December 31, 2011, and 2010, respectively.

The Bank does purchase loan participations from, and does sell loan participations to, other financial institutions. The underwriting standards for loan participations or purchases are the same as non-participated loans, and are subject to the same limitations, collateral requirements, and borrower requirements. The Bank has reduced its level of loan participations over the past several years. Loan participations purchased comprised .9% and 3.9% of the total loan portfolio at December 31, 2011 and 2010, respectively. Loan participations sold comprised 3.3% and 2.0% of the total loan portfolio at December 31, 2011 and 2010, respectively. During the past year, participation lending activity has decreased and currently the Company is participating in few, if any, participation sales or purchases.

In the normal course of business, the Bank makes various loan commitments and incurs certain contingent liabilities. At December 31, 2011 and 2010, loan commitments of the Bank totaled \$62.4 million and \$67.9 million, respectively, and letters of credit totaled \$2.4 million and \$1.8 million, respectively. Of the \$62.4 million in loan commitments outstanding at December 31, 2011, \$10.0 million or 16.0% were for loans with maturities of one year or less. Due to the nature of the business of the Bank's customers, there are no seasonal patterns or absolute predictability to the utilization of unused loan commitments; therefore the Bank is unable to forecast the extent to which these commitments will be exercised within the current year. The Bank does not believe that any such utilization will constitute a material liquidity demand. The Company does however have collateralized and uncollateralized lines of credit which could be utilized if such loan commitments were to be exercised in excess of normal expectations.

In addition to the loan and deposit services discussed above, the Bank also offers a wide range of specialized services designed to attract and service the needs of commercial customers and account holders. These services include online banking, safe deposit boxes, ATM services, payroll direct deposit, cashier's checks, traveler's checks, money orders, and foreign drafts. In addition, the Bank offers a variety of specialized financial services, including wealth management, employee benefit, insurance and loan products, as well as consulting services for a variety of clients. The Bank does not operate a trust department; however, it makes arrangements with its correspondent bank to offer trust services to its customers on request. Most of the Bank's business originates within Fresno, Madera, Kern, and Santa Clara Counties. Neither of the Bank's business or liquidity is seasonal, and there has been no material effect upon the Bank's capital expenditures, earnings or competitive position as a result of federal, state or local environmental regulation.

### Lending Policies

The following is a summary of the Bank's loan policies.

**Loan Documentation** – All loan documentation is prepared by a centralized loan servicing department or by legal counsel based on the terms contained in the approved Credit Authorizations. The documentation, upon completion, is reviewed by a third party (Bank employee) in the loan servicing department prior to forwarding to the relationship managers, who then review the documents to ensure that they have been correctly prepared in accordance with the credit approval before execution by the borrowers.

**Purchased Participations** – The Bank independently underwrites, using the Bank's same guidelines for direct originations, and reviews the loan documentation of participation loans originated by other lenders for acceptability.

Verification of Information – The Bank, principally a commercial business lender, has not and does not make any “No Doc” or “Stated Income” loans. In the underwriting of a commercial loan request, the Bank performs an enterprise analysis of the financial information for trends, verifies major assets and liabilities, and obtains Dun and Bradstreet Credit reports on the entities and credit bureau reports on the principals of the entity. Regarding construction lending, the analyses have been enhanced to investigate and analyze real estate projects being financed by other lenders.

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The Company is not dependent on any individual customer, entity, or group of related entities for deposits nor have a significant percentage of loans to borrowers.

Unsecured - Whether unsecured or secured, guarantees are usually obtained from the principals or from 3rd party guarantors if necessary for additional financial support. Unsecured loans totaled \$58.1 million and \$59.3 million at December 31, 2011 and 2010, respectively.

Historic policy on renewals - The renewal or extension of existing performing lines of credit or loans has not been changed; the credits are re-underwritten for the renewal period. The restructure of lines of credit or loans may occur based on the occurrence of pre-determined event or time, as part of the original underwriting. The renewal or restructuring of criticized credits has changed since the March 2010 FRB Agreement. The restructure or renewal is certified to the Board of Directors that the renewal is necessary to improve and protect the Bank's ultimate interest in the collection of the credit or maximize its potential for collection, that the renewal reflects prudent underwriting based on reasonable repayment terms and is adequately secured, that the Bank has performed a comprehensive credit analysis indicating the borrower has the willingness and ability to repay the debt as per the terms of the restructure plan and that the Bank's Loan Committee, designated by the Board, believes that the renewal will be repaid in accordance with the terms.

Additional Loans to nonaccrual borrowers. – The Bank as a general rule does not make additional loans to borrowers that are past due in principal or interest more than 90-days. However, in selected and limited instances as part of the workout or restructure of non-performing assets, to effect repayment, additional secured advances may be made.

Lending Limits – The Bank approves revolving lines of credit or loans for each borrower with terms and limits. Consideration is given for the aggregate direct borrowing exposure of the borrower, as well as, their indirect liability, plus the indirect liability of any guarantor. Overall, the Bank has established normal "House" lending limits at 50% of the Legal Lending Limit. The Legal Lending Limit is calculated for unsecured loans at 15% of total regulatory capital, and for secured loans at 25% of total regulatory capital. The Board of Directors must approve any borrowing relationship that exceeds the House Lending Limit.

## Competition and Market Share

The banking business in California generally, and in the market area served by the Company specifically, is highly competitive with respect to both loans and deposits. The Company competes for loans and deposits with other commercial banks, savings and loan associations, finance companies, money market funds, credit unions and other financial institutions, including a number that are substantially larger than the Company. Deregulation of the banking industry, increased competition from non-bank entities for the cash balances of individuals and businesses, and continuing developments in the computer and communications industries have had, and most likely will continue to have, a significant impact on the Company's competitive position. With the enactment of interstate banking legislation in California, bank holding companies headquartered outside of California will continue to enter the California market and provide competition for the Company. Additionally, with the Gramm-Leach-Bliley Act of 1999, traditional competitive barriers between insurance companies, securities underwriters, and commercial banks have been eased, allowing a greater number of financial intermediaries to offer a wider assortment of financial services. Many of the major commercial banks operating in the Company's market areas offer certain services such as trust and international banking services, which the Company does not offer directly. In addition, banks with larger capitalization have larger lending limits and are thereby able to serve larger customers.

The Company's primary market area at December 31, 2011 was located in Fresno, Madera, and Kern Counties, in which approximately 30 FDIC-insured financial institutions compete for business. Santa Clara County was added during February 2007 with the Legacy Bank acquisition, in which approximately 50 FDIC-insured financial

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institutions compete for business. The following table sets forth information regarding deposit market share and ranking by county as of June 30, 2011, which is the most current information available.

	Rank	Share
Fresno County	8th	3.91%
Madera County	9th	4.31%
Kern County	14th	.12%
Total of Fresno, Madera, Kern Counties	11th	2.96%
Santa Clara County	45th	0.04%

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Supervision and Regulation

The Company

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

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

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

The BHC Act requires a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. It is the FRB’s policy that a bank holding company should stand ready to use available resources to provide adequate capital funds to subsidiary banks during periods of financial stress and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting a subsidiary bank. Under certain conditions, the FRB may conclude that certain actions of a bank holding company, such as payment of cash dividends, would constitute unsafe and unsound banking practices because they violate the FRB’s “source of strength” doctrine.

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

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

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

The Bank

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

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

**Capital Standards.** The FRB has risk-based capital adequacy guidelines intended to provide a measure of capital adequacy that reflects the degree of risk associated with a banking organization's operations for both transactions reported on the balance sheet as assets, and transactions, such as letters of credit and recourse arrangements, which are reported as off-balance-sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off-balance-sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. government securities, to 100% for assets with relatively higher credit risk, such as business loans.

A banking organization's risk-based capital ratios are obtained by dividing its qualifying capital by its total risk-adjusted assets and off-balance-sheet items. The regulators measure risk-adjusted assets and off-balance-sheet items against both total qualifying capital (the sum of Tier 1 capital and limited amounts of Tier 2 capital) and Tier 1 capital. Tier 1 capital consists of common stock, retained earnings, noncumulative perpetual preferred stock and minority interests in certain subsidiaries, less most other intangible assets. Tier 2 capital may consist of a limited amount of the allowance for loan and lease losses and certain other instruments with some characteristics of equity. The inclusion of elements of Tier 2 capital is subject to certain other requirements and limitations of the federal banking agencies. Since December 31, 1992, the FRB and the FDIC have required a minimum ratio of qualifying total capital to risk-adjusted assets and off-balance-sheet items of 8%, and a minimum ratio of Tier 1 capital to risk-adjusted assets and off-balance-sheet items of 4%.

In addition to the risk-based guidelines, the FRB requires banking organizations to maintain a minimum amount of Tier 1 capital to average total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets is 3%. It is improbable; however, that an institution with a 3% leverage ratio would receive the highest rating by the regulators since a strong capital position is a significant part of the regulators' ratings. For all banking organizations not rated in the highest category, the minimum leverage ratio is 4%. In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the FRB and FDIC have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above the minimum guidelines and ratios.

A bank that does not achieve and maintain the required capital levels may be issued a capital directive by the FDIC to ensure the maintenance of required capital levels. As discussed above, the Company is required to maintain certain levels of capital, as is the Bank. The regulatory capital guidelines as well as the actual capitalization for the Bank and the Company as of December 31, 2011 are as follows:

	Requirement to be:				December 31, 2011			
	Adequately Capitalized		Well Capitalized		Company		Bank	
Tier 1 leverage capital ratio	4.0	%	5.0	%	8.79	%	9.02	%
	4.0	%	6.0	%	11.66	%	11.64	%



Tier 1 risk-based capital ratio							
Total risk-based capital ratio	8.0	%	10.0	%	12.93	%	12.91 %

In that the Bank is subject to a Consent Order with the FRB and DFI, the Bank is subject to additional capital guidelines. Under the Consent Order the Bank is required to maintain a ratio of tangible equity to tangible assets of 9.50%. The Bank at December 31, 2011 was in compliance with this requirements of the Consent Order.

Prompt Corrective Action. Federal banking agencies possess broad powers to take corrective and other supervisory action to resolve the problems of insured depository institutions, including those institutions that fall below one or more prescribed minimum capital ratios described above. An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized, or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions.

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

**Premiums for Deposit Insurance.** The deposit insurance fund of the FDIC insures our customer deposits up to prescribed limits for each depositor. The Federal Deposit Insurance Reform Act of 2005 ("Reform Act") and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 amended the insurance of deposits by the FDIC and collection of assessments from insured depository institutions for deposit insurance. The base assessment rates under the Reform Act ranged from \$0.02 to \$0.40 per \$100 of deposits annually. Implementing the Reform Act, the FDIC approved a final rule in 2006 and amended the rule in February 2009 that sets an insured depository institution's assessment rate on different factors that pose a risk of loss to the Deposit Insurance Fund, including the institution's recent financial ratios and supervisory ratings, and level of reliance on a significant amount of secured liabilities or significant amount of brokered deposits (except that the factor of brokered deposits will not be considered for well capitalized institutions that are not accompanied by rapid growth). The FDIC also in February 2009 set the assessment base rates to range between \$0.12 to \$0.16 per \$100 of insured deposits on an annual basis. In May 2009, the FDIC imposed a special assessment of 5 basis points on each insured depository institution's assets less its Tier 1 capital payable on September 30, 2009 with a ceiling of 10 basis points of an institution's domestic deposits. In November 2009, the FDIC approved a final rule to require all insured depository institutions including the Bank to prepay three years (and ratably expense over three years) of FDIC assessments in the fourth quarter of 2009, except in the event such prepayment is waived by the FDIC.

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

In 2006, the Reform Act increased the deposit insurance limit for certain retirement plan deposit accounts from \$100,000 to \$250,000. The basic insurance limit for other deposits, including individuals, joint account holders, businesses, government entities, and trusts, remained at \$100,000. The Reform Act also provided for the merger of the two deposit insurance funds administered by the FDIC, the Bank Insurance Fund ("BIF") and the Savings Association

Insurance Fund (“SAIF”), into the DIF. On October 3, 2008, the EESA temporarily raised the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. While the basic deposit insurance limit was to have returned to \$100,000 after December 31, 2009, the Helping Families Save Their Homes Act extended the temporary increase in the standard maximum deposit insurance amount to \$250,000 per depositor through December 31, 2013, and the enactment of the Dodd-Frank Act permanently raises the current standard maximum federal deposit insurance amount from \$100,000 to \$250,000 per qualified account.

In November 2008, the FDIC approved the final ruling establishing the Transaction Account Guarantee Program (“TAGP”) as part of the Temporary Liquidity Guarantee Program (“TLGP”). Under this program, all non-interest bearing transaction accounts became fully guaranteed by the FDIC for the entire amount in the account. This unlimited coverage also extended to NOW (interest bearing deposit accounts) earning an interest rate no greater than 0.50% and all IOLTAs (lawyers’ trust accounts). TAGP was extended with the enactment of the Dodd-Frank Act provides for unlimited deposit insurance for noninterest bearing transactions accounts (excluding NOW, but including IOLTAs) expiring on December 31, 2012.

The FDIC is authorized to terminate a depository institution’s deposit insurance upon a finding by the FDIC that the institution’s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the institution’s regulatory agency. The termination of deposit insurance for the bank would have a material adverse effect on our business, financial condition, results of operations and/or cash flows.

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

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

The FHLB – SF capital stock is redeemable on five years written notice, subject to certain conditions. At December 31, 2011 the Bank owned 30,970 shares of the FHLB-SF capital stock.

Federal Reserve. The FRB requires all depository institutions to maintain non-interest bearing reserves at specified levels against their transaction accounts and non-personal time deposits. At December 31, 2010, the Bank was in compliance with these requirements.

Federal Reserve Action against the Company and the Bank dated March 10, 2010

During March 2010, the Federal Reserve Bank took regulatory action against the Company and the Bank. As a result, effective March 23, 2010, United Security Bancshares (the "Company") and its wholly owned subsidiary, United Security Bank (the "Bank"), entered into a written agreement with the Federal Reserve Bank of San Francisco. Under the terms of the agreement, the Company and the Bank agreed, among other things, 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 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 effect 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;

- 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 were adversely classified in the Report of Examination or subsequent report of examination;

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- 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, specifically, that except with the prior written approval of the Federal Reserve Bank, the Company each agree 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);

- 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.

To view 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.

In addition to the submission of the plans referred to in the Agreement to the Federal Reserve Bank for approval, and implementation of those plans, the Bank is required within 30 days after the end of each calendar quarter to submit written progress reports to the Federal Reserve Bank detailing actions taken to secure compliance with the Agreement. On April 27, 2011, July 25, 2011, and October 26, 2011, respectively, the Bank submitted progress reports to the Federal Reserve for the first, second, and third quarters of 2011. As of the January 30, 2012 progress report submitted for the fourth quarter of 2011 the Company and the Bank believe they are in compliance with the Agreement, including remediation of technical violations of laws and regulations regarding stale loan appraisals and the various deadlines in the Agreement.

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### 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 basically similar to the written 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.

### Effect of Governmental Policies and Recent Legislation

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

**Impact of Monetary Policies.** The earnings and growth of the Company are affected not only by general economic conditions, both domestic and foreign, but also by the monetary and fiscal policies of the United States government and its agencies, particularly the Federal Reserve Board (“FRB”). The FRB implements national monetary policies (with objectives such as to curb inflation and combat recession) by its open market operations in United States Government securities, by adjusting the required level of reserves for financial institutions subject to reserve requirements, and by varying the discount rates applicable to borrowing by banks which are members of the Federal Reserve System. The actions of the FRB in these areas influence the growth of bank loans, investments and deposits and also affect interest rates charged on loans and paid on deposits. The FRB’s policies have had a significant effect on the operating results of commercial banks and are expected to continue to do so in the future. The nature and timing of any future changes in monetary policies are not predictable. In addition, adverse economic conditions could make a higher provision for loan losses a prudent course and could cause higher loan charge-offs, thus adversely affecting the Company’s net income.



Extensions of Credit to Insiders and Transactions with Affiliates. The Federal Reserve Act and FRB Regulation O place limitations and conditions on loans or extensions of credit to:

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

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

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

The Community Reinvestment Act (the "CRA") is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal regulatory agencies, in examining insured depository institutions, to assess a bank's record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution's record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations. The agencies use the CRA assessment factors in order to provide a rating to the financial institution. The ratings range from a high of "outstanding" to a low of "substantial noncompliance." In its last examination for CRA compliance, as of September 2010, the Bank was rated "satisfactory."

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

The Truth in Lending Act (the "TILA") is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

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

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

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

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

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

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

### Recent Legislation and Other Changes

Federal and state laws affecting banking are enacted from time to time, and similarly federal and state regulations affecting banking are also adopted from time to time. The following include some of the recent laws and regulations affecting banking.

The 2010 Tax Relief Act was enacted on December 17, 2010. The 2010 Tax Relief Act extends the Bush era tax cuts for individual federal income tax rates through 2012, including keeping the capital gains and dividend rates remain at 0 or 15 percent. In addition, the 2010 Tax Relief Act provides for continuation of education incentives through 2012, including expanded Coverdell accounts and definition of education expenses, expanded exclusion for employer-provided educational assistance of up to \$5,250, expanded student loan interest deduction, exclusion from income of amounts received under certain scholarship programs, and American Opportunity Tax Credit of up to \$2,500 for tuition expenses.

The 2010 Tax Relief Act also provides alternative minimum tax relief by increasing the exemption amounts for 2010 to \$47,450 (individuals) and \$72,450 (married filing jointly) and for 2011 to \$48,450 (individuals) and \$74,450 (married filing jointly). It also allows the nonrefundable personal credits against the AMT. Temporary gift and estate tax is also included in the 2010 Tax Relief Act. The gift and estate exemption was increased to \$5 million per person and \$10 million per couple and a top tax rate of 35 percent for the estate, gift, and generation skipping transfer taxes for two years, through 2012. The exemption amount is also indexed beginning in 2012. The change is effective January 1, 2010, but allows an election to choose no estate tax and modified carryover basis for estates arising on or after January 1, 2010 and before January 1, 2011. The law sets a \$5 million generation-skipping transfer tax exemption and zero percent rate for the 2010 year.

The 2010 Tax Relief Act also extends on a temporary basis the bonus depreciation for taxable years 2011 and 2012. For small businesses, the maximum amount and phase-out threshold under section 179 for taxable years 2012 are set at \$125,000 and \$500,000 respectively, indexed for inflation. The law also provided a one-year reauthorization of federal UI benefits and cuts FICA taxes for employees to 4.2 percent and those self employed to 10.4 percent on self-employment income up to \$106,800.

The Small Business Jobs Act of 2010 ("SBA Jobs Act") enacted in September 2010 provides numerous tax breaks for small businesses including start up small businesses, and more importantly for insured financial institutions eligibility for participation in a U S Treasury program that will provide a maximum \$30 billion for purchases of preferred stock and other debt instruments issued by eligible financial institutions for the purpose of increasing credit availability for small businesses.

In addition, there are important changes to various SBA loan administration programs to aid small businesses under the SBA Jobs Act. The SBA Jobs Act provides for increasing maximum individual loan limits of SBA loans, extending the higher government guarantee level and waiver of borrower fees for certain SBA loans, and allowing alternative underwriting measures, specifically net worth and net income to allow more small businesses to participate in certain SBA loans.

The Dodd-Frank Act, signed into law in July, 2010, will significantly change the current bank regulatory structure and affect the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act creates of a new interagency council, the Financial System Oversight Council that is charged with identifying and monitoring the systemic risk to the U.S. economy posed by systemically significant, large financial companies, including bank holding companies and non-bank financial companies. The Office of Thrift Supervision will be eliminated and its powers distributed among the Office of the Comptroller of the Currency, the Federal Reserve Board and the FDIC. The legislation also establishes a floor for capital of insured depository institutions that cannot be lower than the standards in effect today, and directs the federal banking regulators to implement new leverage and capital requirements within 18 months that take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives.

The Dodd-Frank Act also creates a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rulemaking authority for a wide range of consumer protection laws that apply to all banks and savings institutions such as the Bank, including the authority to prohibit “unfair, deceptive or abusive” acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than \$10 billion in assets. Banks and savings institutions with \$10 billion or less in assets will be examined by their applicable bank regulators. The new legislation also weakens the federal preemption available for national banks and federal savings associations, and gives state attorneys general the ability to enforce applicable federal consumer protection laws.

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The legislation also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increases the maximum amount of deposit insurance for banks, savings institutions and credit unions to \$250,000 per depositor, retroactive to January 1, 2008, and non-interest bearing transaction accounts have unlimited deposit insurance through December 31, 2013. The Dodd-Frank Act also repeals the prohibition on payment of interest on demand deposits.

Section 613 of the Dodd-Frank Act eliminates interstate branching restrictions that were implemented as part of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, and removes many restrictions on de novo interstate branching by national and state-chartered banks. The FDIC and the OCC now have authority to approve applications by insured state nonmember banks and national banks, respectively, to establish de novo branches in states other than the bank's home state if "the law of the State in which the branch is located, or is to be located, would permit establishment of the branch, if the bank were a State bank chartered by such State." The enactment of this section may significantly increase interstate banking by community banks in western states, where barriers to entry were previously high

Many of the provisions of the Dodd-Frank Act will not take effect for at least a year, and the legislation requires various federal agencies to promulgate numerous and extensive implementing regulations over the next several years. Although the substance and scope of these regulations cannot be determined at this time, it is expected that the legislation and implementing regulations, particularly those provisions relating to the new Consumer Financial Protection Bureau, will increase the Bank's operating and compliance costs as it is likely that the Bank's existing regulatory agencies will adopt the same or similar consumer protections as the new Consumer Financial Protection Bureau will adopt.

On June 21, 2010, the federal banking agencies issued final guidance on incentive compensation. The final guidance is largely unchanged from the FRB's preliminary guidance published in 2009, with the exception of a few adjustments/clarifications in response to feedback the FRB received during the open comment period. The guidance became effective on June 25, 2010 (the date published in the Federal Register, and applies to all banks. Except for the largest banking organizations, enforcement of this guidance will be handled through the supervisors' regular risk-focused examination process. The guidance is principles-based, rather than prescriptive, and also identifies expectations of large banking organizations that go beyond what will be expected of community banks, and emphasizes that the application of the guidance should be scaled appropriately for the complexity of the organization and the extent to which incentive arrangements are utilized. The employees covered by the final guidance are senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines; individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk. The guidance provides for three principles for safe and sound incentive compensation arrangements:

- **Balanced Risk-Taking:** Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks;
- **Compatibility with Effective Controls and Risk-Management:** A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements;
- **Strong Corporate Governance:** Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

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

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

The mandatory compliance date for the Regulation E amendments is July 1, 2010 provided that the Bank may continue to assess overdraft service fees or charges on existing customer accounts prior to August 15, 2010, without obtaining the consumer's affirmative consent. The Bank's compliance with the new Regulation E amendments may have an impact on the Bank's revenue from overdraft service fees and non-sufficient funds ("NSF") charges.

In May 2009 the Helping Families Save Their Homes Act of 2009 was enacted to help consumers avoid mortgage foreclosures on their homes through certain loss mitigation actions including special forbearance, loan modification, pre-foreclosure sale, deed in lieu of foreclosure, support for borrower housing counseling, subordinate lien resolution, and borrower relocation. The new law permits the Secretary of Housing and Urban Development (HUD), for mortgages either in default or facing imminent default, to: (1) authorize the modification of such mortgages; and (2) establish a program for payment of a partial claim to a mortgagee who agrees to apply the claim amount to payment of a mortgage on a 1- to 4-family residence. In implementing the law, the Secretary of HUD is authorized to (1) provide compensation to the mortgagee for lost income on monthly mortgage payments due to interest rate reduction; (2) reimburse the mortgagee from a guaranty fund in connection with activities that the mortgagee is required to undertake concerning repayment by the mortgagor of the amount owed to HUD; (3) make payments to the mortgagee on behalf of the borrower, under terms defined by HUD; and (4) make mortgage modification with terms extended up to 40 years from the modification date. The new law also authorizes the Secretary of HUD to: (1) reassign the mortgage to the mortgagee; (2) act as a Government National Mortgage Association (GNMA, or Ginnie Mae) issuer, or contract with an entity for such purpose, in order to pool the mortgage into a Ginnie Mae security; or (3) resell the mortgage in accordance with any program established for purchase by the federal government of insured mortgages. The new law also amends the Foreclosure Prevention Act of 2008, with respect to emergency assistance for the redevelopment of abandoned and foreclosed homes (neighborhood stabilization), to authorize each state that has received certain minimum allocations and has fulfilled certain requirements, to distribute any remaining amounts to areas with homeowners at risk of foreclosure or in foreclosure without regard to the percentage of home foreclosures in such areas.

Also in May 2009, the Credit Card Act of 2009 was enacted to help consumers and ban certain practices of credit card issuers. The new law allows interest rate hikes on existing balances only under limited conditions, such as when a promotional rate ends, there is a variable rate or if the cardholder makes a late payment. Interest rates on new transactions can increase only after the first year. Significant changes in terms on accounts cannot occur without 45 days' advance notice of the change. The new law bans raising interest rates on customers based on their payment records with other unrelated credit issuers (such as utility companies and other creditors) for existing credit card balances, though card issuers would still be allowed to use universal default on future credit card balances if they give at least 45 days' advance notice of the change. The new law allows consumers to opt out of certain significant changes in terms on their accounts. Opting out means cardholders agree to close their accounts and pay off the balance under the old terms. They have at least five years to pay the balance. Credit card issuers will be banned from issuing credit cards to anyone under 21, unless they have adult co-signers on the accounts or can show proof they have enough income to repay the card debt. Credit card companies must stay at least 1,000 feet from college campuses if they are offering free pizza or other gifts to entice students to apply for credit cards.



The new law requires card issuers to give card account holders "a reasonable amount of time" to make payments on monthly bills. That means payments would be due at least 21 days after they are mailed or delivered. Credit card issuers would no longer be able to set early morning or other arbitrary deadlines for payments. When consumers have accounts that carry different interest rates for different types of purchases payments in excess of the minimum amount due must go to balances with higher interest rates first. Consumers must "opt in" to over-limit fees. Those who opt out would have their transactions rejected if they exceed their credit limits, thus avoiding over-limit fees. Fees charged for going over the limit must be reasonable. Finance charges on outstanding credit card balances would be computed based on purchases made in the current cycle rather than going back to the previous billing cycle to calculate interest charges. Fees on credit cards cannot exceed 25 percent of the available credit limit in the first year of the card. Credit card issuers must disclose to cardholders the consequences of making only minimum payments each month, namely how long it would take to pay off the entire balance if users only made the minimum monthly payment. Issuers must also provide information on how much users must pay each month if they want to pay off their balances in 36 months, including the amount of interest.

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On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (“ARRA”) was enacted to provide stimulus to the struggling US economy. ARRA authorizes spending of \$787 billion, including about \$288 billion for tax relief, \$144 billion for state and local relief aid, and \$111 billion for infrastructure and science. In addition, ARRA includes additional executive compensation restrictions for recipients of funds from the US Treasury under the Troubled Assets Relief Program of the Emergency Economic Stimulus Act of 2008 (“EESA”). The provisions of EESA amended by the ARRA include (i) expanding the coverage of the executive compensation limits to as many as the 25 most highly compensated employees of a TARP funds recipient and its affiliates for certain aspects of executive compensation limits and (ii) specifically limiting incentive compensation of covered executives to one-third of their annual compensation which is required to be paid in restricted stock that does not vest until all of the TARP funds are no longer outstanding (note that if TARP warrants remain outstanding and no other TARP instruments are outstanding, then such warrants would not be considered outstanding for purposes of this incentive compensation restriction. In addition, the board of directors of any TARP recipient is required under EESA, as amended to have a company-wide policy regarding excessive or luxury expenditures, as identified by the Treasury, which may include excessive expenditures on entertainment or events; office and facility renovations; aviation or other transportation services; or other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the business operations of the TARP recipient.

On February 10, 2009, the U. S. Treasury, the Federal Reserve Board, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision all announced a comprehensive set of measures to restore confidence in the strength of U.S. financial institutions and restart the critical flow of credit to households and businesses. This program is intended to restore the flows of credit necessary to support recovery.

The core program elements include:

- A new Capital Assistance Program to help ensure that our banking institutions have sufficient capital to withstand the challenges ahead, paired with a supervisory process to produce a more consistent and forward-looking assessment of the risks on banks' balance sheets and their potential capital needs.
- A new Public-Private Investment Fund on an initial scale of up to \$500 billion, with the potential to expand up to \$1 trillion, to catalyze the removal of legacy assets from the balance sheets of financial institutions. This fund will combine public and private capital with government financing to help free up capital to support new lending.
- A new Treasury and Federal Reserve initiative to dramatically expand – up to \$1 trillion – the existing Term Asset-Backed Securities Lending Facility (TALF) in order to reduce credit spreads and restart the securitized credit markets that in recent years supported a substantial portion of lending to households, students, small businesses, and others.
- An extension of the FDIC's Temporary Liquidity Guarantee Program to October 31, 2009. A new framework of governance and oversight to help ensure that banks receiving funds are held responsible for appropriate use of those funds through stronger conditions on lending, dividends and executive compensation along with enhanced reporting to the public.

In October 2008, the President signed the Emergency Economic Stabilization Act of 2008 (“EESA”), in response to the global financial crisis of 2008 authorizing the United States Secretary of the Treasury with authority to spend up to \$700 billion to purchase distressed assets, especially mortgage-backed securities, under the Troubled Assets Relief Program (“TARP”) and make capital injections into banks under the Capital Purchase Program. EESA gives the government the unprecedented authority to buy troubled assets on balance sheets of financial institutions under the Troubled Assets Relief Program and increases the limit on insured deposits from \$100,000 to \$250,000 through December 31, 2009 (this became permanent in 2010.) Some of the other provisions of EESA are as follows:

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accelerated from 2011 to 2008 the date that the Federal Reserve Bank could pay interest on deposits of banks held with the Federal Reserve to meet reserve requirements;

- to the extent that the U. S. Treasury purchases mortgage securities as part of TARP, the Treasury shall implement a plan to minimize foreclosures including using guarantees and credit enhancements to support reasonable loan modifications, and to the extent loans are owned by the government to consent to the reasonable modification of such loans;
- limits executive compensation for executives for TARP participating financial institutions including a maximum corporate tax deduction limit of \$500,000 for each of the top five highest paid executives of such institution, requiring clawbacks of incentive compensation that were paid based on inaccurate or false information, limiting golden parachutes for involuntary and certain voluntary terminations to 2.99x their average annual salary and bonus for the last five years, and prohibiting the payment of incentive compensation that encourages management to take unnecessary and excessive risks with respect to the institution;
- extends the mortgage debt forgiveness provision of the Mortgage Forgiveness Debt Relief Act of 2007 by three years (2012) to ease the income tax burden on those involved with certain foreclosures; and

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- qualified financial institutions may count losses on FNMA and FHLMC preferred stock against ordinary income, rather than capital gain income.

On February 10, 2009, the Treasury Secretary announced a new comprehensive financial stability legislation (the “Financial Stability Plan”), which earmarked the second \$350 billion of unused funds originally authorized under the EESA. The major elements of the Financial Stability Plan included: (i) a capital assistance program that has invested in convertible preferred stock of certain qualifying institutions, (ii) a consumer and business lending initiative to fund new consumer loans, small business loans and commercial mortgage asset-backed securities issuances, (iii) a public/private investment fund intended to leverage public and private capital with public financing to purchase up to \$500 billion to \$1 trillion of legacy “toxic assets” from financial institutions, and (iv) assistance for homeowners by providing up to \$75 billion to reduce mortgage payments and interest rates and establishing loan modification guidelines for government and private programs.

On October 22, 2009, the Federal Reserve Board issued a comprehensive proposal on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The proposal, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors. The proposal also contemplates a detailed review by the Federal Reserve Board of the incentive compensation policies and practices of a number of “large, complex banking organizations.” Any deficiencies in compensation practices that are identified may be incorporated into the organization’s supervisory ratings, which can affect its ability to make acquisitions or perform other actions. In addition, the proposal provides that enforcement actions may be taken against a banking organization if its incentive compensation arrangements or related risk-management control or governance processes pose a risk to the organization’s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies. Similarly, on January 12, 2010, the FDIC announced that it would seek public comment through advance notice of rule making on whether banks with compensation plans that encourage risky behavior should be charged at higher deposit assessment rates than such banks would otherwise be charged.

On September 3, 2009, the U.S. Treasury issued a policy statement entitled “Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms.” The statement was developed in consultation with the U.S. bank regulatory agencies and sets forth eight “core principles” intended to shape a new international capital accord. Six of the core principles relate directly to bank capital requirements. The statement contemplates changes to the existing regulatory capital regime that would involve substantial revisions to, if not replacement of, major parts of the Basel I and Basel II and affect all regulated banking organizations and other systemically important institutions. The statement calls for higher and stronger capital requirements for bank and non-bank financial firms that are deemed to pose a risk to financial stability due to their combination of size, leverage, interconnectedness and liquidity risk. The statement suggested that changes to the regulatory capital framework be phased in over a period of several years with a recommended schedule providing for a comprehensive international agreement by December 31, 2010, with the implementation of reforms by December 31, 2012, although it does remain possible that U.S. bank regulatory agencies could officially adopt, or informally implement, new capital standards at an earlier date. Following the issuance of the statement, on December 17, 2009, the Basel committee issued a set of proposals (the “Capital Proposals”) that would significantly revise the definitions of Tier 1 capital and Tier 2 capital, with the most significant changes being to Tier 1 capital. Most notably, the Capital Proposals would disqualify certain structured capital instruments, such as trust preferred securities, from Tier 1 capital status. The Capital Proposals would also re-emphasize that common equity is the predominant component of Tier 1 capital by adding a minimum common equity to risk-weighted assets ratio and requiring that goodwill, general intangibles and certain other items that

currently must be deducted from Tier 1 capital instead be deducted from common equity as a component of Tier 1 capital. The Capital Proposals also leave open the possibility that the Basel committee will recommend changes to the minimum Tier 1 capital and total capital ratios of 4.0% and 8.0%, respectively. Concurrently with the release of the Capital Proposals, the Basel committee also released a set of proposals related to liquidity risk exposure (the “Liquidity Proposals”). The Liquidity Proposals have three key elements, including the implementation of (i) a “liquidity coverage ratio” designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets sufficient to meet the bank’s liquidity needs over a 30-day time horizon under an acute liquidity stress scenario, (ii) a “net stable funding ratio” designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon, and (iii) a set of monitoring tools that the Basel committee indicates should be considered as the minimum types of information that banks should report to supervisors and that supervisors should use in monitoring the liquidity risk profiles of supervised entities.

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In June 2009, the Administration proposed a wide range of regulatory reforms that, if enacted, may have significant effects on the financial services industry in the United States. Significant aspects of the Administration's proposals included, among other things, proposals (i) that any financial firm whose combination of size, leverage and interconnectedness could pose a threat to financial stability be subject to certain enhanced regulatory requirements, (ii) that federal bank regulators require loan originators or sponsors to retain part of the credit risk of securitized exposures, (iii) that there be increased regulation of broker-dealers and investment advisers, (iv) for the creation of a federal consumer financial protection agency that would, among other things, be charged with applying consistent regulations to similar products (such as imposing certain notice and consent requirements on consumer overdraft lines of credit), (v) that there be comprehensive regulation of OTC derivatives, (vi) that the controls on the ability of banking institutions to engage in transactions with affiliates be tightened, and (vii) that financial holding companies be required to be "well-capitalized" and "well-managed" on a consolidated basis. The Congress, state lawmaking bodies and federal and state regulatory agencies continue to consider a number of wide-ranging and comprehensive proposals for altering the structure, regulation and competitive relationships of the nation's financial institutions, including rules and regulations related to the broad range of reform proposals set forth by the Obama administration described above. Along with amendments to the Administration's proposal there are separate comprehensive financial reform bills intended to address in part or whole or vary in part or in whole from the proposals set forth by the Administration were introduced in both houses of Congress in the second half of 2009 and in 2010 and remain under review by both the U.S. House of Representatives and the U.S. Senate.

On January 1, 2012, SB 664 (Committee on Banking and Financial Institutions, Chapter 243, Statutes of 2011) became operative. While some substantive changes were included in this legislation due to the passage of the Dodd-Frank federal legislation and some technical corrections that resulted from earlier amendments to the Code, the majority of the work involved in SB 664 was to reorder the section numbering in the Code. Among other things, the law requires a bank that establishes a branch office in this state in accordance with the National Bank Act, as amended by the Dodd-Frank Act to provide a specified notice to the Commissioner of DFI within 10 days of the establishment, relocation, or redesignation of offices.

In California, SB931 enacted in 2010 requires the holder of a first mortgage or deed of trust that is secured by 1-4 family residential real property to accept as full payment, the proceeds of a short sale to which it agrees to in writing, and obligates the holder to discharge the remaining amount of a borrower's indebtedness on such mortgage or deed of trust (excludes borrowers that are corporate entities or political subdivisions), except to the extent the borrower has committed fraud or waste upon the property.

The enactment of AB 2325 in 2010 requires foreclosure consultants register and become certificated by the Department of Justice. The definition of foreclosure consultant includes one who arranges or attempts to arrange for the audit of any obligation secured by a lien on a residence in foreclosure.

The enactment of SB1427 in 2010 provides that prior to imposing a fine or penalty for failure to maintain a vacant property in California that is subject to a notice of default or that has been purchased at a foreclosure sale or acquired through foreclosure under a mortgage or deed of trust that a governmental entity shall provide the owner of that property with a notice of violation and an opportunity to correct the violation.

The enactment of AB329 in 2009, the Reverse Mortgage Elder Protection Act of 2009 prohibits a lender or any other person who participates in the origination of the mortgage from participation in, being associated with, or employing any party that participates in or is associated with any other financial or insurance activity or referring a prospective borrower to anyone for the purchase of other financial or insurance products; and imposes certain disclosure requirements on the lender.

The enactment of AB1160 in 2009, requires a supervised financial institution in California that negotiates primarily in any of a number of specified languages in the course of entering into a contract or agreement for a loan or extension of credit secured by residential real property, to deliver, prior to the execution of the contract or agreement, and no later than 3 business days after receiving the written application, a specified form in that language summarizing the terms of the contract or agreement; provides for administrative penalties for violations; and requires the California Department of Corporations and the Department of Financial Institutions to create a form for providing translations and make it available in Spanish, Chinese, Tagalog, Vietnamese and Korean. The statute becomes operative on July 1, 2010, or 90 days after issuance of the form, whichever occurs later.

The enactment of AB 1291 in 2009 makes changes to the California Unclaimed Property Law including (among other things): allowing electronic notification to customers who have consented to electronic notice; requiring that notices contain certain information and allow the holder to provide electronic means to enable the owner to contact the holder in lieu of returning the prescribed form to declare the owner's intent; authorizing the holder to give additional notices; and requiring, beginning January 1, 2011, a banking or financial organization to provide a written notice regarding escheat at the time a new account or safe deposit box is opened.

The enactment of SB306 makes specified changes to clarify existing law related to filing a notice of default on residential real property in California, including (among other things): clarifying that the provisions apply to mortgages and deeds of trust recorded from January 1, 2003 through December 31, 2007, secured by owner-occupied 3 4 residential real property containing no more than 4 dwelling units; revising the declaration to be filed with the notice of default; specifying how the loan servicers have to maximize net present value under their pooling and servicing agreements applies to certain investors; specifying how and when the notice to residents of property subject to foreclosure is to be mailed; and extending the time during which the notice of sale must be recorded from 14 to 20 days. The bill also makes certain changes related to short-pay agreements and short-pay demand statements.

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On February 20, 2009, Governor Schwarzenegger signed ABX2 7 and SBX2 7, which established the California Foreclosure Prevention Act. The California Foreclosure Prevention Act modifies the foreclosure process to provide additional time for borrowers to work out loan modifications while providing an exemption for mortgage loan servicers that have implemented a comprehensive loan modification program. Civil Code Section 2923.52 requires an additional 90 day period beyond the period already provided before a Notice of Sale can be given in order to allow all parties to pursue a loan modification to prevent foreclosure of loans meeting certain criteria identified in that section.

A mortgage loan servicer who has implemented a comprehensive loan modification program may file an application for exemption from the provisions of Civil Code Section 2923.52. Approval of this application provides the mortgage loan servicer an exemption from the additional 90-day period before filing the Notice of Sale when foreclosing on real property covered by the new law.

California Assembly Bill 1301 was signed by the Governor on July 16, 2008 and became law on January 1, 2009. Among other things, the bill eliminated unnecessary applications that consume time and resources of bank licensees and which in many cases are now perfunctory. All of current Article 5 – “Locations of Head Office” of Chapter 3, and all of Chapter 4 – “Branch Offices, Other Places of Business and Automated Teller Machines” were repealed. A new Chapter 4 – “Bank Offices” was added. The new Chapter 4 requires notice to the California Department of Financial Institutions (“DFI”) the establishment of offices, rather than the current application process. Many of the current branch applications are perfunctory in nature and/or provide for a waiver of application. Banks, on an exception basis, may be subject to more stringent requirements as deemed necessary. As an example, new banks, banks undergoing a change in ownership and banks in less than satisfactory condition may be required to obtain prior approval from the DFI before establishing offices if such activity is deemed to create an issue of safety and soundness. The bill eliminated unnecessary provisions in the Banking Law that are either outdated or have become undue restrictions to bank licensees. Chapter 6 – “Powers and Miscellaneous Provisions” was repealed. A new Chapter 6 - “Restrictions and Prohibited Practices” was added. This chapter brings together restrictions in bank activities as formerly found in Chapter 18 – “Prohibited Practices and Penalties.” However, in bringing the restrictions into the new chapter, various provisions were updated to remove the need for prior approval by the DFI Commissioner. The bill renumbered current Banking Law sections to align like sections. Chapter 4.5 – “Authorizations for Banks” was added. The purpose of the chapter is to provide exceptions to certain activities that would otherwise be prohibited by other laws outside of the Financial Code. The bill added Article 1.5 - “Loan and Investment Limitations” to Chapter 10 – “Commercial Banks.” This article is new in concept and acknowledges that investment decisions are business decisions – so long as there is a diversification of the investments to spread any risk. The risk is diversified in this article by placing a limitation on the loans and investments that can be made to any one entity. This section is a trade-off for elimination of applications to the DFI for approval of investments in securities, which were repealed.

Other changes AB 1301 made to the Banking Law:

Authorized a bank or trust acting in any capacity under a court or private trust to arrange for the deposit of securities in a securities depository or federal reserve bank, and provided how they may be held by the securities depository;  
Reduced from 5% to 1% the amount of eligible assets to be maintained at an approved depository by an office of a foreign (other nation) bank for the protection of the interests of creditors of the bank’s business in this state or for the protection of the public interest;

Enabled the DFI to issue an order against a bank licensee parent or subsidiary;

Provided that the examinations may be conducted in alternate examination periods if the DFI concludes that an examination of the state bank by the appropriate federal regulator carries out the purpose of this section, but the DFI may not accept two consecutive examination reports made by federal regulators;

Provided that the DFI may examine subsidiaries of every California state bank, state trust company, and foreign (other nation) bank to the extent and whenever and as often as the DFI shall deem advisable;



Enabled the DFI issue an order or a final order to now include any bank holding company or subsidiary of the bank, trust company, or foreign banking corporation that is violating or failing to comply with any applicable law, or is conducting activities in an unsafe or injurious manner;

Enabled the DFI to take action against a person who has engaged in or participated in any unsafe or unsound act with regard to a bank, including a former employee who has left the bank.

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It is impossible to predict what effect the enactment of certain of the above-mentioned legislation will have on the Company. Moreover, it is likely that other bills affecting the business of banks may be introduced in the future by the United States Congress or California legislature.

### Employees

At December 31, 2011, the Company employed 138 persons on a full-time equivalent basis. The Company believes its employee relations are excellent.

### Available Information

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

### Item 1B. - Unresolved Staff Comments

The Company had no unresolved staff comments at December 31, 2011.

### Item 2 - Properties

The Bank's Main bank branch is located at 2151 West Shaw Avenue, Fresno, California. The Company owns the building and leases the land under a sublease dated December 1, 1986 between Central Bank and USB. The current sublessor under the master ground lease is Bank of the West, which acquired the position through the purchase of Central Bank. The lessor under the ground lease (Master Lease) is Thomas F. Hinds. The lease expires on December 31, 2015 and the Company has options to extend the term for four (4) ten-year periods and one seven (7) year period.

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

The Company leases the Oakhurst bank branch located at the Old Mill Village Shopping Center, 40074 Highway 49, Oakhurst, California. The branch facility consists of approximately 5,000 square feet with a lease term of 15 years ending April 2014, and has two five-year options to extend the lease term after that date.

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

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

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

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

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

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

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

The Company leases the Campbell branch located at 1875 S. Bascom Ave. Suite 19, Campbell, California, which has approximately 2,984 square feet. The lease commenced on January 1, 2011 and expires on December 31, 2021.

The Company owns its administrative headquarters at 2126 Inyo Street, Fresno, California and is occupied by the Company's administrative staff and USB financial services. The facility consists of approximately 21,400 square feet. A portion of the premises has been subleased to a third-party under a lease term of approximately seven years.

Item 3 - Legal Proceedings

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

Item 4 - Reserved

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PART II

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

Trading History

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

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

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

During the third quarter ended September 30, 2008 and the fourth quarter ended December 31, 2008, the Company declared 1% stock dividends. During each of the twelve consecutive quarters ended March 31, 2009, June 30, 2009, September 30, 2009, December 31, 2009, March 31, 2010, June 30, 2010, September 30, 2010, December 31, 2010, March 31, 2011, June 30, 2011, September 30, 2011 and December 31, 2011, the Company again declared 1% stock dividends. Share information for all periods presented in this Form 10-K has been restated to reflect the effect of the 1% stock dividends.

The following table sets forth the high and low closing sales prices by quarter for the Company's common stock, for the years ended December 31, 2011 and 2010.

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Quarter	Closing Prices		Volume
	High	Low	
4th Quarter 2011	\$ 2.97	\$ 1.99	271,189
3rd Quarter 2011	\$ 3.22	\$ 2.99	457,433
2nd Quarter 2011	\$ 3.59	\$ 2.71	296,759
1st Quarter 2011	\$ 3.74	\$ 2.68	659,466
4th Quarter 2010	\$ 4.75	\$ 3.23	853,916
3rd Quarter 2010	\$ 4.38	\$ 3.18	425,964
2nd Quarter 2010	\$ 4.89	\$ 3.33	622,516
1st Quarter 2010	\$ 4.98	\$ 3.75	640,632

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At December 31, 2011, there were approximately 790 record holders of common stock of the Company. This does not reflect the number of persons or entities who hold their stock in nominee or street name through various brokerage firms.

## Dividends

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

The Company distributed a 1% stock dividend to shareholders on January 19, 2011, April 20, 2011, July 27, 2011, and October 26, 2011,.The Company distributed a 1% stock dividend to shareholders on January 20, 2010, April 21, 2010, July 21, 2010,and October 20, 2010,.

The amount and payment of dividends by the Company to shareholders are set by the Company's Board of Directors with numerous factors involved including the Company's earnings, financial condition and the need for capital for expanded growth and general economic conditions. No assurance can be given that cash or stock dividends will be paid in the future.

## Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth securities authorized for issuance under equity compensation plans as for December 31, 2011.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (column a)	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	154,757	\$ 12.50	428,809
Equity compensation plans not approved by security holders	N/A	N/A	N/A
<b>Total</b>	<b>154,757</b>	<b>\$ 12.50</b>	<b>428,809</b>

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

Purchases of Equity Securities by Affiliates and Associated Purchasers

On May 16, 2007, the Company announced another stock repurchase plan to repurchase, as conditions warrant, up to 701,179 shares of the Company's common stock on the open market or in privately negotiated transactions. The repurchase plan represents approximately 5.00% of the Company's currently outstanding common stock. The duration of the program is open-ended and the timing of purchases will depend on market conditions.

As of December 31, 2011, there were 600,362 shares available for repurchase. The Company did not repurchase any common shares during the year ended December 31, 2011 or 2010.

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

Overview

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

The Company

On June 12, 2001, the United Security Bank (the "Bank") became the wholly owned subsidiary of United Security Bancshares (the "Company") through a tax-free holding company reorganization, accounted for on a basis similar to the pooling of interest method. In the transaction, each share of Bank stock was exchanged for a share of Company stock on a one-to-one basis. No additional equity was issued as part of this transaction. In the following discussion, references to the Bank are references to United Security Bank. References to the Company are references to United Security Bancshares (including the Bank).

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

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



Results of Operations).

Effective April 23, 2004, the Company completed its merger with Taft National Bank headquartered in Taft, California. Taft National Bank ("Taft") was merged into United Security Bank and Taft's two branches, one located Taft and the other located in Bakersfield, California, began operating as branches of United Security Bank. The total consideration paid to Taft shareholders was 241,447 shares of the Company's common stock valued at just over approximately \$6.0 million. As a result of the merger, the Company acquired \$15.4 million in cash and short-term investments, \$23.3 million in loans, and \$48.2 million in deposits. The merger was accounted for using the purchase method of accounting, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Taft based on the fair value of those assets and liabilities, with resultant goodwill of \$1.6 million and core deposits intangibles of \$1.9 million. Goodwill is not amortized but is reviewed at least annually for impairment, while core deposit intangibles are being amortized over a period of approximately 7 years. The Company has recognized no impairment on either the goodwill or core deposit intangible related to the Taft merger. The two branches purchased during 2004 have grown since the merger in 2004, with loans totaling \$41.7 million, and deposits totaling \$81.4 million at December 31, 2011. Like much of the rest of the San Joaquin Valley, the Bakersfield area has been impacted to a large degree by the slowdown in residential real estate markets and resulting depressed real estate prices. Of the \$31.8 million in total impaired loans reported by the Company at December 31, 2011, \$10.7 million was related to the Bakersfield operation with a specific reserve of \$127,000.

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On February 16, 2007, the Company completed its merger of Legacy Bank, N.A. with and into United Security Bank, a wholly owned subsidiary of the Company. Legacy Bank which began operations in 2003 operated one banking office in Campbell, California serving small business and retail banking clients. With its small business and retail banking focus, Legacy Bank provides a unique opportunity for United Security Bank to serve a loyal and growing small business niche and individual client base in the San Jose area. Upon completion of the merger, Legacy Bank's branch office began operating as a branch office of United Security Bank. As of February 16, 2007, Legacy Bank had net assets of approximately of \$8.6 million, including net loans of approximately \$62.4 million and deposits of approximately \$69.6 million. At the time of the merger, Legacy had \$62.5 million in net loans and \$69.6 million in total deposits. At December 31, 2011, net loans and total deposits related to the Campbell branch totaled \$38.4 million and \$25.4 million, respectively, and have decreased as the result of declines in lending markets in that area as well as significant competition for deposits. Impaired loans related to the Campbell branch at December 31, 2011 totaled \$686,000 with a related specific reserve of \$18,000.

In the merger with Legacy Bank, the Company issued 976,411 shares of its stock in a tax free exchange for all of the Legacy Bank common shares. The total value of the transaction was approximately \$21.7 million. The merger transaction was accounted for using the purchase accounting method, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy based on the fair value of those assets and liabilities. Fair value adjustments and intangible assets totaled approximately \$12.9 million, including \$8.8 million in goodwill. The allocations of purchase price based upon the fair market value of assets acquired and liabilities assumed were finalized during the fourth quarter of 2007. Goodwill is not amortized but is reviewed at least annually for impairment, while core deposit intangibles are being amortized over a period of approximately 7 years. The Company recognized goodwill impairment charges of \$1.5 million and \$1.4 million for the years ended December 31, 2011, and 2010, respectively. In addition, the Company recognized impairment charges related to core deposit intangibles of \$36,000 and \$57,000 during the years ended December 31, 2011 and 2010, respectively.

During July 2007, the Company formed USB Capital Trust II, a wholly-owned special purpose entity, for the purpose of issuing Trust Preferred Securities. Like USB Capital Trust I formed in July 2001, USB Capital Trust II is a Variable Interest Entity (VIE) and a deconsolidated entity pursuant current accounting standards related to variable interest entities. On July 23, 2007, USB Capital Trust II issued \$15 million in Trust Preferred securities. The securities have a thirty-year maturity and bear a floating rate of interest (repricing quarterly) of 1.29% over the three-month LIBOR rate. Interest is payable quarterly. Concurrent with the issuance of the Trust Preferred securities, USB Capital Trust II used the proceeds of the Trust Preferred securities offering to purchase a like amount of junior subordinated debentures of the Company. The Company is to pay interest on the junior subordinated debentures to USB Capital Trust II, which represents the sole source of dividend distributions to the holders of the Trust Preferred securities. The Company elected at September 30, 2009 to defer quarterly payments of interest on the junior subordinated debentures beginning with the quarterly payment due October 1, 2009. In addition, the Agreement entered into with the Federal Reserve Bank of San Francisco during March 2010 prohibits the Bank from making distributions, including dividends and interest payments, without prior written approval. The terms of the debentures permit the deferment of payment of interest for up to 20 consecutive quarters. Interest continues to accrue while interest payments are deferred. Under the terms of the trust preferred securities the Company is prohibited from paying dividends on its capital stock (including common stock) during the deferral period. The Company may redeem the junior subordinated debentures at anytime before October 2012 at 100.66, or at par anytime after October 2012.

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 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 as of the filing of the fourth quarter written response to the Agreement, Company is in compliance with the terms of the Agreement. (For more information on the terms of the Agreement see the "Regulatory Matters" section included in this Management's Discussion and Analysis of Financial Condition and Results of Operations.)

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The Agreement entered into with the Federal Reserve Bank of San Francisco during March 2010 was a result of a regulatory examination conducted by the Federal Reserve and the California Department of Financial Institutions in June 2009. The following issues related to the June 2010 examination led to the agreement between the Federal Reserve Bank and the Company that corrective action was required:

Asset quality continued to deteriorate as adversely classified assets increased over four consecutive target and full-scope examinations conducted from 2006 through the June 2009 exam. The dollar volume of adversely classified assets increased by 16.7% during the six months prior to the exam to \$142.1 million at the June 2009 examination.

Below investment grade investment securities classified substandard at the previous examination totaling \$9.1 million increased to \$17.1 million at the June 2010 examination, representing 18.6% of tier 1 capital and reserves as of March 31, 2009. The classified investment securities are comprised of three private-label residential mortgage backed securities that are below investment grade as graded by a national rating agency, were divided between \$16.9 million in substandard and \$163,000 in loss. The portion listed as loss represented the amount identified as other-than-temporary-impairment (OTTI) and had been recognized as loss as of March 31, 2009.

During the June 2009 examination, it was the opinion of the Federal Reserve Bank that the Bank's methodology related to the allowance for loan and leases losses was flawed, leading the Federal Reserve Bank to conclude that additional provisions were required to raise reserves to an appropriate level. In addition, weaknesses in the ALLL policy were identified and needed to be addressed, which included improvements in documentation related to identification and analysis of loans under SFAS No. 114 and SFAS No. 5, and more detailed justification for the qualitative factors used in the ALLL process. During the six months ended June 30, 2010, several large lending relationships to developers in the San Joaquin Valley deteriorated significantly, requiring an additional \$1.8 million in ALLL. In addition, during that period, the Bank experienced increases in other problem loans or potentially problem loans including nonaccrual loans and special mention loans, and real estate valuations continued to decline. Regulators required an increase in the reserves as calculated by the Federal Reserve Bank using a model they call the "Atlanta Model." The Atlanta Model calculated an estimated range of allowance for loan losses using a blend of national, regional, and local peer bank data. The reserve calculated by the Bank for June 30, 2009 under GAAP included additions to ALLL required for increases in adversely classified and special mention loans experienced during the first half of 2009, and although at the lower range of ALLL as estimated by the Federal Reserve, corresponded favorably with the Federal Reserve's "Atlanta Model". The reserve adjustment required for the second quarter of 2009 totaled \$6.8 million bringing the ALLL level to \$15.8 million (including reserve for unfunded commitments) at June 30, 2009. The ALLL findings of the Federal Reserve Bank included recommendations to better align actual practices with the regulatory governing policy as well as to provide a more specific framework for analyzing, determining, and supporting the factors used in the ALLL methodology.

Earnings performance declined as of June 30, 2009, due in large part to the additional \$6.8 million provision recorded for the second quarter (\$8.2 million year-to-date) resulting in a net loss for the Company of \$4.8 million for the six months ended June 30, 2009. Earnings for the period were also adversely impacted by: a goodwill impairment loss of \$3.0 million (pre-tax and net); year-to-date pre-tax impairment losses of \$403,000 on the real estate mortgage-backed securities; year-to-date pre-tax operating expenses and impairment losses of \$1.3 million related to other real estate owned through foreclosure.

Although the Bank's Tier 1 leverage capital, Tier 1 risk-based capital, and total risk-based capital ratios remained above regulatory Prompt Corrective Action guidelines of adequately capitalized banks at 10.8%, 11.3%, and 12.6%, respectively, at June 30, 2009, the Federal Reserve concluded that capital levels were less than adequate to support the Bank's high risk profile resulting primarily from the continued decline in asset quality. At the June 2009 examination adversely classified assets were in excess of 150.0% of Tier 1 capital and reserves.

The Bank's liquidity position had tightened since the last examination and was considered marginal at the June 2009 examination. The Bank's tight liquidity position was the result of low levels of liquid assets, high percentage of investment securities pledged against borrowing lines, and higher levels of wholesale borrowings including \$64.0 million borrowed from the Federal Home Loan Bank line and \$71.3 million borrowed from the Federal Reserve Bank discount window. Brokered deposits total \$99.3 million, 19.4% of total deposits at June 30, 2009, and compared unfavorably with the peer group at 6.3%.

The Federal Reserve concluded in the June 2009 examination that oversight by the Board of Directors and senior management was not adequate given the escalating risk profile of the Bank's activities. Although the severe economic downturn was a significant factor in the decline in asset quality, the Board of Directors and senior management were deemed responsible for implementing a business strategy which allowed concentrations in higher-risk speculative residential construction lending. The Board of Directors and senior management had taken measures to maintain asset quality, capital, earnings, and liquidity, but had not responded in a timely manner to the rapidly changing real estate conditions. As of March 31, 2009, the concentration in construction and land development loans represented high levels in relation to equity capital and reserves, although the exposures were declining over the prior few years. For example, management increased the ALLL in the second quarter of 2009, ordered new appraisals on property remargined collateral on loans, and was seeking sources for new equity capital. In addition, several transactions to reduce or restructure problem assets were in process. However, these actions had not resulted in material tangible improvements in the overall condition of the Bank as of the June 2009 examination. In addition, the June 2009 examination identified nine technical violations of Regulation Y Subpart B that deal with the failure to obtain the prescribed appraisals or evaluations on loan extensions or renewals. These violations of law were subsequently remedied.

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The June 2009 examination indicated that risk management practices needed improvement. Management information systems needed to be redesigned and implemented to more accurately measure fundamental exposures, such as the ongoing credit risk posed by the residential construction and land development loan portfolio and the emerging liquidity risks. The Bank needed to continue its efforts to address and reduce the increasing volume of problem assets. While the loan grading process showed improvement over the prior several examinations, the ALLL methodology was identified as flawed in the June 2009 examination. While the Board of Directors and management made some progress to address the findings of the June 2009 examination, management needed to make further progress on improving several key areas to identify, measure, monitor, and control the exposures presented by credit, liquidity, market, operational, reputation, and legal risks.

The result of significant increases in nonperforming assets, both classified loans and OREO, during 2008 and the first half of 2009 increased 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 wholesale 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 materially from wholesale funding sources, liquidity risk increased, and higher levels of nonperforming assets increased risk to equity capital and potential volatility in earnings. In addition, the Federal Reserve Bank identified nine technical violations of Regulation Y Subpart B that deal with the failure to obtain the prescribed appraisals or evaluations on loan extensions or renewals. During the fourth quarter of 2010, the Company identified certain material weaknesses related to the allowance for loan losses and the completeness and accuracy of the provision for loan losses, as well as material weaknesses related to the valuation of OREO properties (for further discussion see Item 9A Controls and Procedures.)

As part of the Agreement, the Board of Directors of the Bank has appointed a Compliance Committee to monitor and coordinate the Bank's compliance with the provisions of the Agreement. The Compliance Committee is comprised of the outside Directors and they meet on a monthly basis.

Among other things, the Agreement required the Bank to submit a number of written plans to the Federal Reserve Bank within specified time frames. The following is a list of written plans required to be submitted to the Federal Reserve Bank.

- Plan to Strengthen Board Oversight – Includes actions that the Board of Directors will take to improve the Bank's condition, and maintain effective control and supervision over the Bank's operations including credit risk management, liquidity, and earnings. Also includes the Board's responsibility to monitor adherence to policies and procedures and applicable laws and regulations, and lists information and reports that will enable the Board to perform this oversight function.
- 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.

- Capital Plan – 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. Also contains contingency strategies to obtain additional capital as required to fulfill future capital requirements.
- Plan to Improve Liquidity Position – Includes measures to enhance the monitoring, measurement, and reporting of the Bank’s liquidity to the Board, 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.

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- Contingency Funding Plan – Includes adverse scenario planning, and identifies and quantifies available sources of liquidity for each scenario.
- Earnings Plan and Budget – Includes a revised business plan for the remainder of 2010, including operating assumptions that support for projected income, expense, and balance sheet components.

As of June 30, 2010, the Bank had completed and submitted to the Federal Reserve Bank all the plans listed above within the designated timeframes. The Federal Reserve responded on July 27, 2010 by letter that stated “We have reviewed your submissions and acknowledge the steps taken by the Bank and Bancshares to achieve compliance with the Agreement's provisions. However, we noted that the Plan to Strengthen Board Oversight omitted references to actions to be taken with regard to Bank earnings as required by the first provision.” At the August 24, 2010, regular meeting of the Board, an amended version of the Plan was approved and the amended Plan has been submitted to the Federal Reserve.

In addition to the submission of the above plans to the Federal Reserve Bank for approval, and implementation of the above plans, the Bank is required within 30 days after the end of each calendar quarter to submit written progress reports to the Federal Reserve Bank detailing actions taken to secure compliance with the Agreement. On April 28, 2010, July 30, 2010, and October 30, 2010, respectively, the Bank submitted progress reports to the Federal Reserve for the first, second, and third quarters of 2010. As of the January 31, 2011 the Company submitted a progress report for the fourth quarter of 2010. At this time the Company and the Bank believe they are in compliance with the Agreement, including remediation of technical 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 basically similar to the written 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. During the fourth quarter of 2010, the Company identified certain material weaknesses related to the allowance for loan losses and the



completeness and accuracy of the provision for loan losses, as well as material weaknesses related to the valuation of OREO properties (for further discussion see Item 9A Controls and Procedures.)

(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.)

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

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## Current Trends Affecting Results of Operations and Financial Position

The Company's overall operations are impacted by a number of factors, including not only interest rates and margin spreads, which impact results of operations, but also the composition of the Company's balance sheet. One of the primary strategic goals of the Company is to maintain a mix of assets that will generate a reasonable rate of return without undue risk, and to finance those assets with a low-cost and stable source of funds. Liquidity and capital resources are considered as well in the planning process to mitigate risk and allow for growth. Net interest income has declined over the past two years, totaling \$25.0 million and \$27.9 million for the years ended December 31, 2011 and 2010, respectively. The decline in net interest income was primarily the result of declines in the volume of interest-earning assets which more than outweighed the decrease in interest expense during 2011. Average interest-earning assets decreased approximately \$53.6 million between 2010 and 2011 as the size of the balance sheet was reduced in line with economic impact on the Company's loan portfolio. The decrease in average earning assets between 2010 and 2011 consisted of a decrease of \$65.5 million in loans and \$11.8 million in investment securities offset by increases of \$25.0 million in federal funds sold and interest-bearing deposits in the Federal Reserve Bank. During the last two years, the Company's cost of interest-bearing liabilities has declined significantly as market rates of interest declined, with the average cost of interest-bearing liabilities dropping from 0.93% during 2010 to 0.73% for the year ended December 31, 2011. Over the two year period, the mix of average interest-bearing liabilities changed, with interest-bearing deposits increasing on average by \$72.6 million between the years ended December 31, 2010 and 2011. Borrowings decreased \$13.2 million on average between the years ended December 31, 2010 and 2011 as the Company sought to reduce its dependence on wholesale funding sources.

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

	YTD Average 12/31/11		YTD Average 12/31/10	
Loans	76.39	%	80.42	%
Investment securities	8.80	%	10.16	%
Interest-bearing deposits in other banks	0.43	%	0.40	%
Interest-bearing deposits in FRB	14.39	%	4.18	%
Federal funds sold	0.00	%	4.84	%
Total earning assets	100.00	%	100.00	%
NOW accounts	11.80	%	12.78	%
Money market accounts	30.43	%	23.57	%
Savings accounts	9.67	%	7.20	%
Time deposits	40.21	%	47.22	%
Other borrowings	5.43	%	7.16	%
Trust Preferred Securities	2.46	%	2.07	%
Total interest-bearing liabilities	100.00	%	100.00	%

The residential real estate markets in the five county region from Merced to Kern showed signs of improvement during 2011. The severe declines in residential construction and home prices that began in 2008 showed signs of easing and reversing direction in late 2011. 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. The level of restructured loans decreased during 2011 from a balance of \$24.9 million at December 31, 2010 to \$19.0 million at December 31, 2011, total nonperforming loans decreased approximately \$4.4 million during the year ended December 31, 2011.

New home median sales prices increased in each of the five counties from Merced to Kern between December 2010 to December 2011. Median sales prices on all homes, including condo's, existing single family and new homes, showed modest declines under 5% in Fresno, Merced and Tulare. Kern County median sales prices on all homes increased by 6% while Madera declined by nearly 11%. Notices of default have fallen in the five- county region since 2009 with Fresno County down 26% in the third quarter of 2011 over the same quarter in 2009.

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Unemployment in Fresno County is 17% at year end 2011, about the same as a year earlier. Fresno's rate is historically higher than the State (11%) or Nation (9.1%) but population growth in Fresno County (13.85%) from 2000 to 2010 outpaces the State (9.75%) and the Nation (9.61%) as well. The next couple of years will likely remain challenging for Fresno real estate, but the fundamentals suggest a recovery in commercial and residential development is emerging as we enter 2012. Fresno is the largest agriculture-producing county in the US and a strong agricultural market fueled by global demand and growth in exports is driving ag product prices and demand for local agricultural land higher. The agriculture affect benefits the Fresno County economy.

Kern County varies slightly from Fresno County. Kern performed slightly better in unemployment (14% for 2011) and residential real estate markets show greater signs of recovery with recent data indicating a 6% rise in the median price for all. The rate of population growth was 26% in the decade ending 2010. Kern County also has a strong agricultural base, albeit smaller than Fresno County, and Kern is home to a significant oil industry.

Santa Clara County is one of the few areas with consistent job and income growth in 2011 based on the strength of its high-tech manufacturing sector that has benefited from increasing business investment. It is one of the few areas where unemployment rates are lower in 2011 (9%) than in 2010 (11%). Median home prices fared similar to those in the five-county region, showing a modest decline under 5% from December 2010 – December 2011. Foreclosure rates and notices of default declined 20% in the County in the fourth quarter 2011 compared with the same quarter for 2010.

The Company's loan portfolio, particularly real estate, declined over the past four years because of the economic downturn. The largest decreases are in real estate construction and development loans and commercial and industrial loans, as the Company reduced exposure to real estate markets hardest hit from the downturn. Loans decreased \$33.0 million between December 31, 2010 and December 31, 2011. More specifically, real estate construction and development loans decreased \$14.8 million between December 31, 2010 and December 31, 2011, as real estate construction declined significantly in the San Joaquin Valley and California overall. The Company did not make material additions to the real estate construction and development loan portfolio over the past few years because of the depressed real estate markets, and has focused its attention on monitoring existing construction loans in the portfolio. Real estate construction and development loans amounted to 12.3% and 14.8% of the total loan portfolio at December 31, 2011 and 2010. Additionally, commercial real estate loans (a component of real estate mortgage loans) amounted to 29.1% and 29.8%, of the total loan portfolio at December 31, 2011, and 2010, respectively. Residential mortgage loans are not generally a large part of the Company's loan portfolio, but some residential mortgage loans are made 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. Loan participations, both sold and purchased, have declined over the past two years as lending originations have slowed significantly and the loan participation market with it. As a result, loan participations purchased have declined from \$17.0 million or 3.9% of the portfolio at December 31, 2010, to \$3.6 million or .9% of the portfolio at December 31, 2011. Loan participations sold have increased from \$8.9 million or 2.0% of the portfolio at December 31, 2010, to \$13.3 million or 3.3% of the portfolio at December 31, 2011.

With market rates of interest remaining at historically low levels for more than a year, the Company continues to experience compressed net interest margins. During 2011, the Company's net interest margin fell from 4.58% for the year ended December 31, 2010, to 4.49% for the year ended December 31, 2011. With approximately 50% of the loan portfolio in floating rate instruments at December 31, 2011, the effects of low market rates continue to keep loan yields compressed. The Company has successfully sought to mitigate the low-interest rate environment with loan floors included in new and renewed loans over the past year. Loans yielded 6.02% during the years ended December 31, 2011 and December 31, 2010. In addition, the Company's yield on investment securities decreased from 4.60% at December 31, 2010 to 4.38% at December 31, 2011. The Company's cost of funds has continued to decline over the past year and has mitigated much of the decrease in yields on earning assets. The Company's average cost of funds was

0.73% for the year ended December 31, 2011 as compared to 0.93% for the year ended December 31, 2010. Wholesale borrowing and brokered deposit rates have remained low since late 2008, resulting in overnight and short-term borrowing rates of less than 0.35% during much of the past year. The Company benefited from the low interest rate environment, and continues to utilize short-term borrowing lines through the Federal Home Loan Bank. Although the Company does not intend to increase its current level of brokered deposits, and in fact as a result of the recent Agreement with the Federal Reserve Bank and Order with the California Department of Financial Institutions, will systematically reduce brokered deposit levels as they mature in the future, the \$40.9 million in brokered deposits at December 31, 2011 continues to provide the Company with a low-cost source of deposits. The Company will continue to utilize these funding sources when possible to maintain prudent liquidity levels, while seeking to increase core deposits when possible.

Total noninterest income of \$6.9 million reported for the year ended December 31, 2011 increased \$938,000 or 15.8% as compared to the year ended December 31, 2010. Noninterest income continues to be driven by customer service fees, which totaled \$3.6 million for the year ended December 31, 2011, representing a decrease of \$172,000 or 4.5% over the \$3.8 million in customer service fees reported for the year ended December 31, 2010. Customer service fees represented 52.9% and 64.2% of total noninterest income for the years ended December 31, 2011 and 2010, respectively. Other components of noninterest income have become more volatile during the past several years as many have been nonrecurring or non-sustainable, including gains or losses on other real estate owned through foreclosure or other asset disposals as the Company works to reduce problem assets. Other components of noninterest income recognized during the year ended December 31, 2011 fair value gains of \$1.9 million on the Company's junior subordinated debt, as well as \$565,000 from an increase in the cash surrender value of bank owned life insurance.

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Noninterest expense increased approximately \$1.8 million or 6.1% between the years ended December 31, 2010 and December 31, 2011. Increases experienced during the year ended December 31, 2011 were primarily the result of both increases in OREO impairment charges and other OREO related expenses totaling approximately \$3.0 million. Decreases in noninterest expense experienced during the year ended December 31, 2011 included decreases of \$464,000 in regulatory assessments and 341,000 in impairment losses on investment securities.

Effective September 30, 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 March 22, 2011, June 28, 2011, September 27, 2011, and December 21, 2011, 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 April 8, 2011, July 9, 2011, October 14, 2011, and January 7, 2011, respectively, an additional 131,031, 131,304, 132,663, and 133,985 shares, respectively, were issued to shareholders. For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to the 1% stock dividends to shareholders for all periods presented.

The Company has sought to maintain a strong, yet conservative balance sheet while continuing to reduce the level of nonperforming assets and improve liquidity during the year ended December 31, 2011. Total assets decreased approximately \$26.9 million during the year ended December 31, 2011, with a decrease of \$33.0 million in loans, a decrease of \$13.0 million in investment securities, and \$1.5 million in goodwill. Offsetting these decreases was an increase of \$25.8 million in cash and cash equivalents. During the second quarter of 2010, the Company completed the sale of two purchased real estate mortgage loan portfolios totaling \$17.1 million, recognizing a gain of \$509,000 on the transaction. The sale of the mortgage loan portfolios has provided additional liquidity. Decreases of \$32.0 million in FHLB term borrowings between December 31, 2010 and December 31, 2011 were offset by increases of \$17.0 million in net deposits. Increases of \$85.0 million in NOW and money market accounts during the year ended December 31, 2011 were offset by decreases of \$12.2 million in savings and money market accounts and \$56.1 million in time deposits as the Company continued its efforts to reduce the level of brokered time deposits during 2011. Average loans comprised approximately 77% of overall average earning assets during the year ended December 31, 2011, as compared to 80% of average earning assets for the year ended December 31, 2010..

Nonperforming assets, which are primarily related to the real estate loan and property portfolio, remained high during the year ended December 31, 2011 as real estate markets continue to suffer from the mortgage crisis which began during mid-2007. Nonaccrual loans totaling \$18.1 million at December 31, 2011, decreased \$16.3 million from the balance reported at December 31, 2010. 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. Valuations on these loans and the underlying collateral continued to deteriorate during much of 2010 and 2011, resulting in increased charge-offs and levels of impaired loans. Impaired loans decreased \$19.1 million during the year ended December 31, 2011 to a balance of \$31.9 million at December 31, 2011. Other real estate owned through foreclosure decreased \$8.5 million between December 31, 2010 and December 31, 2011. During the year ended December 31, 2011, write-downs on, and sales of, other real estate owned through foreclosure more than offset the \$2.8 million in loans transferred to other real estate owned during the year. As a result of these events, nonperforming assets as a percentage of total assets decreased from 12.17% at December 31, 2010 to 8.76% at December 31, 2011.

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

(in thousands)	December 31, 2011	December 31, 2010	December 31, 2009
Provision for credit losses during period	\$ 13,602	\$ 12,475	\$ 13,375
Allowance as % of nonperforming loans	45.52 %	35.19 %	29.57 %
Nonperforming loans as % total loans	7.34 %	10.63 %	9.99 %
Restructured loans as % total loans	4.74 %	5.65 %	5.13 %

As the economy has declined along with asset valuations, increased emphasis has been placed on impairment analysis of both tangible and intangible assets on the balance sheet. As of March 31, 2011, the Company conducted annual impairment testing on the largest component of its outstanding balance of goodwill, that of the Campbell operating unit (resulting from the Legacy merger during February 2007.) In part, as a result of continued declines in interest rates and other economic factors within the industry, we could not conclude at March 31, 2011 that there was not a possibility of goodwill impairment under the current economic conditions. During the second quarter of 2011, the Company utilized an independent valuation service to determine the aggregate fair value of the individual assets, liabilities, and identifiable intangible assets of the Campbell operating unit in question to determine if the goodwill related to that operating unit was impaired, and if so, how much the impairment was. Management, with the assistance of the independent third-party, concluded that there was impairment of the goodwill related to the Campbell operating unit, and as a result the Company recognized an impairment loss of \$1.5 million or \$0.11 per share (pre-tax and after-tax) for the quarter ended June 30, 2011 and the year ended December 31, 2011. The Company recognized an impairment loss of \$1.4 million or \$0.11 per share (pre-tax and after-tax) for the quarter ended June 30, 2010 and the year ended December 31, 2010.

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. As the real estate market declined through 2008, and that accelerated throughout much of 2009, the level of problem assets increased, and the estimated real estate values on many of those assets decreased resulting in increased charge-offs or write-downs of those assets. 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. As a result of these efforts, restructured loans increased from a single loan totaling \$378,000 at December 31, 2008 to approximately 50 loans totaling \$26.1 million at December 31, 2009 decreasing to 47 loans totaling \$24.9 million at December 31, 2010, and then decreasing to 41 loans totaling \$19.4 million at December 31, 2011. Provisions made to the allowance for credit losses, totaled \$13.6 million during the year ended December 31, 2011 as compared to \$12.5 million for the year ended December 31, 2010. The provisions made to the allowance for credit losses, totaling \$875,000 during the first quarter of 2011, \$9.2 million during the second quarter of 2011, \$2.5 million made during the third quarter of 2011, and \$1.1 million made during the fourth quarter of 2011, provided a level in the allowance for credit losses that is deemed adequate to cover inherent losses in the loan portfolio. Net loan and lease charge-offs during the year ended December 31, 2011 totaled \$16.5 million, as compared to \$11.1 million for the year ended December 31, 2010. The Company charged-off approximately 78 loans during the year ended December 31, 2011, compared to 74 loans during the year ended December 31, 2010. Net loan and lease charge-offs totaling \$16.5 million during the year ended December 31, 2011 included \$665,000 during the quarter ended March 31, 2011, \$6.0 million during the quarter ended June 30, 2011, \$8.4 million during the quarter ended September 30, 2011, and an additional \$1.4 million during the fourth quarter of 2011. The percentage of net charge-offs to average loans were 3.9%, 2.2%, and 1.9% for the years ended December 31, 2011, 2010 and 2009, respectively.



Deposits increased by \$17.0 million during the year ended December 31, 2011, with increases experienced in NOW, money market, and savings accounts, which were offset by decreases of \$56.1 million in time deposits during 2011. Decreases in time deposits experienced during the year ended December 31, 2011 were primarily the result of decreases in brokered wholesale deposits, as the Company continues to reduce its reliance on brokered deposits and other wholesale funding sources, while enhancing liquidity.

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Brokered deposits have provided the Company a relatively inexpensive funding source over the past several years totaling \$40.9 million or 7.1% of total deposits at December 31, 2011, as compared to \$81.5 million or 14.6% of total deposits at December 31, 2010. 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 increased its efforts early in 2009 to develop core deposit growth with employee training throughout the entire organization and a deposit-gathering program that incented employees to bring in new deposits from our local market area and establish more extensive relationships with our customers. The Company continues its deposit gathering program and committed additional resources to its efforts during 2010 including two full time employees dedicated to business development. As part of its liquidity position improvement plan resulting from the formal agreement with the Federal Reserve Bank issued in March 2010, the Company will reduce its reliance on brokered deposits over the next two years to levels more comparable with peers, which is currently about 5% of total deposits. The Company will seek to replace maturing brokered deposits with core deposits, but may also control loan growth to help achieve that objective.

While the Company still has a higher percentage of brokered deposits than peers at December 31, 2011, efforts to restructure the balance sheet through reducing the level of total assets, and specifically real estate loans, are proving successful. Total wholesale borrowings and brokered deposits decreased an additional \$72.6 million during the year ended December 31, 2011 to a balance of \$40.9 million at December 31, 2011.

During October 2011, the Company prepaid \$32.0 million in FHLB advances with an original maturity date of 1/31/2012 as part of its balance sheet management strategy. Although the Company had no borrowings at December 31, 2011, the Company will continue to utilize overnight borrowings and other term credit lines as deemed prudent. Borrowings totaled \$32.0 million at December 31, 2010. The average rate of on term borrowings was 0.46% (net of a prepayment penalty assessed by the FHLB) at December 31, 2011, as compared to 0.35% at December 31, 2010. Use of such lines are monitored closely to ensure sound balance sheet management in light of the current economic and credit environment.

The cost of the Company's subordinated debentures issued by USB Capital Trust II has remained low as market rates declined during most of 2009. With pricing at 3-month-LIBOR plus 129 basis points, the effective cost of the subordinated debt was 1.89% and 1.59% at December 31, 2011 and December 31, 2010, respectively. Pursuant to fair value accounting guidance, the Company has recorded \$1.9 million in pretax fair value gains on its junior subordinated debt during the year ended December 31, 2011, bringing the total cumulative gain recorded on the debt to \$7.1 million at December 31, 2011.

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 declined during much of 2009 and 2010, and continued to do so in 2011. Although we saw some improvement later in 2011, the past year has presented significant challenges for the banking industry with tightening credit markets, weakening real estate markets, and increased loan losses adversely affecting the Banking industry and the Company.

The Company continually evaluates its strategic business plan as economic and market factors change in its market area. Balance sheet management, enhancing revenue sources, and maintaining market share will be of primary importance during 2012 and beyond. The banking industry is currently experiencing continued pressure on net margins as well as asset quality resulting from conditions in the real estate market, and weak credit markets. During March 2010, the Company and the Bank entered into a regulatory agreement with the Federal Reserve Bank which,

among other things, requires improvements in the overall condition of the Company and the Bank. As a result, market rates of interest, asset quality, as well as regulatory oversight will continue to be an important factor in the Company's ongoing strategic planning process.

#### Application of Critical Accounting Policies and Estimates

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

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

### Allowance for Credit Losses

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

### Other Real Estate Owned

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value of the collateral is charged to the allowance for credit losses. The determination of fair value is generally based upon pre-approved, external appraisals. As real estate markets declined over the past three years and essentially became illiquid in many areas, Management was required to use additional judgment in determining the factors associated with fair value of the real estate, including the term over which the properties could be disposed in an orderly liquidation. This became necessary as many appraisals were based upon comparable sales which were deeply discounted forced liquidations or bulk sales caused by the severity of the housing crises. Subsequent declines in the fair value of other real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense. The fair market valuation of such properties is based upon estimates, and as such, is subject to change as circumstances in the Company's market area, or general economic trends, change.

### Impairment of Investment Securities

Investment securities classified as available for sale ("AFS") are carried at fair value and the impact of changes in fair value are recorded on the Company's consolidated balance sheet as an unrealized gain or loss in "Accumulated other comprehensive income (loss)," a separate component of shareholders' equity. Securities classified as AFS or held to maturity ("HTM") are subject to review to identify when a decline in value is other than temporary. In April 2009, the FASB updated the accounting standards for the recognition and presentation of other-than-temporary impairments. The standard amends existing guidance on other-than-temporary impairments for debt securities and requires that the credit portion of other-than-temporary impairments be recorded in earnings and the noncredit portion of losses be recorded in other comprehensive income (loss) when the entity does not intend to sell the security and it is more likely than not that the entity will not be required to sell the security prior to recovery of its cost basis. The Company adopted the standard during the first quarter of 2009. Factors considered in determining whether a decline in value is

other than temporary include: whether the decline is substantial; the duration of the decline; the reasons for the decline in value; whether the decline is related to a credit event or to a change in interest rate; our ability and intent to hold the investment for a period of time that will allow for a recovery of value; and the financial condition and near-term prospects of the issuer.

At December 31, 2011, the Company considered three of its investment securities other than temporarily impaired. The three private-label collateralized mortgage obligations (residential mortgage obligations) have an amortized cost of \$10.2 million and carrying value of \$8.0 million. Impairment analysis on these three residential mortgage obligations was performed utilizing the services of a third-party investment broker specializing in private-label CMO's, and was based upon estimated cash flows. Estimated cash flows were based upon assumptions of future prepayments and default rates, and thus may be subject to revision as events change in the future. For the year ended December 31, 2011, the Company recognized pre-tax losses totaling \$912,000 related to the credit portion of the other-than-temporary impairment in earnings. The remaining \$2.3 million impairment on the three residential mortgage obligations is recorded as a component of other comprehensive income at December 31, 2011.

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### Fair Value

Effective January 1, 2007, the Company adopted fair value option accounting standards choosing to apply the standards to its junior subordinated debt. The Company concurrently adopted the accounting standards related to fair value measurements. The accounting standards related to fair value measurements defines how applicable assets and liabilities are to be valued, and requires expanded disclosures about financial instruments carried at fair value. The fair value measurement accounting standard establishes a hierarchical disclosure framework associated with the level of pricing observability utilized in measuring financial instruments at fair value. The degree of judgment utilized in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Financial instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment utilized in measuring fair value. Conversely, financial instruments infrequently traded or not quoted in an active market will generally have little or no pricing observability and a higher degree of judgment utilized in measuring fair value. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. Determining fair values under the accounting standards may include judgments related to measurement factors that may vary from actual transactions executed in the marketplace. For the years ended December 31, 2011 and December 31, 2010, the Company recorded fair value gains related to its junior subordinated debt totaling \$1.9 million and \$316,000, respectively. (See Notes 8 and 13 of the Notes to Consolidated Financial Statements for additional information about financial instruments carried at fair value.)

### Goodwill

Business combinations involving the Company's acquisition of the equity interests or net assets of another enterprise or the assumption of net liabilities in an acquisition of branches constituting a business may give rise to goodwill. The acquisition of Taft National Bank during April 2004 gave rise to goodwill totaling approximately \$1.6 million, and the acquisition of Legacy Bank during February 2007 resulted in goodwill of approximately \$8.8 million. Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed in transactions accounted for under the purchase method of accounting. The value of goodwill is ultimately derived from the Company's ability to generate net earnings after the acquisition. A decline in net earnings could be indicative of a decline in the fair value of goodwill and result in impairment. For that reason, goodwill is assessed for impairment at a reporting unit level at least annually using an internal discounted cash flow model. During the years ended December 31, 2011 and 2010, the Company recognized goodwill impairment of \$1.5 million, and 1.4 million, respectively, on the goodwill associated with the 2007 Legacy acquisition. While the Company believes all assumptions utilized in its assessment of goodwill for impairment are reasonable and appropriate, changes in earnings, the effective tax rate, historical earnings multiples and the cost of capital could all cause different results for the calculation of the present value of future cash flows.

### Income Taxes

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred taxes are measured using current tax rates applied to such taxable income in the years in which those temporary differences are expected to be recovered. If the Company's future income is not sufficient to apply the deferred tax assets within the tax years to which they may be applied, the deferred tax asset may not be realized and the Company's income will be reduced. At December 31, 2011, the Company had recorded a valuation allowance of \$3.7 million against its deferred tax assets.

On January 1, 2007, the Company adopted the accounting standards related to uncertainty in income taxes. The standard prescribes a recognition threshold and measurement attribute for the financial statement recognition and

measurement of a tax position taken or expected to be taken in a tax return. Under the accounting standards, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. The term “more likely than not” means a likelihood of more than 50 percent.” In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority.

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The Company reviewed its various tax positions, including its ongoing REIT case with the California Franchise Tax Board (FTB), as of January 1, 2007 (adoption date), and then again each subsequent quarter during 2007 in light of the adoption of the accounting standards related to uncertainty in income taxes. The Bank, with guidance from advisors believes the case related to consent dividends taken by the Bank's REIT during 2002 has merit with regard to points of law, and that the tax law at the time allowed for the deduction of the consent dividend. However, the Bank, with the concurrence of advisors, cannot conclude that it is "more than likely" (as defined) that the Bank will prevail in its case with the FTB. As a result of this determination, effective January 1, 2007, the Company recorded a reduction of \$1,298,470 to beginning retained earnings upon adoption of the accounting standards related to uncertainty in income taxes to recognize the potential tax liability under the guidelines of the interpretation. The adjustment includes amounts for assessed taxes, penalties, and interest. It is the Company's policy to recognize interest and penalties under FIN48 as a component of income tax expense. At December 31, 2010, the accumulated unrecognized tax liability, including interest to date was \$1,669,000. During 2011, the Company continued to record accrued interest on the unrecognized liability, and then in October 2011, under the provisions of Franchise Tax Board Voluntary Compliance Initiative Program (VCI 2), the Company settled its case related to the REIT consent dividend. As a result, the Company had no FIN 48 reserve as of December 31, 2011.

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

### Revenue recognition

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

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

### Results of Operations

For the year ended December 31, 2011, the Company reported a net loss of \$10.8 million or \$0.80 per share (\$0.80 diluted) compared to a net loss of \$4.4 million or \$0.33 per share (\$0.33 diluted) for the year ended December 31, 2010. Net losses increased \$6.4 million between December 31, 2010 and December 31, 2011 as the result of decreases in interest income and increases in the provisions for credit losses taken during the year in addition to the recognized tax valuation allowance. Net losses decreased \$98,000 between December 31, 2009 and December 31, 2010 as the result of decreased provisions for credit losses, partially offset by increases in OREO impairment losses and regulatory assessments.

The Company's return on average assets was (1.64%) for the year ended December 31, 2011 as compared to (0.63%) for the year ended December 31, 2010. The Company's return on average equity was (15.86%) for the year ended December 31, 2011 as compared to (5.69%) for the year ended December 31, 2010.



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As with variances in net income, changes in the return on average assets and average equity experienced by the Company during 2011 and 2010 were primarily the result of fluctuations in loan loss provisions taken during the past two years, as well as changes in impairment losses and OREO-related expenses.

The following table sets forth certain selected financial data for the Bank for each of the years in the five-year periods ended December 31, 2011 and should be read in conjunction with the more detailed information and financial statements contained elsewhere herein (in thousands except per share data and ratios).

(in thousands except per share data and ratios)	2011	2010	2009	2008	2007
<b>Selected Financial Ratios:</b>					
Return on average assets	(1.64 %)	(0.63 %)	(0.62 %)	0.52 %	1.47 %
Return on average shareholders' equity	(15.86 %)	(5.67 %)	(5.77 %)	4.93 %	13.73 %
Average shareholders' equity to average assets	10.36 %	11.06 %	10.71 %	10.60 %	10.73 %
Dividend payout ratio	0.00 %	0.00 %	0.00 %	80.12 %	56.39 %

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## Net Interest Income

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

Net interest income before provision for credit losses totaled \$25.0 million for the year ended December 31, 2011 as compared to \$27.9 million for the year ended December 31, 2010. This represents a decrease of \$2.9 million or 10.5 % between the two years. The decrease in net interest income between 2010 and 2011, is primarily the result of decreased volumes of, and yields earned, on interest-earning assets, which more than offset the decreased yields on interest-bearing liabilities. Significant declines in the Company's cost of funds helped to mitigate declines in net interest income and minimized the decrease in the net margin between the two periods.

Table 1. – Distribution of Average Assets, Liabilities and Shareholders' Equity:  
Interest rates and interest differentials  
Years Ended December 31, 2011 and 2010

(Dollars in thousands)	2011			2010		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
<b>Assets:</b>						
<b>Interest-earning assets:</b>						
Loans (1)	\$ 424,961	\$ 25,573	6.02 %	\$ 490,421	\$ 29,502	6.02 %
Investment Securities – taxable	48,929	2,141	4.38 %	60,696	2,794	4.60 %
Investment Securities – nontaxable (2)	0	0	0.00 %	1,246	58	4.65 %
Interest on deposits in other banks	2,366	39	1.65 %	2,457	41	1.67 %
Interest on deposits in FRB	80,025	186	0.23 %	25,519	59	0.23 %
Federal funds sold and reverse repos	0	1	0.00 %	29,506	36	0.12 %
<b>Total interest-earning assets</b>	<b>556,281</b>	<b>\$ 27,940</b>	<b>5.02 %</b>	<b>609,845</b>	<b>\$ 32,490</b>	<b>5.33 %</b>
Allowance for credit losses	(15,021 )			(13,825 )		
<b>Noninterest-bearing assets:</b>						
Cash and due from banks	21,746			16,815		
	12,831			12,950		

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Premises and equipment, net									
Accrued interest receivable	1,790				2,105				
Other real estate owned	32,702				37,089				
Other assets	47,774				42,708				
Total average assets	\$ 658,103				\$ 707,687				
Liabilities and Shareholders' Equity:									
Interest-bearing liabilities:									
NOW accounts	\$ 47,825	\$ 86	0.18	%	\$ 62,779	\$ 128	0.20	%	
Money market accounts	123,312	1,014	0.82	%	115,752	1,434	1.24	%	
Savings accounts	39,174	133	0.34	%	35,336	139	0.39	%	
Time deposits	162,910	1,387	0.85	%	231,876	2,516	1.09	%	
Other borrowings	22,014	101	0.46	%	35,181	124	0.35	%	
Trust Preferred securities	9,941	243	2.44	%	10,172	248	2.44	%	
Total interest-bearing liabilities	405,176	\$ 2,964	0.73	%	491,096	\$ 4,589	0.93	%	
Noninterest-bearing liabilities:									
Noninterest-bearing	179,239				133,458				
Accrued interest payable	196				318				
Other liabilities	5,304				4,556				
Total average liabilities	589,915				629,428				
Total average shareholders' equity	68,189				78,259				
Total average liabilities and Shareholders' equity	\$ 658,104				\$ 707,687				
Interest income as a percentage of average earning assets			5.02	%			5.33	%	
Interest expense as a percentage of average earning assets			0.53	%			0.75	%	
Net interest margin			4.49	%			4.58	%	



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- (1) Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan fees of approximately \$696,000, and \$1,165,000 for the years ended December 31, 2011 and 2010, respectively.
- (2) Applicable nontaxable securities yields have not been calculated on a tax-equivalent basis because they are not material to the Company's results of operations.

The Bank's year-to-date net interest margin, as shown in Table 1, decreased to 4.49% at December 31, 2011 from 4.58% at December 31, 2010, a decrease of 9 basis points (100 basis points = 1%) between the two periods.

The prime rate averaged 3.25% for the years ended December 31, 2011 and 2010.

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

Table 2. Rate and Volume Analysis

(In thousands)	2011 compared to 2010			2010 compared to 2009		
	Total	Rate	Volume	Total	Rate	Volume
Increase (decrease) in interest income:						
Loans	\$ (3,929 )	\$ 10	(3,939 )	\$ (1,695 )	\$ 954	\$ (2,649 )
Investment securities	(711 )	(136 )	(575 )	(1,504 )	(445 )	(1,059 )
Interest-bearing deposits in other banks	(1 )	1	(2 )	(76 )	(27 )	(49 )
Interest-bearing deposits in FRB	127	0	127	56	(21 )	77
Federal funds sold and securities purchased under agreements to resell	(35 )	37	(72 )	33	2	31
Total interest income	(4,549 )	(88 )	(4,461 )	\$ (3,186 )	463	(3,649 )
Increase (decrease) in interest expense:						
Interest-bearing demand accounts	(462 )	(437 )	(25 )	(828 )	(1,056 )	228

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Savings accounts	(6 )	(22 )	16	(80 )	(81 )	1
Time deposits	(1,129 )	(408 )	(721 )	(1,067 )	(1,487 )	420
Other						
borrowings	(23 )	35	(58 )	(680 )	(316 )	(364 )
Trust Preferred securities	(5 )	4	(9 )	(83 )	(43 )	(40 )
Total interest expense	(1,625 )	(828 )	(797 )	(2,738 )	(2,983 )	245
Increase (decrease) in net interest income	\$ (2,924 )	\$ 1,952	(4,876 )	\$ (448 )	\$ 3,446	\$ (3,894 )

Total interest income decreased approximately \$4.5 million, or 14.0% between the years ended December 31, 2010 and 2011, as the result of declines in the volume of averaging earning assets between the two periods. Earning asset volumes decreased in all earning-asset categories except federal funds sold and interest bearing deposits with the FRB between the two periods, with the largest decrease experienced in loans. On average, loans decreased by approximately \$65.5 million between 2010 and 2011 as the Company continued to focus on the work-out of problem assets. The Company continues to maintain a high percentage of loans in its earning asset mix with loans averaging 76.4% of total earning assets for the year ended December 31, 2011, as compared to 80.4% for the year ended December 31, 2010.

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Total interest expense decreased approximately \$1.6 million, or 35.4% between the years ended December 31, 2010 and 2011, and is attributable to significant declines in the average rates paid on interest-bearing liabilities. Between those two periods, average interest-bearing liabilities decreased by \$85.9 million, and the average rates paid on these liabilities decreased by 20 basis points. Average rates decreased in all interest-bearing liabilities except other borrowings and junior subordinated debentures, and higher-cost time deposits decreased on average between the periods.

## Provision for Credit Losses

Provisions for credit losses and the amount added to the allowance for credit losses is determined on the basis of management's continuous credit review of the loan portfolio, consideration of past loan loss experience, current and future economic conditions, and other pertinent factors. Such factors consider the allowance for credit losses to be adequate when it covers estimated losses inherent in the loan portfolio. Based on the condition of the loan portfolio, management believes the allowance is sufficient to cover risk elements in the loan portfolio. For the year ended December 31, 2011 the provision to the allowance for credit losses amounted to \$13.6 million as compared to \$12.5 million for the year ended December 31, 2010.

During 2011, increases in the provision to the allowance for credit losses included large provisions during the third quarter of the year as prolonged weakness in the economy contributed to the further devaluation of real estate in the Company's portfolio. A provision of \$9.2 million was made in the third quarter of 2011.

Provisions to the allowance for credit losses during 2010 included large provisions during the fourth quarters of the year as additional problem loans and further deterioration in existing problem loans were identified during the fourth quarter of 2010. The Company's review of adequacy of the allowance for loans losses during the fourth quarter included reassessments of the economic improvements seen during the first half of the year which appeared to slow or stall during the third and fourth quarters of 2010 due in part to the prolonged nature of the economic downturn. The Company has determined in working with its bank regulators that many of its loans required a more adverse classification and a greater provision for loan losses than had been taken in prior comparable periods.

The amount provided to the allowance for credit losses during 2011 brought the allowance to 3.34% of net outstanding loan balances at December 31, 2011, as compared to 3.75% of net outstanding loan balances at December 31, 2010.

## Noninterest Income

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

(In thousands)	2011	2010	Change
Customer service fees	\$ 3,640	\$ 3,812	\$ (172 )
Increase in cash surrender value of BOLI	565	554	11
Gain (loss) on disposition of securities	11	68	(57 )
(Loss) gain on sale of OREO	(231 )	(85 )	(146 )
Gain on sale of assets	0	0	0
Gain on sale of loans	0	509	(509 )
Proceeds from life insurance	0	174	(174 )
Gain (loss) on swap ineffectiveness	0	0	0
Gain on fair value option of financial liabilities	1,863	316	1,547
(Loss) gain on sale of fixed assets	0	(11 )	11

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Shared appreciation income	0	0	0
Other	1,029	602	427
Total	\$ 6,877	\$ 5,939	\$ 938

Noninterest income consists primarily of fees and commissions earned on services that are provided to the Company's banking customers and, to a lesser extent, gains on sales of Company assets and other miscellaneous income. Noninterest income for the year ended December 31, 2011 increased \$938,000 or 15.8% when compared to the previous year.

Customer service fees continue to provide a substantial part of noninterest income over the two years presented, representing 52.9%, 64.2% of total noninterest income for the years ended December 31, 2011 and 2010, respectively. Customer service fees decreased \$172,000 between the years ended December 31, 2011 and December 31, 2010. Much of the decrease in customer service fees between is attributable to decreases in non sufficient funds charges.



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The primary driver in the increase in noninterest income for the year ended, December 31, 2011 was the recognition of a gain on the fair value of its junior subordinated debt totaling \$1.9 million.

During the year ended December 31, 2010, the Company realized gains on the sale of loans totaling \$509,000 as the result of the sale of two \$17.1 million purchase real estate mortgage portfolios, as well as \$174,000 from insurance proceeds on an insurance policy held as collateral on a previously charged-off loan. Additionally, the Company also saw reductions of \$708,000 in losses on the disposition of OREO properties during the year ended December 31, 2010 as compared to the previous year.

## Noninterest Expense

The following table sets forth the components of total noninterest expense in dollars and as a percentage of average earning assets for the years ended December 31, 2011 and 2010:

(Dollars in thousands)	2011			2010		
	Amount	% of Average Earning Assets		Amount	% of Average Earning Assets	
Salaries and employee benefits	\$ 9,109	1.64	%	\$ 8,949	1.47	%
Occupancy expense	3,487	0.63	%	3,789	0.62	%
Data processing	92	0.02	%	85	0.01	%
Professional fees	2,355	0.42	%	2,081	0.34	%
FDIC/DFI assessments	2,082	0.37	%	2,546	0.42	%
Directors fees	230	0.04	%	232	0.04	%
Amortization of intangibles	620	0.11	%	769	0.13	%
Correspondent bank service charges	302	0.05	%	315	0.05	%
Writedown on investment	1	0.00	%	355	0.06	%
Impairment loss on OREO	3,856	0.69	%	2,831	0.46	%
Impairment loss on intangible assets	36	0.01	%	57	0.01	%
Impairment loss on Goodwill	1,489	0.27	%	1,414	0.23	%
Impairment loss on investment securities	912	0.16	%	1,253	0.21	%
Loss on CA Tax Credit Partnership	418	0.08	%	424	0.07	%
OREO expense	3,503	0.63	%	1,532	0.25	%
Other	2,286	0.41	%	2,388	0.39	%
<b>Total</b>	<b>30,778</b>	<b>5.53</b>	<b>%</b>	<b>\$ 29,020</b>	<b>4.76</b>	<b>%</b>

Noninterest expense, excluding provision for credit losses and income tax expense, totaled \$30.8 million for the year ended December 31, 2011 as compared to \$29.0 million for the year ended December 31, 2010. These figures represent an increase of \$1.8 million or 6.1% between the years ended December 31, 2010 and 2011. As a percentage of average earning assets, total noninterest expense has increased over the past two years primarily as the result of increases in impairment losses on OREO and other OREO related expenses. Noninterest expense amounted to 5.53% of average earning assets for the year ended December 31, 2011 as compared to 4.76% at December 31, 2010.

The increase in noninterest expense between the years ended December 31, 2010 and December 31, 2011 is primarily due to lingering devaluation of real estate during the year, evidenced by the increase of \$1.0 million in OREO impairment losses and an increase of \$2.0 million in OREO expenses. These increases were offset by a decrease of \$341,000 in impairment losses on investment securities, a decrease of \$464,000 in regulatory assessments, and a

decrease in write downs on other investments of \$355,000.

Increases in noninterest expense between the years ended December 31, 2009 and December 31, 2010 include impairment losses of \$2.8 million on OREO, other-than-temporary impairment losses of \$1.3 million on investment securities, and impairment losses of \$1.4 million on goodwill. During the year ended December 31, 2010, the Company recognized a write-down on an equity investment in bank stock totaling \$355,000 as a result of continued deterioration in the economic condition of the company, reflected in a stock price that continued to decline over later half of the year. FDIC insurance assessments increased \$1.4 million during 2010 reflecting both the financial condition of the Bank and a general increase in insurance assessment rates within the industry.

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During the years ended December 31, 2011, and 2010, the Company recognized stock-based compensation expense of \$18,000 (less than \$0.01 per share basic and diluted) and \$41,000 (less than \$0.01 per share basic and diluted), respectively. This expense is included in noninterest expense under salaries and employee benefits. Under the current pool of stock options, the Company expects stock-based compensation expense to be about \$2,500 per quarter for 2012, about \$1,500 per quarter for 2013 and decline after that through 2015. If new stock options are issued, or existing options fail to vest due, for example, to forfeiture, actual stock-based compensation expense in future periods will change.

## Income Taxes

The Company's income tax expense is impacted to some degree by permanent taxable differences between income reported for book purposes and income reported for tax purposes, as well as certain tax credits which are not reflected in the Company's pretax income or loss shown in the statements of operations and comprehensive income. As pretax income or loss amounts become smaller, the impact of these differences become more significant and are reflected as variances in the Company's effective tax rate for the periods presented. In general, the permanent differences and tax credits affecting tax expense have a positive impact and tend to reduce the effective tax rates shown in the Company's statements of operations and comprehensive income.

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

During the second quarter of 2006, the FTB issued the Company a letter of proposed adjustments to, and assessments for, (as a result of examination of the tax years 2001 and 2002) certain tax benefits taken by the Bank's subsidiary REIT during 2002. Since 2007, the Company had asserted its administrative protest and appeal rights on the REIT issue and accrued its potential liability. During 2011, the Company, under the provisions of Franchise Tax Board Voluntary Compliance Initiative Program (VCI 2), settled its case for a total liability of \$1.7 million..

The Company has reviewed all of its tax positions as of December 31, 2011, and has determined that, there are no material amounts that should be recorded under the current income tax accounting guidelines.

## Financial Condition

Total assets decreased by \$26.9 million or 4.0% during the year to \$651.3 million at December 31, 2011, and decreased \$41.9 million or 6.0% from the balance of \$693.2 million at December 31, 2009. During the year ended December 31, 2011, decreases of \$30.1 million were experienced in net loans as construction and real estate lending continued to slow and approximately \$2.8 million in problem loans were transferred to OREO, while another \$17.3 million was charged off against the allowance for loan losses. Overnight interest-bearing deposits in the Federal Reserve Bank, and federal funds sold, increased a net \$11.0 million, while investment securities decreased by \$13.0 million during the year ended December 31, 2011. Total deposits of \$574.4 million at December 31, 2011 increased \$17.0 million or 3.0% from the balance reported at December 31, 2010, a \$12.8 million or 2.3% increase from the balance of \$561.7 million reported at December 31, 2009. Declines of \$40.6 million in brokered time deposits were partially offset by growth in NOW, money market, and other interest-bearing deposit accounts. Decreases in brokered time deposits during 2011 are the result of the Company's plan to reduce its dependence on brokered deposits and other wholesale funding sources.

During the year ended December 31, 2010, decreases of \$68.2 million were experienced in net loans as construction and real estate lending continued to slow and approximately \$14.2 million in problem loans were transferred to OREO, while another \$11.9 million was charged off against the allowance for loan losses. Overnight interest-bearing deposits in the Federal Reserve Bank, and federal funds sold, increased a net \$70.9 million, while investment securities decreased by \$19.9 million during the year ended December 31, 2010. Total deposits of \$557.5 million at December 31, 2010 decreased \$4.2 million or 0.8% from the balance reported at December 31, 2009, but increased \$49.0 million or 9.6% from the balance of \$508.5 million reported at December 31, 2008. Declines of \$47.8 million in brokered time deposits were partially offset by growth in NOW, money market, and other interest-bearing deposit accounts. Decreases in brokered time deposits during 2010 are the result of the Company's plan to reduce its dependence on brokered deposits and other wholesale funding sources.

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Earning assets averaged approximately \$556.3 million during the year ended December 31, 2010, as compared to \$609.8 million for the year ended December 31, 2010. Average interest-bearing liabilities decreased to \$405.2 million for the year ended December 31, 2011, as compared to \$491.18 million for the year ended December 31, 2010.

## Loans

The Company's primary business is that of acquiring deposits and making loans, with the loan portfolio representing the largest and most important component of its earning assets. Loans totaled \$408.7 million at December 31, 2011, representing a decrease of \$33.0 million or 7.5% when compared to the balance of \$441.7 million at December 31, 2010. During 2011 average loans decreased 13.4% when compared to the year ended December 31, 2010. Average loans totaled \$490.4 million, \$534.8 million, and \$582.5 million for the years ended December 31, 2010, 2009 and 2008, respectively.

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

(In thousands)	2011		2010		2009		2008		2007	
	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans
Commercial and industrial	\$166,426	40.7 %	\$159,224	36.0 %	\$167,930	33.0 %	\$188,207	34.6 %	\$188,826	31.9 %
Real estate – mortgage	144,747	35.4 %	157,781	35.7	165,629	32.6	130,856	24.0	135,252	22.8
RE construction & development	50,400	12.3 %	65,182	14.8	105,220	20.7	151,091	27.7	200,836	33.8
Agricultural	35,811	8.8 %	46,308	10.5	50,897	10.0	52,020	9.6	46,387	7.8
Installment/other	11,282	2.8 %	12,891	2.9	18,191	3.6	20,782	3.8	18,171	3.1
Lease financing	49	0.0 %	305	0.1	706	0.1	1,595	0.3	3,323	0.6
<b>Total Loans</b>	<b>\$408,715</b>	<b>100.0%</b>	<b>\$441,691</b>	<b>100.0%</b>	<b>\$508,573</b>	<b>100.0%</b>	<b>\$544,551</b>	<b>100.0%</b>	<b>\$592,795</b>	<b>100.0%</b>

Loan volume continues to be greatest in what has historically been the Bank's primary lending emphasis: commercial, real estate mortgage, and construction lending. With the continued deterioration of real estate markets that began in 2008, the Company experienced decreases in all loan categories, except commercial and industrial during 2011, with a decrease of \$14.8 million or 22.7 % in construction loans, a decrease of 13.0 million or 8.3 % in real estate mortgage loans, a decrease of \$10.5 million or 22.7% in agricultural loans and a decrease of \$1.6 million or 12.5 % in installment loans. Lease financing also experienced moderate decreases, as the Company is no longer originating commercial leases. Approximately \$2.8 million of the total \$33.0 million decrease in loans experienced during the year ended December 31, 2011, was the result of nonperforming loans transferred to other real estate owned when all other means of settlement were exhausted.

During 2010, the company experienced decreases in all loan categories: a decrease of \$40.0 million or 38.1 % in construction loans, a decrease of \$8.7 million or 5.8% in commercial and industrial loans, and a decrease of 7.8 million or 4.7 % in real estate mortgage loans. Modest decreases were also experienced in agricultural loans and installment loans. Lease financing decreased \$401,000. Approximately \$14.2 million of the total \$66.9 million decrease in loans experienced during the year ended December 31, 2010, was the result of nonperforming loans transferred to other real estate owned when all other means of settlement were exhausted.

At December 31, 2011, approximately 66% of commercial and industrial loans have floating rates and, although some may be secured by real estate, many are secured by accounts receivable, inventory, and other business assets.

Residential housing markets remained depressed through 2010 and 2011, and as a result, residential construction loans decreased during 2010, and again during 2011. Real estate construction loans decreased \$14.8 million or 22.7% during 2011, as compared to a decrease of \$40.0 million or 38.1% during 2010. Construction loans are generally short-term, floating-rate obligations, which consist of both residential and commercial projects. Agricultural loans consisting of mostly short-term, floating rate loans for crop financing, decreased \$10.5 million or 22.7% between December 31, 2010 and December 31, 2011, while installment loans decreased \$1.6 million or 12.5% during that same period.

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The real estate mortgage loan portfolio totaling \$144.7 million at December 31, 2011 consists of commercial real estate, residential mortgages, and home equity loans. Commercial real estate is the core of this segment of the portfolio, with balances of \$118.9 million, and \$131.6 million at December 31, 2011 and 2010, respectively. Commercial real estate loans are generally a mix of short to medium-term, fixed and floating rate instruments and, are mainly tied to commercial income and multi-family residential properties. The Company does not currently offer traditional residential mortgage loans, but may purchase mortgage portfolios. The residential real estate mortgage portfolio had balances of \$24.0 million and \$23.8 million at December 31, 2011 and 2010, respectively. The Company also offers short to medium-term, fixed-rate, home equity loans, which totaled \$1.9 million at December 31, 2011 and \$2.4 million at December 31, 2010.

The following table sets forth the maturities of the Bank's loan portfolio at December 31, 2011. Amounts presented are shown by maturity dates rather than repricing periods:

(In thousands)	Due in one year or less	Due after one Year through Five years	Due after Five years	Total
Commercial and agricultural	\$ 108,738	\$ 79,013	\$ 14,632	\$ 202,283
Real estate construction & development	25,033	24,367	0	50,400
	139,761	114,714	16,239	270,714
Real estate – mortgage	28,816	97,278	17,536	143,630
All other loans	4,460	5,669	2,173	12,302
Total Loans	\$ 168,047	\$ 206,327	\$ 34,340	\$ 408,715

For the year ended December 31, 2011 and 2010, the average yield on loans was 6.02%. This consistent yield was due in part to the Company utilizing rate floors intended to mitigate interest rate risk as interest rates fall, as well as to compensate the Company for additional credit risk under current market conditions. The Bank's loan portfolio is generally comprised of short-term or floating rate loans and is therefore susceptible to fluctuations in market rates of interest.

At December 31, 2011 and 2010, approximately 49.9% and 57.6% of the Bank's loan portfolio consisted of floating rate instruments, with the majority of those tied to the prime rate.

The following table sets forth the contractual maturities of the Bank's fixed and floating rate loans at December 31, 2011. Amounts presented are shown by maturity dates rather than repricing periods, and do not consider renewals or prepayments of loans:

(In thousands)	Due in one year or less	Due after one Year through Five years	Due after Five years	Total
Accruing loans:				
Fixed rate loans	\$ 19,331	\$ 147,876	\$ 29,813	\$ 197,020
Floating rate loans	135,369	54,275	3,953	193,597
Total accruing loans	154,700	202,151	33,766	390,617
Nonaccrual loans:				
Fixed rate loans	3,886	4,062	1,085	9,033
Floating rate loans	8,495	570	0	9,065
Total nonaccrual loans	12,381	4,632	1,085	18,098
Total Loans	\$ 167,081	\$ 206,783	\$ 34,851	\$ 408,715

Securities

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

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(In thousands)	December 31, 2011				December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
Available-for-sale:								
U.S. Government agencies	\$ 23,680	\$ 1,377	\$ (7 )	\$ 25,051	\$ 32,486	\$ 1,303	\$ (1 )	\$ 33,788
U.S Gov't agency collateralized mortgage obligations	5,010	425	0	5,435	7,203	552	0	7,755
Residential mortgage obligations	10,238	0	(2,265 )	7,972	11,955	0	(1,995 )	9,960
Total available-for-sale	\$ 38,928	\$ 1,802	\$ (2,272 )	\$ 38,458	\$ 51,644	\$ 1,855	\$ (1,996 )	\$ 51,503

The contractual maturities of investment securities as well as yields based on amortized cost of those securities at December 31, 2011 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	One year or less		After one year to five years		After five years to ten years		After ten years		Total	
	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)
Available-for-sale:										
U.S. Government agencies	\$1,515	1.75 %	\$8,133	1.47 %	\$4,641	5.07 %	\$10,762	4.80 %	\$25,051	3.58 %
U.S. Gov't agency collateralized mortgage obligations	---	---	---	---	5,435	4.50 %	---	---	5,435	4.50 %
Residential mortgage obligations	---	---	---	---	---	---	7,972	6.25 %	7,972	6.25 %
Total estimated fair value	\$1,515	1.75 %	\$8,133	1.47 %	\$10,076	4.76 %	\$18,734	5.41 %	\$38,458	4.27 %
(1)	Weighted average yields are not computed on a tax equivalent basis									

At December 31, 2011 and 2010, available-for-sale securities with an amortized cost of approximately \$17.0 million and \$46.7 million, respectively (fair value of \$17.8 million and \$47.2 million, respectively) were pledged as collateral for public funds and FHLB borrowings.

Deposits

The Bank attracts commercial deposits primarily from local businesses and professionals, as well as retail checking accounts, savings accounts and time deposits. Total deposits increased \$17.0 million or 3.0% during the year to a

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balance of \$574.4 million at December 31, 2011. Core deposits, consisting of all deposits other than time deposits of \$100,000 or more and brokered deposits, continue to provide the foundation for the Bank's principal sources of funding and liquidity. These core deposits amounted to 84.2% and 71.5%, of the total deposit portfolio at December 31, 2011 and 2010.

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

(In thousands)	2011	December 31, 2010	2009	Change during Year 2011	2010
Noninterest-bearing deposits	\$ 224,907	\$ 139,690	\$ 139,724	\$ 85,217	\$ (34 )
Interest-bearing deposits:					
NOW and money market accounts	165,937	181,061	158,795	(15,124 )	22,266
Savings accounts	40,099	37,177	34,146	2,922	3,031
Time deposits:					
Under \$100,000	53,271	58,629	64,481	(5,358 )	(5,852 )
\$100,000 and over	90,213	140,909	164,514	(50,696 )	(23,605 )
Total interest-bearing deposits	349,520	417,776	421,936	(68,256 )	(4,160 )
Total deposits	\$ 574,427	\$ 557,466	\$ 561,660	\$ 16,9601	\$ (4,194 )

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As a result of the March 2010 agreement with the Federal Reserve Bank, the Company will continue 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 will systematically reduce the level of brokered deposits to peer levels (as percentage of total deposits) over a period of approximately two years. This will be achieved by letting some or all of the maturing brokered deposits run-off as needed to achieve planned reductions in brokered deposits at the end of each quarter over the two-year period.

During the year ended December 31, 2011, an increase in non-interest bearing deposits of \$85.2 million and an increase in savings accounts of 2.9 million or 7.9% more than off-set decreases in NOW and money market accounts of \$15.1 million, or 8.4%, decreases in time deposits under \$100,000 of \$5.4 million, or 9.1%, and decreases in time deposits of \$100,000 or more of \$50.7 million or 36.0%, during the year ended December 31, 2010. \$40.6 million of the decrease in time deposits of \$100,000 or more is attributable to decreases in brokered deposits.

During the year ended December 31, 2010, decreases were experienced primarily 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 \$29.5 million or 12.9% during the year ended December 31, 2010, brokered deposits, a component of total time deposits, decreased \$47.8 million or 37.0% during the year. NOW and money market accounts increased \$22.3 million or 14.0% while savings accounts increased \$3.0 million or 8.9% during the year ended December 31, 2010. Pricing of brokered time deposits and other wholesale deposits have remained low over the past two years and have provided a viable alternate to borrowings from the Federal Reserve or the FHLB. The Company believes this rate structure will eventually turn, and wholesale funding sources, both deposits and borrowings, will again become 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 requires 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, and savings accounts, as well as noninterest-bearing checking accounts, continue to provide the Company's primary funding source.

The Company's deposit base consists of two major components represented by noninterest-bearing (demand) deposits and interest-bearing deposits. Interest-bearing deposits consist of time certificates, NOW and money market accounts and savings deposits. Total noninterest-bearing deposits increased \$85.2 million or 61.0% between December 31, 2010 and December 31, 2011, while interest-bearing deposits decreased \$68.3 million or 16.4% during the same period. Between December 31, 2009 and December 31, 2010, total interest-bearing deposits decreased \$4.2 million or -1.0%, while noninterest-bearing deposits decreased \$34,000 less than 0.1%.

On a year-to-date average basis, total deposits decreased \$26.4 million or 4.6% between the years ended December 31, 2010 and December 31, 2011. Of that total, interest-bearing deposits decreased by \$72.5 million or 16.3%, while noninterest-bearing deposits increased \$43.8 million or 32.8% during 2011. On average, the Company experienced decreases in NOW accounts and time deposits, while money market and savings accounts increased between the years ended December 31, 2010 and December 31, 2011. On a year-to-date average, the Company experienced an increase of \$42.1 million or 7.8 % in total deposits between the years ended December 31, 2009 and December 31, 2010. Between these two periods, average interest-bearing deposits increased \$43.5 million or 10.8%, while total noninterest-bearing checking decreased \$1.58 million or -1.1% on a year-to-date average basis. On average, the Company experienced increases in NOW accounts, savings accounts, and time deposits between the years ended December 31, 2009 and December 31, 2010, while money market accounts experienced only minor declines on average during 2010.

The following table sets forth the average deposits and average rates paid on those deposits for the years ended December 31, 2011, 2010 and 2009:

(Dollars in thousands)	2011		2010		2009	
	Average Balance	Rate %	Average Balance	Rate %	Average Balance	Rate %
Interest-bearing deposits:						
Checking accounts	171,137	0.64 %	\$ 178,531	0.87 %	\$ 161,711	1.48 %
Savings	39,174	0.34 %	35,336	0.39 %	35,228	0.62 %
Time deposits (1)	162,910	0.85 %	231,876	1.09 %	205,261	1.75 %
Noninterest-bearing deposits	179,239		133,458		134,925	

(1) Included at December 31, 2010, are \$140.9 million in time certificates of deposit of \$100,000 or more, of which \$86.4 million matures in three months or less, \$31.2 million matures in 3 to 6 months, \$11.7 million matures in 6 to 12 months, and \$11.6 million matures in more than 12 months.

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## Short-term Borrowings

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

The Company had collateralized and uncollateralized lines of credit aggregating \$232.5 million and \$118.7 million, as well as FHLB lines of credit totaling \$17.6 million and \$32.6 million at December 31, 2011 and 2010, respectively. At December 31, 2011, the Company had no outstanding balances drawn against its FHLB line of credit. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR.

The table below provides further detail of the Company’s federal funds purchased, repurchase agreements and FHLB advances for the years ended December 31, 2011, 2010 and 2009:

(Dollars in thousands)	2011	December 31,		2009
		2010		
At period end:				
Federal funds purchased	\$ 0	\$ 0		\$ 0
Repurchase agreements	0	0		0
FHLB advances	0	32,000		40,000
Total at period end	\$ 0	\$ 32,000		\$ 40,000
Average ending interest rate – total	0 %	0.35 %		0.86 %
Average for the year:				
Federal funds purchased	\$ 0	\$ 17		\$ 40,443
Repurchase agreements	0	0		0
FHLB advances	22,014	35,164		59,434
Total average for the year	\$ 22,014	\$ 35,181		\$ 99,877
Average interest rate – total	0.46 %	0.69 %		0.80 %
Maximum total borrowings outstanding at Any month-end during the year:				
Federal funds purchased	\$ 0	\$ 0		\$ 87,530
FHLB advances	32,000	39,000		73,700
Total	\$ 32,000	\$ 39,000		\$ 161,230

## 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. Implicit in lending activities is the fact that losses will be experienced and that the amount of such losses will vary from time to time, depending on the risk characteristics of the loan portfolio as affected by local economic conditions and the financial experience of borrowers.

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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 collectibility of loans and commitments to extend credit; including current economic conditions, past credit experience, collateral, and concentrations of credit. There is no precise method of predicting specific losses or amounts which may ultimately be charged off on particular segments of the loan portfolio. The collectibility of a loan is subjective to some degree, but must relate to the borrower's financial condition, cash flow, quality of the borrower's management expertise, collateral and guarantees, and the state of the local economy. When determining the adequacy of the allowance for credit losses, the Company follows, in accordance with GAAP, the guidelines set forth in the Interagency Policy Statement on the Allowance for Loan and Lease Losses ("Statement") issued jointly by banking regulators during 2003, and updated and revised in 2006. The Statement 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. Securities and Exchange Commission Staff Accounting Bulletin No. 102 was also released at this time which 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.

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 to 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 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 eleven segments of the Company's loan portfolio are as follows (subtotals are provided as needed to allow the reader to reconcile the amounts to the Company's loan classification reported elsewhere in these financial statements):



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Loan Segments for Loan Loss Reserve Analysis (dollars in 000's)		Loan Balances at December 31,				
		2011	2010	2009	2008	2007
1	Commercial and Business Loans	\$ 163,442	\$ 154,624	\$ 161,292	\$ 180,750	\$ 181,123
2	Government Program Loans	2,984	4,600	6,638	7,457	7,703
	Total Commercial and Industrial	166,426	159,224	167,930	188,207	188,826
3	Commercial Real Estate Term Loans	118,857	131,632	117,010	86,007	95,085
4	Single Family Residential Loans	24,031	23,764	45,828	41,608	37,195
5	Home Improvement/Home Equity Loans	1,859	2,385	2,791	3,241	2,972
	Total Real Estate Mortgage	144,747	157,781	165,629	130,856	135,252
6	Total RE Construction and Development Loans	50,400	65,182	105,220	151,091	200,836
7	Total Agricultural Loans	35,811	46,308	50,897	52,020	46,387
8	Consumer Loans	11,073	12,462	17,939	20,370	17,521
9	Overdraft protection Lines	85	74	73	80	85
10	Overdrafts	124	355	179	332	565
	Total Installment/other	11,282	12,891	18,191	20,782	18,171
11	Total Lease Financing	49	305	706	1,595	3,323
	Total Loans	\$ 408,715	\$ 441,691	\$ 508,573	\$ 544,551	\$ 592,795

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 impaired
- and the unallocated allowance

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

portfolio as of the evaluation date. Factors that may affect collectibility of the loan portfolio include:

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

Management determines the loss factors for problem-graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates loan losses over the past twelve quarters (three 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. The twelfth quarter loss factor is compared to the 4th and 8th quarter loss factors and the average loss factor for the 12 quarters. The model may be more heavily weighted on the most current periods if those periods are more indicative of future trends because losses are accelerating in the shorter term. Based on an analysis of the information, current economic conditions and current and historical loss trends for the Bank, the existing net loss factors, prior to qualitative adjustment, are adjusted to recognize and quantify the loss exposure from changes in loss histories 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 homogenous in nature and are therefore pooled by risk grade. These homogenous 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 loans categorized as substandard, doubtful, and loss. At December 31, 2011, problem graded or "classified" loans totaled \$55.6 million or 13.6% of gross loans, as compared to \$53.6 million or 12.1% of gross loans at December 31, 2010.

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

The formula allowance includes reserves for certain off-balance sheet risks including letters of credit, unfunded loan commitments, and lines of credit. Reserves for undisbursed commitments are generally formula allocations based on the Company's historical loss experience and other loss factors, rather than specific loss contingencies. At December 31, 2011 and 2010, the formula reserve allocated to undisbursed commitments totaled \$174,000 and \$189,000, respectively. The reserve for unfunded commitments is considered a reserve for contingent liabilities and is therefore carried as a liability on the balance sheet for all periods presented.

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in impaired loans. 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, specific allowances, where required, 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 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 the result of both expected and unanticipated changes in various conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations, and other business conditions.

The following table summarizes the specific allowance, formula allowance, and unallocated allowance at December 31, 2011, 2010 and 2009.

(in 000's)	Balance December 31, 2011	Balance December 31, 2010	Balance December 31, 2009
Specific allowance – impaired loans	\$ 1,254	\$ 11,326	\$ 7,974
Formula allowance – classified loans not impaired	4,049	394	1,979
Formula allowance – special mention loans	450	493	587
Total allowance for special mention and classified loans	5,753	12,213	10,540
Formula allowance for pass loans	7,654	4,281	4,476
Unallocated allowance	241	26	0
Total allowance	\$ 13,648	\$ 16,520	\$ 15,016
Impaired loans	\$ 31,882	\$ 50,998	\$ 53,794
Classified loans not considered impaired	12,120	2,585	15,816
Total classified loans	\$ 44,002	\$ 53,583	\$ 69,610
Special mention loans	\$ 11,603	\$ 24,645	\$ 27,939

Although the total loan portfolio has declined over the past three years from \$507.7 million at December 31, 2009, to \$441.0 million at December 31, 2010, and to \$408.7 million at December 31, 2011, the level of nonperforming loans has

remained high but declined from \$46.9 million at December 31, 2010 to \$30.0 million at December 31, 2011. During the same period, total classified loans increased from \$53.6 million at December 31, 2010 to \$55.6 million at December 31, 2011.

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	December 31, 2011	December 31, 2010	December 31, 2009
Allowance for loan losses - period end	\$ 13,648	\$ 16,520	\$ 15,016
Net loans charged off during period	(16,474 )	(10,971 )	(9,888 )
LLR Provision during period	13,602	12,475	13,375
Loans outstanding at period-end	\$ 408,714	\$ 441,046	\$ 507,709
ALLL as % of loans at period-end	3.34 %	3.75 %	2.96 %
Nonaccrual loans	\$ 18,098	\$ 34,394	\$ 34,757
Restructured Loans	11,885	12,554	16,026
Total nonperforming loans	29,983	46,948	50,873
ALLL as % of nonperforming loans	45.52 %	35.19 %	29.57 %
Impaired loans	\$ 31,837	\$ 50,998	\$ 53,794
Classified loans not considered impaired	23,723	2,585	15,816
Total classified loans	\$ 55,560	\$ 53,583	\$ 69,610
ALLL as % of classified loans	24.56 %	30.83 %	21.57 %

Impaired loans decreased approximately \$19.2 million between December 31, 2010 and December 31, 2011. As a result, the specific allowance related to impaired loans decreased \$10.1 million for the year ended December 31, 2011 and the formula allowance related to loans that are not impaired (including pass, special mention and substandard loans) increased approximately \$6.9 million between December 31, 2010 and December 31, 2011.

Decreases in the formula allowance for the year ended December 31, 2010 were the result of decreases in the volume of loans in those categories, which were only partially offset by increases in adjusting factors for current economic trends and conditions, and trends in delinquent and nonaccrual loans. The level of "pass" loans decreased approximately \$46.6 million during the year ended December 31, 2010, and the related formula allowance decreased \$195,000 for 2010 as a result of the volume decrease which more than offset increases in percentage loss allocations, as well as factor allocation increases due to current economic conditions.

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 probable 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. They 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 concentration, and 10) other business conditions. There were no changes in estimation methods or assumptions during 2011 that affected the methodology for assessing the overall adequacy of the allowance for credit losses.

Management and the Company's lending officers evaluate the loss exposure of classified and impaired loans on a weekly and 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 Criticized Asset Reports, which are reviewed by senior management. With this information, the migration analysis and the impaired loan analysis are performed on a quarterly basis and adjustments are made to the allowance as deemed necessary. As the real estate market and economic crisis became more severe beginning during the later part of 2008, the Company has successfully worked with many of its borrowers to re-margin loans as collateral values declined, weakening the Company's credit position and increasing the potential for losses. This process of working with potentially troubled borrowers is monitored closely through the loan review process.

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The specific allowance for impaired loans is measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. The amount of impaired loans is not directly comparable to the amount of nonperforming loans disclosed later in this section. The primary differences between impaired loans and nonperforming loans are: i) all loan categories are considered in determining nonperforming loans while impaired loan recognition is limited to commercial and industrial loans, commercial and residential real estate loans, construction loans, and agricultural loans, and ii) impaired loan recognition considers not only loans 90 days or more past due, restructured loans and nonaccrual loans but also may 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, restructured debt, and performing loans in which full payment of principal or interest is not expected. Management bases the measurement of these impaired loans on the fair value of the loan's collateral or the expected cash flows on the loans discounted at the loan's stated interest rates. Cash receipts on impaired loans not performing to contractual terms and that are on nonaccrual status are used to reduce principal balances. Impairment losses are included in the allowance for credit losses through a charge to the provision, if applicable.

At December 31, 2011 and 2010, the Company's recorded investment in loans for which impairment has been recognized totaled \$31.9 million and \$51.0 million, respectively. Included in total impaired loans at December 31, 2011, are \$13.8 million of impaired loans for which the related specific allowance is \$1.3 million, as well as \$18.1 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. Total impaired loans at December 31, 2010 included \$40.9 million of impaired loans for which the related specific allowance is \$11.3 million, as well as \$10.1 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. The average recorded investment in impaired loans was \$41.9 million and \$49.8 million during the years ended December 31, 2011 and 2010, respectively. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms, income is recognized under the accrual method.

The largest category of impaired loans at December 31, 2011 were real estate mortgage and real estate construction and development loans, comprising of 37% and almost 36% of total impaired loans at December 31, 2011, respectively. Impaired construction loans decreased \$11.3 million, impaired commercial and industrial loans decreased \$8.3 million, and impaired agricultural loans decreased \$1.3 million during the year ended December 31, 2011 while impaired real estate mortgage loans increased \$1.9 million. Specific collateral related to impaired loans is reviewed for current appraisal information, economic trends within geographic markets, loan-to-value ratios, and other factors that may impact the value of the loan collateral. Adjustments are made to collateral values as needed for these factors. Of total impaired loans, approximately \$27.5 million or 86.1% are secured by real estate at December 31, 2010, as compared to 37.8 million or 74.1% of total impaired loans at December 31, 2010. The following table summarizes the components of impaired loans and their related specific allowance at December 31, 2011, 2010 and 2009.

	Balance December 31, 2011	Allowance December 31, 2011	Balance December 31, 2010	Allowance December 31, 2010	Balance December 31, 2009	Allowance December 31, 2009
(in 000's)						
Commercial and industrial	\$ 6,639	\$ 112	\$ 14,887	\$ 5,005	\$ 9,064	\$ 2,383
Real estate – mortgage	11,871	690	9,922	744	12,584	536

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RE construction and development	11,432	71	22,759	4,891	25,606	4,741
Agricultural	1,853	381	3,107	686	6,212	153
Installment/other	87	0	148	0	328	160
Lease financing	0	0	175	0	0	0
Total impaired loans	\$ 31,882	\$ 1,254	\$ 50,998	\$ 11,326	\$ 53,794	\$ 7,973

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



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At December 31, 2010, more than \$13.7 million of the total \$24.9 million in TDR's was for real estate construction and development, and \$5.0 million and \$2.8 million related to developers in commercial real estate and commercial and industrial, respectively at December 31, 2010.

At December 31, 2010 and 2009, the Company held approximately \$3.3 million and \$4.0 million, respectively, in restructured residential mortgage loans of borrowers unable to secure take-out financing at the end of their construction loan with the Company. In part to assist the borrowers to retain newly constructed homes under California Senate Bill SB1137, the Company modified loans at market rates of interest with 30-year amortization to mature in three-to-five year terms. TDR's at December 31, 2010 as a percentage of the loan portfolio is similar to the percentage breakout of the \$26.1 million in TDR's reported at December 31, 2009. The majority of these credits are related to real estate construction projects that have 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. This reflects current market conditions in the San Joaquin Valley. 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 downturn in the real estate construction market is protracted, and although the Company has had success in its restructuring efforts, not all restructured efforts will be entirely successful. Regions such as Bakersfield California had been slower to recover than others in out market area but now show signs of leading the recovery compared with other southern San Joaquin Valley regions. While recent data indicates real estate prices stabilized in 2011, deterioration beyond current expectations may require additional reserves to lower asset values to allow borrowers to continue completing construction projects and selling units at lower prices.

The following tables summarizes TDR's by type, classified separately as nonaccrual or accrual, which are included in impaired loans at December 31, 2011 and December 31, 2010.

(in thousands)	Total TDR's December 31, 2011	Nonaccrual TDR's December 31, 2011	Accruing TDR's December 31, 2011
Commercial and industrial	\$ 2,619	\$ 1,084	\$ 1,535
Real estate - mortgage:			
Commercial real estate	6,850	2,506	4,344
Residential mortgages	3,477	0	3,477
Home equity loans	36	15	22
Total real estate mortgage	10,363	2,521	7,843
RE construction & development	6,034	3,620	2,415
Agricultural	0	0	0
Installment/other	34	0	34
Lease financing	0	0	0
Total Troubled Debt Restructurings	\$ 19,050	\$ 7,225	\$ 11,827

(in thousands)	Total TDR's December 31, 2010	Nonaccrual TDR's December 31, 2010	Accruing TDR's December 31, 2010
Commercial and industrial	\$ 2,751	\$ 1,359	\$ 1,392
Real estate - mortgage:			
Commercial real estate	5,019	0	5,019

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Residential mortgages	3,261	0	3,261
Home equity loans	93	43	50
Total real estate mortgage	8,373	43	8,330
RE construction & development	13,730	10,978	2,752
Agricultural	0	0	0
Installment/other	80	0	80
Lease financing	0	0	0
Total Troubled Debt			
Restructurings	\$ 24,934	\$ 12,380	\$ 12,554

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Of the \$19.0 million in total TDR's at December 31, 2011, \$7.2 million were on nonaccrual status at period-end. Of the \$24.9 million in total TDR's at December 31, 2010, \$12.4 million were on nonaccrual status at period-end. As of December 31, 2011, the Company has no commercial real estate (CRE) workouts whereby an existing loan was restructured into multiple new loans (i.e., A Note/B Note structure).

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

The following table summarizes special mention loans by type for the year ended December 31, 2011 and December 31, 2010.

(in thousands)	December 31, 2011	December 31, 2010
Commercial and industrial	\$ 10,431	\$ 7,769
Real estate - mortgage:		
Commercial real estate	749	4,419
Residential mortgages	0	195
Home equity loans	0	0
Total real estate mortgage	749	4,614
RE construction & development	0	10,737
Agricultural	0	1,525
Installment/other	423	0
Lease financing	0	0
<b>Total Special Mention Loans</b>	<b>\$ 11,603</b>	<b>\$ 24,645</b>

The Company focuses on competition and other economic conditions within its market area and other geographical areas in which it does business, which may ultimately affect the risk assessment of the portfolio. The Company continues to experience increased competition from major banks, local independents and non-bank institutions creating pressure on loan pricing. Low interest rates and a weak economy continue to dominate, even though signs of 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. Even though business and consumer spending show improvement in recent quarters current GDP remains anemic. It is difficult to forecast the impact Federal Reserve actions to hold rates low will be on the economy. The local market has remained relatively more 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 areas' 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 from local and worldwide economic conditions, as well as potentially volatile real estate markets, and takes these factors into consideration when analyzing the adequacy of the allowance for credit losses.

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

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	December 31,									
(Dollars in thousands)	2011		2010		2009		2008		2007	
Total loans outstanding at end of period before deducting allowances for credit losses	\$	408,714	\$	441,045	\$	507,709	\$	543,317	\$	591,056
Average net loans outstanding during period	\$	424,961	\$	490,421	\$	534,830	\$	582,500	\$	575,448
Balance of allowance at beginning of period	\$	16,520	\$	15,016	\$	11,529	\$	7,431	\$	4,381
Loans charged off:										
Real estate	(7,224 )		(8,119 )		(4,245 )		(3,103 )		(4,005 )	
Commercial and industrial	(9,340 )		(2,878 )		(5,648 )		(1,890 )		(303 )	
Lease financing	(110 )		(81 )		(122 )		(281 )		(8 )	
Installment and other	(620 )		(858 )		(130 )		(271 )		(177 )	
Total loans charged off	(17,294 )		(11,936 )		(10,145 )		(5,545 )		(4,493 )	
Recoveries of loans previously charged off:										
Real estate	159		10		1		0		0	
Commercial and industrial	650		940		245		92		46	
Lease financing	0		0		1		14		0	
Installment and other	11		15		10		11		18	
Total loan recoveries	820		965		257		117		64	
Net loans charged off	(16,474 )		(10,971 )		(9,888 )		(5,428 )		(4,429 )	
Reclassification of off-balance sheet reserve	0		0		0		0		0	
Reserve acquired in business acquisition	0		0		0		0		1,268	
Provision charged to operating expense	13,602		12,475		13,375		9,526		6,211	
Balance of allowance for credit losses at end of period	\$	13,648	\$	16,520	\$	15,016	\$	11,529	\$	7,431
Net loan charge-offs to total average loans	3.88	%	2.24	%	1.85	%	0.93	%	0.77	%
Net loan charge-offs to loans at end of period	4.03	%	2.49	%	1.95	%	1.00	%	0.75	%
Allowance for credit losses to total loans at end of period	3.34	%	3.75	%	2.96	%	2.12	%	1.26	%

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Net loan charge-offs to allowance for credit losses	120.70	%	66.41	%	68.85	%	47.08	%	59.60	%
Net loan charge-offs to provision for credit losses	121.11	%	87.94	%	73.93	%	56.98	%	71.31	%

Loan charge-offs increased during the year ended December 31, 2011 when compared to the year ended December 31, 2010, while loan recoveries decreased slightly during the same period.

Loan charge-offs of \$17.3 million during the year ended December 31, 2011 included a \$3.6 million commercial and industrial relationship secured by real estate, with specific reserves of \$2.9 million and a \$4.5 million real estate construction relationship secured by real estate, with specific reserve of \$3.6 million. Net loan charge-offs totaled \$1.4 million during the fourth quarter including \$758 thousand on two real estate secured relationships.

Loan charge-offs of \$11.9 million experienced during the year ended December 31, 2010 included a \$2.5 million charge-off of an impaired nonaccrual loan which had a specific reserve of \$2.1 million at December 31, 2010, a charge-off of \$857,000 on a \$2.1 million nonaccrual loan transferred to OREO during the second quarter of 2010, and a \$600,000 charge-off resulting from a short-sale of the underlying collateral for a real-estate secured loan. Recoveries during 2010 included \$846,000 in death benefit proceeds received during the second quarter from a life insurance policy held as collateral on a loan that had been charged-off during 1998.

The following is a summary of the quarterly activity in the allowance for loan losses for the year ended December 31, 2011

Description	Loss	Recoveries	Provision	Balance
Balance Forward				\$ 16,520
1st quarter - 2011	\$ 699	\$ 34	\$ 890	16,745
2nd quarter - 2011	6,668	697	3,529	14,303
3rd quarter - 2011	8,498	53	8,077	13,936
4th quarter - 2011	1,429	36	1,105	13,648
Total YTD - 2011	\$ 17,294	\$ 820	\$ 13,602	\$ 13,648

At December 31, 2011 and 2010, \$174,000 and \$189,000, respectively, of the formula allowance is allocated to unfunded loan commitments and is, therefore, carried separately in other liabilities.

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Management believes that the 3.34% credit loss allowance to total loans at December 31, 2011 is adequate to absorb known and inherent risks in the loan portfolio. No assurance can be given, however, that the economic conditions which may adversely affect the Company's service areas or other circumstances will not be reflected in increased losses in the loan portfolio. Management is not currently aware of any conditions that may adversely affect the levels of losses incurred in the Company's loan portfolio.

Although the Company does not normally allocate the allowance for credit losses to specific loan categories, an allocation to the major categories has been made for the purposes of this report as set forth in the following table. The allocations are estimates based on the same factors as considered by management in determining the amount of additional provisions to the credit loss allowance and the overall adequacy of the allowance for credit losses.

	2011		2010		2009		2008		2007	
	Allowance for Credit	% of Loans	Allowance for Credit	% of Loans	For Credit	% of Loans	for Credit	% of Loans	for Credit	% of Loans
(Dollars in thousands)	Losses	Loans	Losses	Loans	Losses	Loans	Losses	Loans	Losses	Loans
Commercial and industrial	\$6,787	40.7 %	\$8,209	36.0 %	\$7,125	33.0 %	\$4,620	34.6 %	\$3,008	31.9 %
Real estate – mortgage	1,416	35.4 %	1,620	35.7 %	1,426	32.6 %	787	24.0 %	593	22.8 %
RE construction and development	4,579	12.3 %	5,763	14.8 %	5,561	20.7 %	4,795	27.7 %	3,070	33.8 %
Agricultural	508	8.8 %	850	10.5 %	334	10.0 %	1,035	9.6 %	559	7.8 %
Installment/other	117	2.8 %	49	2.9 %	535	3.6 %	101	3.8 %	133	3.1 %
Lease financing	1	0.0 %	3	0.1 %	35	0.1 %	49	0.3 %	68	0.6 %
Not allocated	241	--	26	--	0	--	142	--	0	--
	\$13,648	100.0%	\$16,520	100.0%	\$15,016	100.0%	\$11,529	100.0%	\$7,431	100.0%

During 2011, reserve allocations decreased in all categories during the year, except for a small increase in the reserve on installment loans.

During 2010, reserve allocations increased in all categories except installment loans and lease financing loans, which decreased approximately \$486,000 and \$32,000, respectively, during the year. Increases in reserve allocations during 2010 are primarily the result of declining collateral values during the year.

During 2009, reserve allocations increased for commercial and industrial loans, real estate mortgage loans, construction loans, and installment loans. Increased reserve allocations for commercial and industrial loans are the result of increased loan volume and increased loss factors applied to classified loan classifications, while increases in reserve allocations for real estate mortgage and installment loans are primarily the result of increases in substandard loans in those categories. Reserve allocations increased for real estate construction loans as a result of both an increase in the level of special mention loans in that category, as well as increased specific reserves on certain loans in that category between December 31, 2008 and December 31, 2009.

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

(Dollars in 000's)	2011	2010	December 31, 2009	2008	2007
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Formula allowance	\$ 12,153	\$ 5,168	\$ 7,043	\$ 6,414	\$ 6,447
Specific allowance	1,254	11,326	7,973	4,973	984
Unallocated allowance	241	26	0	142	0
Total allowance	\$ 13,648	\$ 16,520	\$ 15,016	\$ 11,529	\$ 7,431

At December 31, 2011, the allowance for credit losses totaled \$13.6 million, and consisted of \$12.1 million in formula allowance, \$1.3 million in specific allowance, and \$241,000 in unallocated allowance. At December 31, 2011, \$523,000 of the specific allowance was allocated commercial real estate loans, and the remaining \$381,000, \$166,000, \$112,000, and \$71,000 were allocated to agricultural, commercial real estate, residential mortgage loans, and real estate construction loans, respectively



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At December 31, 2010, the allowance for credit losses totaled \$16.5 million, and consisted of \$5.2 million in formula allowance, \$11.3 million in specific allowance, and \$26,000 in unallocated allowance. At December 31, 2010, \$4.9 million of the specific allowance was allocated to real estate construction loans, and the remaining \$5.0 million, \$476,000, \$241,000, and \$686,000 were allocated to commercial and industrial loans, commercial real estate, residential mortgage loans, and agricultural loans, respectively.

At December 31, 2009, the allowance for credit losses totaled \$15.0 million, and consisted of \$7.0 million in formula allowance, \$8.0 million in specific allowance, and no unallocated allowance. At December 31, 2009, \$4.7 million of the specific allowance was allocated to real estate construction loans, and the remaining \$2.4 million, \$536,000, \$160,000, and \$153,000 were allocated to commercial and industrial loans, commercial real estate, installment loans, and agricultural loans, respectively.

The allowance for credit losses totaled \$11.5 million At December 31, 2008, and consisted of \$6.4 million in formula allowance, \$5.0 million in specific allowance, and \$142,000 in unallocated reserve. At December 31, 2008, \$2.3 million of the specific allowance was allocated to real estate construction loans, and the remaining \$2.3 million, \$227,000, and \$68,000 were allocated to commercial and industrial loans, real estate commercial loans, and agricultural loans, respectively.

The total formula allowance increased approximately \$7.0 million between 2010 and 2011, primarily due to increased reserve factors resulting from losses incurred during the year. Between December 31, 2010 and December 31, 2011, substandard loans decreased \$12.3 million, while special mention decreased \$13.0 million. There were no loans classified as doubtful at December 31, 2011 or December 31, 2010.

The total formula allowance decreased approximately \$1.9 million between 2009 and 2010, primarily as the result of decreased volume in "pass" loans. The formula allowance for commercial loans decreased \$1.5 million during 2010, and decreased \$330,000 for installment loans, with only minor changes in other loan categories. Between December 31, 2009 and December 31, 2010, substandard loans decreased \$10.1 million, while special mention and doubtful loans decreased \$3.7 million and \$2.5 million, respectively.

The total formula allowance increased approximately \$629,000 between 2008 and 2009, primarily as the result of increased loss factors applied to "pass loans" which more than outweighed the decline in volume of "pass" loans. Between December 31, 2008 and December 31, 2009, sub-substandard loans decreased \$14.5 million, while special mention loans decreased \$5.9 million, but the specific reserve increased \$3.0 million during the period as a result of deterioration in the impaired loan portfolio.

Although in some instances, the downgrading of a loan resulting from the factors used by the Company in its allowance analysis has been reflected in the formula allowance, management believes that in some instances, the impact of material events and trends has not yet been reflected in the level of nonperforming loans or the internal risk grading process regarding these loans. Accordingly, the Company's evaluation of probable losses related to these factors may be reflected in the unallocated allowance. The evaluation of the inherent losses concerning these factors involves a higher degree of uncertainty because they are not identified with specific problem credits, and therefore the Company does not spread the unallocated allowance among segments of the portfolio. At December 31, 2011 and December 31, 2010, the Company had an unallocated allowance of \$241,000 and \$26,000, while at December 31, 2009, the Company had no unallocated allowance. Management's estimates of the unallocated allowance are based upon a number of underlying factors including 1) the effect of deteriorating national and local economic trends, 2) the effects of export market conditions on certain agricultural and manufacturing borrowers, 3) the effects of abnormal weather patterns on agricultural borrowers, as well as other borrowers that may be impacted by such conditions, 4) the effect of increased competition in the Company's market area and the resultant potential impact of more relaxed underwriting standards to borrowers with multi-bank relationships, 5) the effect of soft real estate markets, and 6) the

effects of having a larger number of borrowing relationships which are close to the Company's lending limit, any one of which were not to perform to contractual terms, would have a material impact on the allowance.

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

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

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

	December 31,									
(Dollars in thousands, except footnote)	2011		2010		2009		2008		2007	
Nonaccrual loans (1)	\$	18,098	\$	34,394	\$	34,757	\$	45,671	\$	16,158
Restructured loans		11,885		12,554		16,026		0		23
Total non-performing loans		29,983		46,948		50,783		45,671		16,181
Other real estate owned		27,091		35,580		36,217		30,153		6,666
Total non-performing assets	\$	57,074	\$	82,528	\$	87,000	\$	75,824	\$	22,847
Loans, past due 90 days or more, still accruing	\$	74	\$	547	\$	486	\$	680	\$	189
Non-performing loans to total gross loans		7.34 %		10.63 %		9.99 %		8.39 %		2.73 %
Non-performing assets to total gross loans		13.96 %		18.68 %		17.11 %		13.92 %		3.85 %
Allowance for loan losses to nonperforming loans		45.52 %		35.19 %		29.57 %		25.24 %		45.92 %

(1) Included in nonaccrual loans at December 31, 2011 and 2010 are restructured loans totaling \$7.2 million and \$12.4 million, respectively. The interest income that would have been earned on nonaccrual loans outstanding at December 31, 2010, 2009, and 2008, in accordance with their original terms is approximately \$1.7 million, \$3.2 million, and \$3.7 million, respectively.

Non-performing assets remain high at December 31, 2011, but have decreased \$25.5 million between December 31, 2010 and December 31, 2011. While nonaccrual loans decreased \$16.3 million between December 31, 2010 and December 31, 2011, while restructured loans not included in the nonaccrual totals decreased just \$669,000 million. The net decrease of \$8.5 in other real estate owned includes additions of approximately \$2.8 million in properties transferred from loans, write-downs of \$3.9 million, and gross sales of more than \$8.2 million during the year ended December 31, 2011.

Non-performing assets decreased \$4.5 million between December 31, 2009 and December 31, 2010. While nonaccrual loans decreased only \$363,000 between December 31, 2009 and December 31, 2010, restructured loans not included in the nonaccrual totals decreased \$3.5 million as the Company sought to work-out problem credits with borrowers. The net decrease of \$637,000 in other real estate owned includes additions of approximately \$14.2 million in properties transferred from loans, write-downs of \$2.8 million, and gross sales of more than \$12.8 million during the year ended December 31, 2010.

Non-performing assets have increased between December 31, 2008 and December 31, 2009 as the prolonged economic downturn continued into 2009. While nonaccrual loans decreased \$10.9 million between December 31, 2008 and December 31, 2009, restructured loans not included in the nonaccrual totals increased \$16.0 million as the Company sought to work-out problem credits with borrowers. When all other means of repayment failed, the underlying collateral on nonperforming loans was foreclosed upon, resulting in the net increase of \$6.1 million in other real estate owned between December 31, 2008 and December 31, 2009. The net change in other real estate

owned includes additions of approximately \$20.0 million in properties transferred from loans, and gross sales of nearly \$13.6 million during the year ended December 31, 2009.

Non-performing assets increased between December 31, 2007 and December 31, 2008 as declines in real estate markets and related sectors experienced since the later part of 2007 resulting from lending problems continued to impact credit markets and the general economy throughout 2008. Nonaccrual loans increased \$29.5 million between December 31, 2007 and December 31, 2008, with construction loans comprising approximately 57% of total nonaccrual loans at December 31, 2008, and commercial and industrial loans comprising another 19%.

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

	Balance December 31, 2011	Balance December 31, 2010	Balance December 31, 2009	Change from December 31, 2010	Change from December 31, 2009
Nonaccrual Loans (in 000's):					
Commercial and industrial	\$ 5,080	\$ 13,449	\$ 5,355	\$ (8,369 )	\$ 8,094
Real estate - mortgage	3,989	1,592	5,336	\$ 2,397	(3,744 )
Real estate - construction	9,014	16,003	17,590	\$ (6,989 )	(1,587 )
Agricultural	0	3,107	6,212	\$ (3,107 )	(3,105 )
Installment/other	15	68	150	\$ (53 )	(82 )
Lease financing	0	175	114	\$ (175 )	61
Total Nonaccrual Loans	\$ 18,098	\$ 34,394	\$ 34,757	\$ (16,296 )	\$ (363 )

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The increase of \$8.1 million in commercial and industrial non-accrual loans between December 31, 2009 and December 31, 2010 is largely the result of a single large commercial lending relationship totaling \$7.2 million which was transferred to nonaccrual status during the fourth quarter of 2010. The decrease of \$363,000 in total nonaccrual loans between December 31, 2009 and December 31, 2010 includes transfers of nearly \$14.2 million to other real estate owned. Of the \$14.2 million in transfers from nonaccrual loans to other real estate owned during 2010, \$4.4 million was transferred during the fourth quarter of 2010.

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

Except for the loans included in the above table, there were no loans at December 31, 2011 where the known credit problems of a borrower caused the Company to have serious doubts as to the ability of such borrower to comply with the present loan repayment terms and which would result in such loan being included as a nonaccrual, past due or restructured loan at some future date.

## Liquidity and Asset/Liability Management

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

## Liquidity

Liquidity management may be described as the ability to maintain sufficient cash flows to fulfill both on- and off-balance sheet financial obligations, including loan funding commitments and customer deposit withdrawals, without straining the Company's equity structure. To maintain an adequate liquidity position, the Company relies on, in addition to cash and cash equivalents, cash inflows from deposits and short-term borrowings, repayments of principal on loans and investments, and interest income received. The Company's principal cash outflows are for loan origination, purchases of investment securities, depositor withdrawals and payment of operating expenses. Other sources of liquidity not on the balance sheet at December 31, 2011 include unused collateralized and uncollateralized lines of credit from other banks, the Federal Home Loan Bank, and from the Federal Reserve Bank totaling \$250.1 million.

Cash and cash equivalents have fluctuated during the three years ended December 31, 2011, 2010, and 2009, with period-end balances as follows (from Consolidated Statements of Cash Flows – in 000's):

	Balance
December 31, 2011	\$ 124,184
December 31, 2010	\$ 98,430
December 31, 2009	\$ 29,229

Cash and cash equivalents increased \$25.8 million during the year ended December 31, 2011 as compared to an increase of \$69.2 million during the year ended December 31, 2010.

The Company has maintained positive cash flows from operations over the past two years, which amounted to \$5.8 million and \$9.6 million for the years ended December 31, 2011 and 2010, respectively.

The Company experienced net cash inflows from investing activities totaling \$34.6 and \$71.7 million during the years ended December 31, 2011 and 2010, respectively through decreases in loans, sales of OREO properties, and maturities of investment securities.

Net cash flows from financing activities, including deposit growth and borrowings, have traditionally provided funding sources for loan growth, but during 2011 and 2010 the Company experienced net cash outflows totaling \$15.0 million and \$12.1 million, respectively. The cash outflows during 2010 and 2011 were the result of planned reductions in outstanding borrowings and brokered deposits which exceeded increases in demand deposits and savings accounts.

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

The policy also includes a contingency funding plan to address liquidity needs in the event of an institution-specific or a systemic financial market crisis. In addition to unused lines of credit from other banks totaling \$250.1 million, the contingency plan includes identified funding sources, and steps that may be taken in the event the total liquidity ratio falls or is projected to fall below policy limits for any extended period of time. One of the primary directives of the contingency funding plan is to limit the Company's overall level of wholesale funding to no more than 40% of deposits. The current funding program uses both asset-based and liability-based principles, and identifies core deposits as the favored funding source when attainable at a reasonable cost. The policy identifies a number of funding sources or methods the Bank ALCO committee may utilize to fulfill the Company's liquidity funding requirements:

- 1) Local core deposits are the Company's primary funding source. The Company must expand its efforts to attract these deposits through service-related and competitive pricing tactics. Other liquidity funding sources should only be considered if local core deposits are not attractive because of maturity or pricing.
- 2) Unsecured Federal Funds lines with correspondent banks may be used to fund short-term peaks in loan demand or deposit run-off. Currently, unsecured borrowing lines with correspondents are limited and may not be reliable for long periods of time or in times of economic stress.
- 3) Other funding sources such as secured credit lines with the Federal Home Loan Bank or the Federal Reserve may be used for longer periods. The Company collateralizes these available lines with a combination of investment securities and pledged loans. The Company has utilized specific loan pledging with both the FHLB and the Federal Reserve to better ensure the continued availability of those lines of credit.
- 4) The Company presently has a Discount Window facility available from the Federal Reserve Bank of San Francisco collateralized with loans as discussed above. At December 31, 2011 the Company had available credit of \$232.5 million from the Federal Reserve based upon the loans pledged at that date. The Federal Reserve will monitor use of the Discount Window closely given the current status of the Company and the economy as a whole and. In addition, this credit facility may not be competitively priced under normal economic conditions. As such, the Company does not expect to use this facility except in times of crises, but does consider this to be a key contingency funding source.
- 5) As long as the Bank remains "Well Capitalized" the Company may rely on brokered deposits when core deposit rates are higher in the marketplace or maturity structures are not desirable. The Company's current policy limit for brokered deposits is 25% of total deposits. The Company may also utilize other wholesale deposit sources such as memberships that advertise the Bank's time deposit rates to other subscribers, typically banks and credit unions. The Company's current policy limit on other wholesale deposits is 10% of total deposits.
- 6) The Bank may sell whole loans or participations in loans to provide additional liquidity. During economic downturns or other crises events, these funding sources may be difficult to achieve in a short period of time or at a reasonable price. As such, this strategy is better used as a long-term asset/liability management tool to effectively balance assets and liabilities to reduce liquidity risk.
- 7)

The Company currently has Bank Owned Life Insurance (BOLI) policies issued by highly rated insurance companies which may be sold to increase liquidity.

- 8) The Company owns certain real estate including its administration building and several of its branches. These may be sold and vacated or leased back from the purchaser after sale to provide additional liquidity if needed. The sales process may require substantial time to complete, and may have an adverse impact on earnings depending on market rates and other factors at the time of sale.
- 9) Investments near maturity may be sold to meet temporary funding needs but may need to be replaced to maintain liquidity ratios within acceptable limits. At the current time much of the investment portfolio is pledged to secure public deposits and borrowing lines. As wholesale funding dependence is reduced, the available liquidity in the investment portfolio will increase. The Company seeks to maintain an investment-grade securities portfolio to ensure quality collateral for pledging against borrowing lines of credit as well as to provide liquidity in times of needs.



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The Company continues to utilize liability management, when needed, as part of its overall asset/liability management strategy. Through the discretionary acquisition of short term borrowings, the Company has 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. The borrowings are generally short-term and more closely match the repricing characteristics of floating rate loans, which comprise approximately 49.9% of the Company's loan portfolio at December 31, 2011. 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.

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. Within this framework is the objective of maximizing the yield on earning assets. This is generally achieved by maintaining a high percentage of earning assets in loans, which historically have represented the Company's highest yielding asset. At December 31, 2011, the Bank had 62.8% of total assets in the loan portfolio and a loan-to-deposit ratio of 71.0%. Liquid assets at December 31, 2011 include cash and cash equivalents totaling \$124.2 million as compared to \$98.4 million at December 31, 2010.

Liabilities used to fund liquidity sources include core and non-core deposits as well as short-term borrowings. Core deposits, which comprise approximately 84.1% of total deposits at December 31, 2011, provide a significant and stable funding source for the Company. At December 31, 2011, unused lines of credit with the Federal Home Loan Bank and the Federal Reserve Bank totaling \$250.1 million are collateralized in part by certain qualifying loans in the Company's loan portfolio. The carrying value of loans pledged on these used and unused borrowing lines totaled \$346.9 million at December 31, 2011. For further discussion of the Company's borrowing lines, see "Short Term Borrowings" included previously in the financial condition section of this financial review. The Federal Reserve Board has notified the Bank that it will permit the Bank to draw on its line of credit with the Federal Reserve Bank only in limited circumstances and for a short duration.

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 Regulatory Agreement 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.) Under an agreement with the Federal Reserve dated March 23, 2010, the Bank is precluded from paying a cash dividend to the Company. To conserve cash and capital resources, the Company elected at September 30, 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. The Bank paid no dividends to the parent company during the years ended December 31, 2011 and 2010. During the year ended December 31, 2009, cash dividends paid by the Bank to the parent company totaled \$200,000.

Regulatory Matters

Regulatory Agreement

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, among other things, 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.

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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 effect 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;
- 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 were 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;

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- 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, specifically, that except with the prior written approval of the Federal Reserve Bank, the Company each agree 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);
- 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 current Form 8-K filed with the Securities and Exchange Commission on March 25, 2010.

On April 27, 2011 July 25, 2011, October 26, 2011, and January 30, 2012, respectively, the Bank submitted progress reports to the Federal Reserve for the first, second, third and fourth quarters of 2011. At this time, the Company and the Bank believe they are in compliance with the Agreement, including deadlines and remediation of past violations of laws and regulations regarding stale loan appraisals. During the fourth quarter of 2010, the Company identified certain material weaknesses related to the allowance for loan losses and the completeness and accuracy of the provision for loan losses, as well as material weaknesses related to the valuation of OREO properties (for further discussion see Item 9A Controls and Procedures.)

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 basically similar to the written 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

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- 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. During the fourth quarter of 2010, the Company identified certain material weaknesses related to the allowance for loan losses and the completeness and accuracy of the provision for loan losses, as well as material weaknesses related to the valuation of OREO properties (for further discussion see Item 9A Controls and Procedures.)

### 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.

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 10.31% at December 31, 2011.

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.

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The following table sets forth the Company's and the Bank's actual capital positions at December 31, 2011 and the regulatory minimums for the Company and the Bank to be well capitalized under the guidelines discussed above:

	Company Actual Capital Ratios		Bank Actual Capital Ratios		Minimum Capital Ratios		Regulatory Minimums - Well Capitalized	
Total risk-based capital ratio	12.93	%	12.91	%	10.00	%	10.00	%
Tier 1 capital to risk-weighted assets	11.66	%	11.64	%	9.00	%	6.00	%
Leverage ratio	8.97	%	9.02	%	9.00	%	5.00	%



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As is indicated by the above table, the Company and the Bank exceeded all applicable regulatory capital guidelines at December 31, 2011. 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 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, require us to obtain the prior approval before paying a cash dividend or otherwise making a distribution on our 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 year ended December 31, 2010, the Company received no cash dividends from the Bank.

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.

The Company did not repurchase any common stock during the years ended December 31, 2011 or 2010. As a result of the Agreement entered into with the Federal Reserve Bank of San Francisco (FRB) during March 2010 and the Order entered into with the California Department of Financial Institutions (DFI) during May 2010, the Company is prohibited from repurchasing its common shares without prior permission of the FRB and the DFI.

### Reserve Balances

The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At December 31, 2011 the Bank's qualifying balance with the Federal Reserve was approximately \$25,000.



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MANAGEMENT’S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of United Security Bancshares and Subsidiaries (the “Company”) is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, and for performing an assessment of the effectiveness of internal control over financial reporting as of December 31, 2011. The Company’s internal control over financial reporting is a process designed under the supervision of the Company’s management, including the Chief Executive Officer and Chief Financial Officer, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States.

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

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

Under the supervision and with the participation of the Company’s management, including the Company’s Chief Executive Officer and Chief Financial Officer, the Company performed an assessment of the effectiveness of the Company’s internal control over financial reporting as of December 31, 2011 based upon criteria in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). As a result of management’s evaluation of the Company’s internal control over financial reporting, management identified a material weaknesses in the Company’s internal control over financial reporting related to the determination of the allowance for loan losses, provision of loans losses, and valuation of OREO. The material weakness resulted from ineffective controls to accurately access on a timely basis the reserves required for impaired loans, and the overall adequacy of the allowance for loan losses, as well as the impact of lower valuations of OREO. As a result of the material weakness, management has concluded that the Company’s internal control over financial reporting was not effective as of December 31, 2010.

As a result of the enactment in our third quarter of the Dodd-Frank Wall Street Reform and Consumer Protection Act, “Exemption for Non-accelerated Filers,” and in accordance with section 989G of the act, we are not required to provide an attestation report of our independent registered public accounting firm regarding internal control over financial reporting for this fiscal year or thereafter, until such time as we are no longer eligible for the exemption set forth therein.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors  
United Security Bancshares and Subsidiary

We have audited the accompanying consolidated balance sheets of United Security Bancshares and Subsidiary (Company) as of December 31, 2011 and 2010, and the related consolidated statements of operations and comprehensive (loss) income, shareholders' equity and cash flows for each of the two years in the period ended December 31, 2011. These consolidated financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of United Security Bancshares and Subsidiary as of December 31, 2011 and 2010, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles in the United States of America.

/s/ Moss Adams LLP

Stockton, California  
March 30, 2012

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United Security Bancshares and Subsidiaries  
Consolidated Balance Sheets  
December 31, 2011 and 2010

	December 31,	
	2011	2010
(in thousands except shares)		
Assets		
Cash and due from banks	\$ 28,052	\$ 13,259
Cash and due from FRB	96,132	85,171
Cash and cash equivalents	124,184	98,430
Interest-bearing deposits in other banks	2,187	4,396
Investment securities available for sale (at fair value)	38,458	51,503
Loans and leases	408,715	441,691
Unearned fees	(569 )	(645 )
Allowance for credit losses	(13,648 )	(16,520 )
Net loans	394,498	424,526
Accrued interest receivable	1,946	2,152
Premises and equipment - net	12,675	12,909
Other real estate owned	27,091	35,580
Intangible assets	553	1,209
Goodwill	4,488	5,977
Cash surrender value of life insurance	16,150	15,493
Investment in limited partnerships	1,433	1,851
Deferred income taxes	11,485	8,878
Other assets	16,184	15,306
Total assets	\$ 651,332	\$ 678,210
Liabilities & Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	\$ 224,907	\$ 139,690
Interest bearing	349,520	417,776
Total deposits	574,427	557,466
Other borrowings	0	32,000
Accrued interest payable	111	222
Accounts payable and other liabilities	5,594	4,606
Junior subordinated debt (at fair value)	9,027	10,646
Total liabilities	589,159	604,940
Commitments and Contingencies		
Shareholders' Equity		
Common stock, no par value 20,000,000 shares authorized, 13,531,832 and 13,003,849 issued and outstanding, in 2011 and 2010, respectively	41,435	39,869
Retained earnings	21,447	33,807
Accumulated other comprehensive loss	(709 )	(406 )
Total shareholders' equity	62,173	73,270
Total liabilities and shareholders' equity	\$ 651,332	\$ 678,210

See notes to consolidated financial statements

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United Security Bancshares and Subsidiaries  
Consolidated Statements of Operations and Comprehensive (Loss) Income  
Years Ended December 31, 2011, and 2010

(in thousands except shares and EPS)	2011	2010
<b>Interest Income</b>		
Loans, including fees	\$25,573	\$29,502
Investment securities - AFS – taxable	2,141	2,794
Investment securities - AFS – nontaxable	0	58
<b>Federal funds sold and securities purchased under agreements to resell</b>		
Interest on deposits in FRB	186	59
Interest on deposits in other banks	39	41
Total interest income	27,940	32,490
<b>Interest Expense</b>		
Interest on deposits	2,620	4,217
Interest on other borrowed funds	344	372
Total interest expense	2,964	4,589
<b>Net Interest Income Before</b>		
Provision for Credit Losses	24,976	27,901
Provision for Credit Losses	13,602	12,475
Net Interest Income	11,374	15,426
<b>Noninterest Income</b>		
Customer service fees	3,640	3,812
Increase in cash surrender value of BOLI	565	554
Gain on disposition of securities	11	68
(Loss)on sale of other real estate owned	(231 )	(85 )
Gain on sale of loans	0	509
Gain on sale of assets	0	0
Gains from life insurance	0	174
Gain on fair value option of financial liability	1,863	316
Gain (loss) on sale of premises and equipment	0	(11 )
Other	1,029	602
Total noninterest income	6,877	5,939
<b>Noninterest Expense</b>		
Salaries and employee benefits	9,109	8,949
Occupancy expense	3,487	3,789
Data processing	92	85
Professional fees	2,355	2,081
FDIC/DFI insurance assessments	2,082	2,546
Director fees	230	232
Amortization of intangibles	620	769
Correspondent bank service charges	302	315
Impairment loss on other investments	1	355
Impairment loss on OREO	3,856	2,831
Impairment loss on intangible assets	36	57
Impairment loss on goodwill	1,489	1,414
Impairment loss on investment securities (cumulative total other-than-temporary loss of \$4.5 million and \$4.1 million net of \$2.3 million and \$2.0 million recognized in other	912	1,253



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comprehensive loss, pre-tax)		
Loss in equity of limited partnership	418	424
Expense on other real estate owned	3,503	1,532
Other	2,286	2,388
Total noninterest expense	30,778	29,020
(Loss) Income Before Provision for Taxes on Income	(12,527 )	(7,655 )
(Benefit) Provision for Taxes on Income	(1,715 )	(3,216 )
Net (Loss) Income	\$(10,812 )	\$(4,439 )
Other comprehensive (loss) income, net of tax		
Unrealized income (loss) on available for sale securities and unrecognized post-retirement costs - net of income tax expense (benefit) of \$(208) and \$1,232, respectively	(303 )	1,847
Comprehensive (Loss) Income	\$(11,115 )	\$(2,592 )
Net (Loss) Income per common share		
Basic	\$(0.80 )	\$(0.33 )
Diluted	\$(0.80 )	\$(0.33 )
Weighted shares on which net (loss) income per common share were based		
Basic	13,531,832	13,531,832
Diluted	13,531,832	13,531,832

See notes to consolidated financial statements

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United Security Bancshares and Subsidiaries  
 Consolidated Statements of Changes in Shareholders' Equity  
 Years Ended December 31, 2011

(in thousands except shares)	Common stock Number of Shares	Amount	Retained Earnings	Accumulated	
				Other Comprehensive Income (Loss)	Total
Balance January 1, 2010	12,496,499	\$37,575	\$40,499	\$ (2,253 )	\$75,821
Net changes in unrealized gain on available for sale securities (net of income tax expense of \$1,340)				2,010	2,010
Net changes in unrecognized past service Costs of employee benefit plans (net of income tax benefit of \$108)				(163 )	(163 )
Common stock dividends	507,350	2,253	(2,253 )		0
Stock-based compensation expense		41			41
Net Loss			(4,439 )		(4,439 )
Balance December 31, 2010	13,003,849	39,869	33,807	(406 )	73,270
Net changes in unrealized gain on available for sale securities (net of income tax benefit of \$152)				(228 )	(228 )
Net changes in unrecognized past service Costs of employee benefit plans (net of income tax benefit of \$56)				(75 )	(75 )
Common stock dividends	527,983	1,548	(1,548 )		
Stock-based compensation expense		18			18
Net Loss			(10,812 )		(10,812 )
Balance December 31, 2011	13,531,832	41,435	21,447	(709 )	62,173

See notes to consolidated financial statements

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United Security Bancshares and Subsidiaries  
 Consolidated Statements of Cash Flows  
 Years Ended December 31, 2011 and 2010

(in thousands)	2011	2010
Cash Flows From Operating Activities:		
Net Loss	\$(10,812 )	\$(4,439 )
Adjustments to reconcile net(loss) income to cash provided by operating activities:		
Provision for credit losses	13,602	12,475
Depreciation and amortization	1,768	2,256
Accretion and amortization of investment securities	(524 )	(14 )
(Gain) loss on disposition of securities	(11 )	(68 )
Decrease (increase) in accrued interest receivable	206	345
(Decrease) Increase in accrued interest payable	(111 )	(153 )
Decrease in unearned fees	(76 )	(220 )
(Decrease) increase in income taxes payable	(2,168 )	(3,899 )
Stock-based compensation expense	18	41
Deferred income taxes	(2,398 )	(2,569 )
Increase in accounts payable and accrued liabilities	859	(13 )
Impairment loss on other investments	0	355
Loss on sale of other real estate owned	231	85
Impairment loss on securities (OTTI)	912	1,253
Impairment loss on goodwill	1,489	1,414
Gain on sale of loans	0	(509 )
Impairment loss on other real estate owned	3,856	2,831
Impairment loss on intangible assets	36	57
Gain on fair value option of financial assets	(1,619 )	(316 )
Income from life insurance proceeds	0	(174 )
Loss (gain) on sale of premises and equipment	0	11
Increase in surrender value of life insurance	(565 )	(554 )
Loss in limited partnership interest	418	424
Net decrease (increase) in other assets	656	984
Net cash provided by operating activities	5,767	